



SEC Comments and Trends

An analysis of current reporting issues

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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 applicable accounting standards, as well as disclosures the SEC staff believes could be enhanced or clarified. The ultimate 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. We also have seen frequent SEC staff comments on a topic influence the standard-setting agenda. That's how Accounting Standard Update No. 2010-26, *Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts*, came about.

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.

This year, the SEC staff has devoted significant resources to evaluating and enforcing compliance with current loss contingency disclosure requirements. The SEC staff has challenged both the sufficiency of disclosures, particularly those involving a reasonably possible range of loss, and a registrant's ability to estimate that range. The SEC staff has increased its attention on disclosures about liquidity, risk factors and results of operations for registrants with foreign operations. The SEC staff has been paying particular attention to registrants' disclosures when specific foreign operations

have a disproportionate effect on the financial statements relative to their size. The SEC staff has been questioning the tax effects of operating in foreign jurisdictions, including the effect on liquidity of permanently reinvesting foreign earnings. The SEC staff also has started asking registrants to provide more detailed disclosures about any exposure they may have to European sovereign debt.

The SEC staff is expanding its review of whether information disclosed in a registrant's SEC filings is consistent with other information available about a registrant (e.g., a registrant's earnings calls and websites). The SEC staff asks registrants to explain any perceived inconsistencies between information reviewed and may request expanded disclosure. For example, if the SEC staff perceives inconsistencies between the manner in which a registrant's business is described in its segment footnote and in public information beyond its filings, the SEC staff often asks for an explanation, and may request information provided to a registrant's Chief Operating Decision Maker, in order to evaluate the registrant's identification of operating segments. The SEC staff also has renewed its focus on non-GAAP financial measures, asking registrants to enhance disclosures in their press releases and filings to describe how a non-GAAP measure is useful to investors and challenging the appropriateness of presenting such a measure when a registrant is unable to demonstrate that it is useful.

The main section of *SEC Comments and Trends* discusses matters that relate to all registrants. Other sections highlight matters related to specific industries and foreign private issuers, as well as best practices for the SEC review process.

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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Management's discussion and analysis (MD&A)

Critical accounting estimates

Summary of issues noted

The SEC staff continues to request further disclosure about critical accounting estimates that are subject to significant judgment. In particular, the SEC staff believes that MD&A should make investors aware of the quality and variability of assumptions, as well as the related methodologies, underlying key accounting estimates.

Analysis of current issues

Critical accounting estimates are defined as those 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 should not merely repeat disclosure already included in the notes to the financial statements. 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 when:

- ▶ The nature of the estimates or assumptions is material due to the levels of subjectivity and judgment necessary 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 uncertainties involved in making the accounting estimate as of the financial reporting date and the variability that is reasonably likely to result 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

These disclosures should supplement the summary of significant accounting policies in the notes to the financial statements by focusing on those areas that are subject to significant judgment and 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 present management's insights 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 matters that are highly uncertain, the SEC believes that registrants should consider analyzing their specific sensitivity to change based on other outcomes that are reasonably likely to occur and 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 would provide material information.

The SEC staff frequently requests enhancements to the MD&A discussion of the critical accounting estimates that are discussed separately in this publication (e.g., loss contingencies, allowance for doubtful accounts).

Resources

2010 SEC annual reports: Report to shareholders Form 10-K (SCORE No. CC0305), Ernst & Young, 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 with a focus on the sources and uses of cash and the availability of cash to fund liquidity needs. This year, the SEC staff has focused attention on the implications of liquid assets held by foreign subsidiaries whose earnings have been assumed to be indefinitely reinvested for tax purposes.

Further, as the uncertain economic environment and weak operating results in certain sectors continue to present operating and financing challenges for many registrants, affecting their ability to comply with financial covenants, the SEC staff often requests that registrants provide 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, as well as the uses of such assets. The registrant should consider disclosing the amounts outstanding and available at the balance sheet date under each source of liquidity. These disclosures also should highlight cash needs over the next 12 months, including any significant planned capital expenditures and whether these expenditures are necessary or discretionary.

- ▶ A discussion of the sufficiency of the amount available under any 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. When the filing specifies minimum financial ratios that the registrant is reasonably likely of failing, the SEC staff has requested that the registrant also disclose its calculated ratio for the latest compliance dates or periods.
- ▶ A discussion and analysis of cash flows that addresses material changes in the underlying drivers of cash flows 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 continued to request that registrants enhance disclosures about significant liquidity ratios and explain significant fluctuations therein.

Foreign earnings

The SEC staff recently has begun requesting 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, 2010, \$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 would then be asked to discuss the income tax implications of repatriation and the effects of repatriation on liquidity. This can be an important disclosure 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 without tax implications.

Registrants are being asked to discuss the income tax implications of repatriation and its effect on liquidity.

Registrants also should consider the SEC staff comments issued about results of operations and risk factors related to foreign operations. For further discussion, refer to the Results of operations and Risk factors sections of this publication.

Debt covenant compliance

With a significant amount of US corporate debt maturing in the next two to three years, many non-investment grade companies may face difficulty refinancing current debt and complying with their ongoing 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. Accordingly, registrants whose risk of noncompliance with debt covenants is more than remote may be requested to expand their related disclosures. The SEC staff focuses on providing financial statement users with 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 impact on the registrant's liquidity, to the extent 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.

Contractual obligations

MD&A rules require 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. As a result of releasing FR-83, the SEC staff has focused less on requiring that specific items be included in the table and more on the overall presentation and disclosures, including off-balance sheet items.

Resources

2010 SEC annual reports: Report to shareholders Form 10-K (SCORE No. CC0305), Ernst & Young, 2011.

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

Non-GAAP financial measures

The SEC staff objects to the presentation of a full non-GAAP income statement as doing so may provide undue prominence to the measure.

Summary of issues noted

The SEC staff frequently requests that registrants provide additional disclosures or modify disclosures when presenting non-GAAP financial measures. The comments recently issued on non-GAAP financial measures focus on the following issues:

- ▶ Inconsistencies between non-GAAP disclosures in SEC filings and those in other public communications
- ▶ Presentations that give greater prominence to non-GAAP financial measures than GAAP measures
- ▶ 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

Analysis of current issues

After the SEC staff issued Compliance and Disclosure Interpretations in January 2010 that made it easier for a registrant to include non-GAAP financial measures in its 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.

In certain cases, the SEC staff also asks why a registrant chose not to disclose a non-GAAP financial measure in its SEC filings that it publicly disclosed elsewhere. While the SEC does not require that any non-GAAP measure a registrant reports publicly also be included in its SEC filings, the SEC staff does monitor the disclosure of non-GAAP financial measures outside a registrant's SEC filings (e.g., by listening to analyst calls, reviewing the registrant's website and reading press releases) to identify inconsistencies with the registrant's SEC filings. In these situations, the SEC staff wants to ensure that registrants are communicating a consistent analysis of key business drivers and key performance indicators in their SEC filings and other public communications.

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. We have seen a significant focus on situations in which the SEC staff believes that registrants have given undue prominence to non-GAAP information either in an SEC filing or a press release. 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. 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 when the length of the discussion of non-GAAP measures significantly exceeds the length of the discussion of the corresponding 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 often tend to be boilerplate or are 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 request that the disclosure 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 describe an adjusted measure using terms that would imply it is an unadjusted measure. For example, a measure that includes adjustments to the standard definition of EBITDA should not be labeled "EBITDA."
- ▶ Non-GAAP financial measures should be presented net of tax, if appropriate. If it presents non-GAAP measures net of tax, a registrant should disclose how it calculated the tax effects when reconciling the non-GAAP financial measures to the most directly comparable GAAP measures. The SEC staff may question items that were not presented net of tax or when the tax effects of a particular measure were not transparent from the reconciliation. For example, registrants often inappropriately present net income before stock compensation expense without also reflecting the tax effect.
- ▶ 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.

Resources

2010 SEC annual reports: Report to shareholders Form 10-K (SCORE No. CC0305), Ernst & Young, 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 factors that have affected their earnings and that are reasonably likely to have a material effect on future earnings. This year, the SEC staff has increased its attention on registrants with foreign operations, particularly in countries subject to political or financial risk or other uncertainties.

Analysis of current issues

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

- ▶ 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 may affect a 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 (e.g., 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 (e.g., the effect of uncertainties created by the debt crisis in Europe)
- ▶ Discuss the extent to which material increases in net sales or revenue are due to increased sales volume, introduction of new products or services or increased sales prices. If possible, the SEC staff expects registrants to quantify each factor's effect on net sales.
- ▶ In addition to the discussion of the registrant as a whole, discuss any relevant segment information necessary to understand the registrant's results of operations, including the effect the performance of a particular product line may have had on those results

In December 2003, the SEC issued Financial Release No. 72, *Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations* (FR-72), which 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 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.

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. Registrants should clearly identify which performance indicators management considers to be key. They also should describe the underlying drivers of each key performance indicator they identify and the significant effects those drivers could have on the results of operations.

Foreign operations

The SEC staff has increased its attention on 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 has been paying particular attention to registrants' disclosures when their foreign operations have a disproportionate effect on the financial statements relative to their size (e.g., registrants with relatively small Venezuelan operations, if 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. For example, the SEC staff has asked registrants with Venezuelan operations to disclose the related business and financial risks, as well as cash flow effects. Such disclosures might include discussions of the effect of pricing controls, any related changes in business practices or policies, and the risks of further currency devaluation on revenues and profits. Disaggregated financial information about the monetary assets and liabilities exposed to exchange rate changes and the sensitivity of the registrants' sales and cost of sales to future currency changes has also been sought.

In addition, specific to registrants with operations in Venezuela, the SEC staff may ask registrants to disclose the specific amount of Bolivar-denominated monetary assets and liabilities as of each balance sheet date and to provide a break-out of the amounts along with the exchange rate at which such amounts are being remeasured into US dollars (i.e., the functional currency). Registrants are requested to provide such information at a reasonably detailed level (e.g., disclose amounts for cash and accounts receivable). Registrants also may be requested to disclose the amount of sales and cost of sales for the Venezuelan operations and to separately disclose the amounts denominated in Bolivar fuerte and US dollars. Given the currency devaluations, some registrants may expect to receive diminished dividends from their Venezuelan operations in the future. Under such circumstances, the SEC staff asks a registrant to disclose whether there were any events or circumstances that caused the registrant to evaluate its investment in the Venezuelan operations for impairment. If so, the registrant is requested to disclose those events and

circumstances, the result of its impairment assessment including any significant assumptions, the extent to which it believes future impairments are likely and what developments or changes in assumptions are likely to cause such impairments.

Registrants also should clearly disclose any significant effect on income from continuing operations related to significant events that cause uncertainty in a registrant's foreign operations, such as the natural disaster in Japan this year. To the extent material, registrants should consider providing summarized financial information (i.e., balance sheet and income statement) for any subsidiaries for which the effects of the natural disaster or other significant event are material to the consolidated operations or are reasonably expected to materially affect the registrant in future periods. In considering materiality, registrants should be mindful of situations in which the quantitative effect might be disproportionate to the historical significance of the foreign operations to the consolidated entity.

Registrants also should provide forward-looking information considering any material trends and uncertainties resulting from the natural disaster in Japan or other significant events on a registrant's liquidity and capital resources and results of operations. As an example, these disclosures might include a discussion of any risk of impairment or other charges to the extent not yet recognized. They also might include disclosure of any expected changes in business practices that will affect operations and liquidity, including when the relationship between costs and revenues could be materially affected.

Registrants also should consider the SEC staff comments issued about liquidity and risk factors related to foreign operations. For further discussion, refer to the Liquidity and capital resources and Risk factor sections of this publication.

Resources

2010 SEC annual reports: Report to shareholders Form 10-K (SCORE No. CC0305), Ernst & Young, 2011.

Technical Line: Accounting for the effects of natural disasters – Japan (SCORE No. BB2105), Ernst & Young, 29 March 2011.

SEC reporting issues

Board structure and nominee criteria

Summary of issues noted

As a result of the SEC's proxy disclosure enhancements issued in December 2009, the SEC staff has focused on disclosures about how a registrant considered diversity and other qualifications in board nominations and why its leadership structure is most appropriate.

Analysis of current issues

As required by Item 407(c) of Regulation S-K, the SEC staff often 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.

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

2011 proxy statements: An overview of the requirements (SCORE No. CC0306), Ernst & Young, 2011.

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

Executive compensation disclosures

Summary of issues noted

The SEC staff focuses its reviews on registrants' Compensation Discussion & Analysis in an effort to promote more direct, specific and clear disclosures.

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 requests that registrants specifically disclose peer companies that were used for the purpose of 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 amounts paid to 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 with respect to named executive officers. The SEC staff routinely requests that registrants provide the detail of individual and corporate performance criteria and targets, both quantitative and qualitative, for each named executive. If the disclosure of 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 these undisclosed targets.

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 402(s) disclosures explain the basis for the conclusion that disclosure is not necessary and describe the process they used to reach that conclusion.

Resources

2011 proxy statements: An overview of the requirements (SCORE No. CC0306), Ernst & Young, 2011.

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

Internal control over financial reporting and disclosure controls and procedures

Summary of issues noted

The SEC staff questions the nature and timely identification of material weaknesses as well as the omission of disclosures about changes in internal control over financial reporting (ICFR) when a material weakness is either identified or remediated. The SEC staff also questions 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 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 additional 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 and therefore is not yet able to identify related ICFR changes, the disclosures should identify when the acquired entity will be included in the scope of the registrant's Item 308(c) disclosures.

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

2010 SEC annual reports: Report to shareholders Form 10-K (SCORE No. CC0305), Ernst & Young, 2011.

Materiality

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 such factor is included in the SAB Topic 1-M examples.

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 determination and instead develop a qualitative and quantitative analysis that is specific to the registrant's facts and circumstances. Such an analysis should include a consideration of the effects of errors on key performance indicators that may be important to investors even if they are non-GAAP measures.

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 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 describing 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 defined 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.

Resources

2011 proxy statements: An overview of the requirements (SCORE No. CC0306), Ernst & Young, 2011.

Risk factors

Risk factors should be specific to the registrant's facts and circumstances, not merely general risks that could apply to any registrant.

Summary of issues noted

The SEC staff continues to comment about the specificity and completeness of registrants' risk factor disclosures. Recently, the SEC staff has focused on risks associated with cyber security 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 a statement of how each of the risks affects it. 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.

Cyber security has become an area of increasing concern. 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 cyber security will depend on the facts and circumstances of the registrant, the probability of the risk occurring and the risk's magnitude. SEC Chairman Schapiro addressed cyber security disclosures in a response¹ to members of the Senate Commerce Committee highlighting that the SEC would consider the sufficiency of disclosures in this area.

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. The SEC staff requests that registrants provide more detailed disclosures about the current and potential effect of those risks and uncertainties (e.g., impairment of holdings of Greek sovereign bonds).

Further, the SEC staff questions registrants that have key customers or suppliers located in foreign countries subject to similar risks. For example, a registrant with a key supplier or customer located in Japan may be required to include MD&A and risk factor disclosures related to the natural disaster in Japan this year if there has been a material effect on results of operations or it is reasonably likely there could be a material effect on future results or liquidity.

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 Results of operations sections of this publication.

Resources

2010 SEC annual reports: Report to shareholders Form 10-K (SCORE No. CC0305), Ernst & Young, 2011.

¹ SEC Chairman Schapiro's response can be found at: http://commerce.senate.gov/public/?a=Files.Serve&File_id=abb71f29-9439-45e8-a366-b9d95d8027de

Other SEC reporting issues

Summary of issues noted

The SEC staff often questions the completeness and compliance of the electronic document 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 recently noted a number of instances in which the conformed signature of the accounting firm did not appear on the annual "Report of Independent Registered Public Accounting Firm" filed on EDGAR. These deficiencies often require amendment of the registrant's annual report.

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 from the Division of Risk, Strategy, and Financial Innovation performs select reviews of interactive data submissions and has noted several significant and recurring errors². Registrants should focus on avoiding these errors in their next interactive data submission.

Resources

2010 SEC annual reports: Report to shareholders Form 10-K (SCORE No. CC0305), Ernst & Young, 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.

² The SEC staff observations are included in its third edition of *Staff Observations from Review of Interactive Data Financial Statements*, and can be found at <http://www.sec.gov/spotlight/xbrl/staff-review-observations-061511.shtml>.

Financial statement presentation

Income statement presentation *Rule 5-03(b)*

Summary of issues noted

The SEC staff frequently comments on the income statement presentation of revenues and related costs of revenues. Rule 5-03(b) of Regulation S-X requires that the statement of operations present sales and revenues, and costs of sales and revenues, by specific categories (e.g., products and services).

Analysis of current issues

The SEC staff often asks registrants to explain their consideration of Rule 5-03(b) when they discuss the sale of tangible products and services elsewhere in the filing, such as significant accounting policies or MD&A, but do not separately present revenues from goods and services in the statement of operations. Many registrants derive revenues from the sale of different categories of products and services. In these cases, the SEC staff expects registrants to separately present revenues by category if such presentation would provide meaningful information to the users of the financial statements, particularly if the gross margins of the various categories of transactions differ significantly.

The SEC staff also questions the methodology used to allocate revenues and related costs of revenue between products and services when they are bundled or provided in multiple-element arrangements. In these cases, revenue should be allocated between products and services for income statement presentation according to the applicable revenue recognition guidance, such as ASC 605-25 or 985-605. Generally, this means that registrants should use relative selling prices as the basis for allocating revenues between products and services. If the deliverables in a multiple-element arrangement are combined for revenue recognition purposes, a registrant should develop an appropriate separation method for income statement presentation purposes. This method should be based on the specific facts and circumstances of the arrangement, including consideration of the presentation that would be most meaningful to investors.

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 include 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 pursuant to ASC 235. Shipping costs are costs incurred to physically move products from the seller's place of business to the buyer's designated location. Handling costs are costs 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 allocate the appropriate amount of depreciation and amortization expense to cost of sales or revise the description of the gross profit line item to make it clear that cost of sales excludes depreciation and amortization expense in accordance with SAB Topic 11-B.

Statement of cash flows classification and presentation

When classification of an item is not clear, registrants should analyze the nature of the activity and the predominant source of related cash flows.

Summary of issues noted

The SEC staff asks registrants to explain the basis for the statement of cash flows classification of certain items, to revise future filings when their reconciliation of net cash flows from operating activities begins with a financial metric other than net income and to explain why certain cash flows are reported on a net basis rather than a gross basis in accordance with ASC 230.

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 a registrant 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 expects registrants to analyze the nature of the activity and the predominant source of the related cash flows. 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 the reconciliation to net cash flows from operating activities with net income. 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 other amount that is not net income.

The SEC staff also asks registrants to explain why certain cash flows are reported on a net basis rather than a gross basis in accordance with ASC 230 or to revise the presentation. In general, gross presentation is required. However, there are limited exceptions for which gross reporting is not required, such as for the cash receipts and cash disbursements associated with:

- ▶ Revolving lines of credit that are repayable on demand or that are subject to a note with a maturity of three months or less
- ▶ Commercial letters of credit
- ▶ Fee-based financial services (e.g., cash receipts and disbursements associated with servicing mortgage loans owned by others)

Resources

Financial reporting developments: Statement of cash flows – Accounting Standards Codification 230 (SCORE No. 42856), Ernst & Young, July 2010.

Accounts receivable

Allowance for doubtful accounts disclosures

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. Further, they 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. In cases where registrants have indicated the allowance is based on historical experience, the SEC staff asks registrants to describe how current conditions are factored into the analysis and whether reserves are recognized for specific accounts determined to be uncollectible.

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 number of customers caused the changes and what steps management has taken to collect outstanding balances.

Business combinations

Business combinations disclosures

Registrants still do not fully comply with the disclosure requirements of ASC 805.

Summary of issues noted

The SEC staff frequently requests that registrants enhance their existing business combinations disclosures to include all the information required by ASC 805-10-50, 20-50 and 30-50. Specifically, many SEC staff comments request that registrants provide or update the pro forma information required by ASC 805-10-50-2(h). In addition, when an acquisition includes a contingent consideration arrangement, the SEC staff often challenges the adequacy of the disclosures regarding the arrangement.

Analysis of current issues

General disclosures

The disclosures in ASC 805 are intended to satisfy certain disclosure objectives 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 required by ASC 805-10-50, 20-50 and 30-50. The SEC staff also often 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 calculation to support the registrant's assertion that the acquisition is not material.

The SEC staff may request that registrants disclose additional information to meet the objectives listed above. The SEC staff also frequently challenges whether additional intangible assets should have been recognized in a business combination. For further discussion, please refer to the Intangible assets section of this publication.

Contingent consideration arrangements

The SEC staff frequently asks registrants to provide more robust descriptions of any contingent consideration arrangements and their basis for determining the amount of the payments. The SEC staff often asks registrants to disclose how they account for and determine the fair value of contingent payments to former owners as of the acquisition date and in subsequent periods (including whether payments represent compensation or consideration). Consistent with ASC 805-30-50-1(c), the SEC staff also requests that registrants disclose in future filings an estimate of the range of outcomes (undiscounted) or, if a range cannot be estimated, that fact and the reasons why a range cannot be estimated. If the maximum amount of the payment is unlimited, a registrant also should disclose that fact.

Resources

Financial reporting developments: Business combinations – Accounting Standards Codification 805 (SCORE No. BB1616), Ernst & Young, September 2011.

Contingencies

Accounting for and disclosure of loss contingencies

Summary of issues noted

When the Financial Accounting Standards Board (FASB) delayed its loss contingency disclosure project in late 2010, the SEC staff said it would renew its focus on enforcing compliance with existing loss contingency disclosure requirements. This has led to a significant increase in comments to registrants as the SEC staff seeks to assess, as well as enforce, registrants' compliance with existing disclosure requirements.

Analysis of current issues

The SEC staff has challenged registrants for failing to make required footnote disclosures when loss contingencies are considered reasonably possible of occurring or for failing to disclose the range of reasonably possible losses, including when there was 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 loss, or, if applicable, a statement that the amount of a loss cannot be estimated. The SEC staff requests that a registrant's disclosures be 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, that an estimate cannot be made or that the estimated additional loss or range of loss is not material).

The SEC staff has generally 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 basis³
- ▶ The amount or range of reasonably possible losses in certain cases and a statement that the registrant cannot estimate an amount for other cases

As expected, following comments at the 2010 American Institute of Certified Professional Accountants (AICPA) National Conference, 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 an estimate cannot be made, the SEC staff expects the conclusion to be supported by a sufficient process. The SEC staff also expects management to evaluate loss contingency disclosures (or lack thereof) each reporting period and expects that the disclosures will evolve to include more quantitative information as the loss contingency progresses. More specifically, in situations in which a registrant is unable to estimate losses that are reasonably possible, the SEC staff asks for specific and comprehensive discussion about why the registrant cannot make an estimate and what procedures the registrant has in place to attempt to determine such an estimate on a quarterly basis. Registrants should not be surprised if the SEC staff continues to issue comments on the same matter in subsequent annual and quarterly periods.

The SEC staff may ask a registrant about the internal control process it used in evaluating an estimate of reasonably possible losses and the sufficiency of the related disclosures.

³ While it is acceptable to aggregate the amount or range of 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).

Because US GAAP does not require a level of “certainty” or “confidence” when estimating the range of loss, the SEC staff will challenge disclosures that imply a need for precision in estimating the loss or range of loss. Further, registrants can expect the SEC staff to challenge the adequacy of historical disclosures when loss contingencies are settled. In particular, the SEC staff may review prior-period disclosures and make inquiries to determine whether disclosures were appropriate in the past and whether an accrual was recognized in the appropriate 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 policy in future filings.

Resources

To the Point: Loss contingency disclosure (SCORE No. BB2074), Ernst & Young, 5 January 2011.

Compendium of significant accounting and reporting issues: 2010 AICPA National Conference on Current SEC and PCAOB Developments (SCORE No. CC0313), Ernst & Young, 13 December 2010.

Debt

Modifications, exchanges or extinguishments

Registrants should be prepared to provide the SEC staff with detailed analyses and calculations to support their accounting conclusions when a transaction represents a debt exchange or modification.

Summary of issues noted

Registrants continue to 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 asking registrants to provide detailed analyses and related calculations to support their conclusions.

Analysis of current issues

The accounting differs significantly depending on whether the transaction is a troubled debt restructuring, extinguishment or modification. 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. For example, in the last year the SEC staff has requested further explanation of the following:

- ▶ Inclusion or exclusion of certain fees (e.g., fees paid to lenders and fees paid to third parties) in the 10% cash flow test
- ▶ 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 (formerly FSP APB 14-1)
- ▶ Determination of the effective interest rate used in the quantitative tests
- ▶ Accounting treatment of transaction fees subsequent to the determination of modification versus extinguishment accounting
- ▶ How the calculation of gain/loss on extinguishment was affected by the issuance of other instruments (e.g., preferred stock and successor common stock) in connection with the restructuring
- ▶ Details about the write-off of debt discounts and why it was appropriate to write off amounts

Fair value measurements

Accounting and disclosures

Summary of issues noted

The SEC staff focuses on fair value measurements and the required disclosures in ASC 820. The SEC staff inquires about registrants' processes for evaluating broker quotes and third-party pricing information, classifications in the fair value hierarchy and the amount of information disclosed about valuation techniques and inputs. Other areas of focus include registrants' procedures for weighting different indications of value when multiple valuation techniques are used and fair value disclosures of cash equivalents.

Analysis of current issues

Fair value hierarchy classification

The SEC staff continues to ask numerous questions about where assets and liabilities are classified in the fair value hierarchy, often requesting that registrants provide their rationale for classification in a particular level of the hierarchy. It is not uncommon for the SEC staff to challenge classifications it considers inappropriate. For example, the SEC staff remains skeptical about classifications of warrants and other derivative instruments as Level 2 (rather than Level 3) when they are valued based on historical volatility.

Use of broker quotes and pricing service data

Broker quotes and third-party pricing information continue to be an area of inquiry for the SEC staff. The SEC staff requests that registrants provide additional disclosures when broker quotes or pricing service data are used to determine fair value. These additional disclosures include:

- ▶ The extent to which the quotes or prices were used by the registrant in estimating fair value, and whether any adjustments were made to those quotes or prices
- ▶ The number of quotes or prices obtained and how fair value was ultimately determined when multiple quotes were received
- ▶ The extent to which the quotes were based on observable market data or unobservable inputs
- ▶ Whether the broker quotes were binding or nonbinding

The SEC staff remains interested in understanding how registrants validate third-party pricing information to determine proper classification in the fair value hierarchy. The SEC staff frequently asks about registrants' policies for assessing the "significance" of any adjustments applied to broker quotes or pricing service data and how such adjustments affected the hierarchy classification.

Valuation methods and inputs

The SEC staff continues to request additional disclosure about the valuation techniques and inputs registrants use to determine fair value. The SEC staff questions registrants about their compliance with the requirements in ASU 2010-06 to disclose information about the inputs used to estimate the fair value of assets and liabilities classified in Levels 2 and 3 of the hierarchy.

The SEC staff frequently asks about a registrant's process for evaluating broker quotes and third-party pricing information, classifications in the fair value hierarchy and disclosures about valuation techniques and inputs.

The SEC staff's inquiries are not limited to disclosures, but cover measurement as well. The SEC staff asks about particular valuation techniques or inputs used by registrants covering a wide variety of assets and liabilities ranging from complex financial instruments to real estate, intangible assets and goodwill impairments.

The SEC staff also focuses on fair value measurements determined using multiple valuation techniques. In some cases, when registrants use multiple approaches, the SEC staff challenges reliance on the results of one valuation approach over another. In other instances, the SEC staff questions how registrants weighted the value indications that resulted from different valuation techniques. For example, the SEC staff may challenge a fair value estimated by applying equal weight (or a simple average) to two valuation methods that produced materially different results.

The SEC staff also takes exception when registrants either ignore or adjust the quoted price when measuring the fair value of securities traded in an active market (i.e., a Level 1 measurement).

Other disclosures

The SEC staff challenged fair value disclosures about cash equivalents this year. In numerous instances, the SEC staff asked for further detail about the composition of cash equivalents and how the fair value disclosures (including hierarchy classification) were considered for the various instruments.

Level 3 disclosures continue to be an area of significant inquiry for the SEC staff. In addition to asking about the inputs used in these measurements, the SEC staff also asks questions about the Level 3 rollforward. For example, the SEC staff may question why certain amounts are presented as settlements instead of losses in a Level 3 rollforward.

The SEC staff also remains interested in registrants' disclosures about nonrecurring fair value measurements pertaining to the impairment of a wide range of assets (e.g., goodwill, fixed assets and intangible assets). For these items, the SEC staff emphasizes the requirement to provide disclosures by class of assets and liabilities for each annual period for which a statement of financial position is presented, and to show quantitative disclosures in a table as required by ASC 820-10-50-8.

Resources

Financial reporting developments: Fair value measurements and disclosures – Accounting Standards Codification Topic No. 820 (SCORE No. BB1462), Ernst & Young, June 2010.

Financial instruments

Redeemable noncontrolling interests and redeemable equity instruments

Summary of issues noted

The SEC staff frequently issues comments relating to the accounting for “redeemable noncontrolling interests” and “redeemable equity instruments.” 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

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 (that is, 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 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: Noncontrolling interests in consolidated financial statements (SCORE No. BB1577), Ernst & Young, July 2011.

Financial reporting developments: Accounting for derivative instruments and hedging activities (SCORE No. BB0977), Ernst & Young, November 2010.

Warrants and embedded conversion features

The SEC staff has recently focused on how a registrant analyzed a specific feature or provision of a convertible instrument or equity derivative under the relevant accounting guidance.

Summary of issues noted

The SEC staff often focuses on the classification and measurement of convertible instruments and other equity derivatives that may be settled in a registrant's own stock.

Analysis of current issues

The SEC staff stresses the need for 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 continues to emphasize 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 in general whenever convertible instruments or equity derivatives were issued. While it continues to ask these questions, the recent trend in the SEC staff's comments has been toward more focused questions related to 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.

The analysis of an equity-related derivative or convertible instrument requires the consideration of guidance in ASC 470-20, ASC 480, and ASC 815-40. The SEC staff often detects issues related to the following:

- ▶ 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 (for example, net-share settlement versus net-cash settlement) and who controls the choice of settlement form under ISDA Agreements⁴ 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
- ▶ 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 pursuant to ASC 470-20
- ▶ Beneficial conversion features under the relevant guidance in ASC 470-20
- ▶ Puttable warrants and other similar instruments settleable in redeemable shares under ASC 480-10-25-8 through 25-13 and ASC 480-10-55-33

⁴ International Swaps and Derivatives Association (ISDA) Master Agreements and ISDA Definitions (collectively the "ISDA Agreements")

Specifically, in comment letters, the SEC staff focuses 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 that are intended to protect the holder from declines in the stock price (i.e., the "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 in accordance with ASC 815-40-35-12 and 35-13 in partially reclassifying an instrument from equity to a liability either at the initial assessment or subsequent assessment of the classification of the instrument
- ▶ 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 and has requested explanations of why other models (e.g., binomial or lattice model) were not used. This is likely because of the limited assumptions in the Black-Scholes model and the actual contractual terms of the instruments. 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: Accounting for derivative instruments and hedging activities (SCORE No. BB0977), Ernst & Young, November 2010.

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: EITF Issue No. 07-5, "Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock" (SCORE No. BB1662), Ernst & Young, 19 December 2008.

Technical Line: Implementation issues related to FASB Staff Position APB 14-1 (SCORE No. BB1623), Ernst & Young, 12 November 2008.

Goodwill

Impairment analysis and disclosures

Weak economic conditions continue to affect the assessment of recoverability and the timing of goodwill impairment.

Summary of issues noted

The SEC staff frequently challenges disclosures about reporting units that may be at risk of goodwill impairment, requests supplemental information about the registrant's impairment testing policy and asks that the registrant disclose the current and future implications of a goodwill impairment to its business.

Analysis of current issues

Weak economic conditions continue to affect the assessment of recoverability and the timing of goodwill impairments. It is likely the SEC staff will continue to focus on this area until there is a significant improvement in economic conditions.

Goodwill impairment risks

The SEC staff continues to frequently request that registrants discuss the possible future impairment of goodwill for any reporting unit with an estimated fair value that is not substantially in excess of its carrying value (i.e., the reporting unit is at potential risk of failing a future Step 1 impairment test under ASC 350), particularly when the registrant's operating results (or that of the relevant segment) have declined significantly. The SEC staff requests that registrants disclose in MD&A the following for each reporting unit determined to be at risk:

- ▶ The amount of goodwill allocated to the reporting unit
- ▶ The percentage by which the fair value of each reporting unit exceeds its carrying amount at the date of the last impairment test
- ▶ A qualitative discussion of key assumptions that drive the fair value of the reporting unit (i.e., the SEC staff encourages, but does not require, disclosure of the key numerical assumptions or a quantitative sensitivity analysis)
- ▶ Uncertainties surrounding key assumptions
- ▶ Events and (or) circumstances that could have a negative effect on the fair value of the reporting unit

While no bright lines exist to determine whether a reporting unit's goodwill is considered "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, it should disclose that fact.

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 (for further discussion, please refer to the Segment reporting section of this publication)

- ▶ 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
- ▶ Details of the registrant's analysis of events that occurred since the latest annual goodwill impairment assessment and whether those events are indicators of impairment necessitating an interim goodwill impairment assessment
- ▶ The reconciliation of the aggregate fair values of the reporting units to the registrant's market capitalization
- ▶ The type of events that could result in a future goodwill impairment

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

Disclosure of accounting policies

The SEC staff often asks registrants to provide more robust disclosures of accounting policies 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, 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" (i.e., there is a reasonable possibility that the reporting unit might fail a future Step 1 impairment test)

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.

Resources

Financial reporting developments: Intangibles – Goodwill and other – Accounting Standards Codification 350 (SCORE No. BB1499), Ernst & Young, November 2009.

Impairment of long-lived assets

Assets held and used

Summary of issues noted

The SEC staff focuses on company-specific impairment indicators and asks whether impairment indicators were present to cause the registrant to evaluate long-lived assets for impairment. The SEC staff also continues to ask 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

Entities 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 (ASC 360-10-35-15 through 35-36). Entities 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 have trended downward as identified in the registrant's filing or other public information. For example, the SEC may question whether an impairment indicator exists when a registrant's stock price decreases (particularly when market capitalization falls below the carrying amount of the entity), its revenue declines, it loses a major customer or contract or it has operating losses or idle facilities or equipment. When any of these factors are present and the registrant did not record an impairment charge, the SEC staff often asks whether the economic factors were considered 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 economic factors were not indicators of impairment.

When the registrant determined that an impairment indicator was present and performed the recoverability test but did 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 did not significantly exceed the carrying value of the assets, the SEC staff requests that the registrant 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 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 question a registrant about whether it considered negative economic factors identified in the registrant's filings or other public information to be indicators of impairment.

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 term⁵ 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, December 2009.

⁵ 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

Deferred tax assets – Realizability

Summary of issues noted

The SEC staff frequently asks registrants to provide further information and enhanced disclosures about:

- ▶ 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 exists suggesting it might be necessary or positive evidence exists suggesting 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.

Analysis of current issues

The SEC staff continues to question 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 recognized a significant loss in the current year. Registrants should carefully assess the realizability of their deferred tax assets and make transparent and requisite disclosures in their financial statements and MD&A about a deferred tax asset's recoverability.

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 in 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.

Recent cumulative losses constitute significant negative evidence. At a minimum, positive evidence of equal or greater significance is needed to overcome that negative evidence before a tax benefit is recognized for deductible temporary differences and loss carryforwards based on a projection of future taxable income. Expectations about future taxable income would rarely be sufficient to overcome the negative evidence of recent cumulative losses, even if supported by detailed forecasts and projections. To estimate future taxable income in such cases, a registrant often would have to predict a turnaround or other change in circumstances, which typically cannot be objectively verified as required by ASC 740. Conversely, taxable income available in carryback years (which generally would be limited in circumstances where pretax losses were incurred for the last few years), reversals of existing taxable temporary differences, and qualifying tax planning strategies can provide positive evidence in these cases.

In addition, when assessing the realizability of deferred tax assets, registrants should keep in mind that the assumptions and projections used to analyze the realizability of assets under US GAAP generally should not change based on the nature of the asset being analyzed. That is, registrants should not have one set of projections for evaluating the need for a valuation allowance on deferred tax assets and another set of projections for evaluating impairment of long-lived assets (e.g., property, plant and equipment, goodwill and other intangible assets). Noteworthy, however, is that ASC 740 may be more restrictive than other standards about when it is appropriate to rely on projections of future taxable income. ASC 740 requires the weight of all available evidence (both positive and negative) to be considered when evaluating the realizability of deferred tax assets. That means that while a registrant's projections may not have changed, negative evidence still may be substantive enough that projections cannot be relied on as a source of future taxable income. 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.

Evaluating the realizability of deferred tax assets requires judgment and use of estimates and assumptions. Registrants should keep in mind that disclosure is required in financial statements when known information available prior to issuance of the financial statements indicates that both (1) it is at least reasonably possible that the estimate of the effect on the financial statements of a condition, situation or set of circumstances that existed at the date of the financial statements will change in the near term due to one or more future confirming events and (2) the effect of the change would be material.

Registrants should consider the completeness of their MD&A disclosure, which should include the following:

- ▶ A discussion of the basis on which management determined that it was more likely than not the deferred tax asset would be realized
- ▶ Disclosure of the types of uncertainties that might affect the ultimate realization of deferred tax assets
- ▶ If the implementation of tax planning strategies is the basis for not recognizing a valuation allowance for all or some portion of the deferred tax asset, the uncertainties that might affect the realization of deferred tax assets, as well as the factors that led management to conclude that it was more likely than not the deferred tax asset would be realized
- ▶ If a material net deferred tax asset's realization depends on improvements over present levels of consolidated pretax income, changes in the present relationship between income reported for financial and tax purposes, or asset sales or other non-routine transactions, a description of these assumed future events, quantified to the extent practicable
- ▶ The amount of future taxable income required to realize the deferred tax assets
- ▶ If significant objective negative evidence indicates uncertainty regarding realization of the deferred asset, the countervailing positive evidence relied on by management in its decision not to establish a full allowance against the asset

- ▶ The effect of a future change in valuation allowance on the entity's compliance with debt covenants and related liquidity issues

In addition, the projections used in the deferred tax asset realization analysis required by US GAAP should be consistent with forward-looking information in MD&A and other sections of filings that contain audited financial statements.

Resources

Financial reporting developments: Accounting for income taxes (SCORE No. BB1150), Ernst & Young, December 2009.

Foreign earnings

The SEC staff may request quantified disclosure when a disproportionate amount of profit is attributable to countries with a low tax rate.

Summary of issues noted

The SEC staff has recently expressed 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 questions whether registrants that label a reconciling item as the difference between the foreign tax rate and the domestic tax rate 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 such that the effect of the low tax rate is presented separately from other items.

Further, if a disproportionate amount of a registrant's profit is attributable to countries with a low tax rate, 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 believes 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 (loss) and income tax expense (benefit) generated from domestic and foreign sources.

Resources

Compendium of significant accounting and reporting issues: 2010 AICPA National Conference on Current SEC and PCAOB Developments (SCORE No. CC0313), Ernst & Young, 13 December 2010.

Intraperiod tax allocation

Summary of issues noted

The SEC staff frequently questions registrants about the application of intraperiod tax allocation provisions of ASC 740 when they have reported losses from continuing operations and income from another source (e.g., discontinued operations, other comprehensive income, extraordinary items).

Analysis of current issues

ASC 740-20-45-7 requires that the tax effect of pretax income from continuing operations be determined without regard to the tax effects of items not included in continuing operations. This is commonly referred to as the “incremental approach.” There is, however, an exception to the general principle of intraperiod tax allocation.

This exception applies in all situations in which there is a loss from continuing operations and income from another item(s) outside of continuing operations. This would include situations when a registrant has recorded a full valuation allowance at the beginning and end of the period and the overall tax provision for the year is zero (i.e., a benefit would be recognized in continuing operations even though the loss from continuing operations does not provide a current-year incremental tax benefit). The exception relates only to the allocation of the current-year tax provision (which may be zero) and does not change a registrant’s overall tax provision. That is, intraperiod tax allocation, including the application of the exception, is performed once the overall tax provision has been computed and simply allocates that provision to various income statement (e.g., continuing operations, discontinued operations and extraordinary items), other comprehensive income, and balance sheet (e.g., goodwill, paid in capital) captions. While intraperiod tax allocation in general (and the application of the exception in particular) does not change the overall tax provision, it may result in a gross-up of the individual components, thereby changing the amount of tax provision included in each category.

Registrants should ensure that the allocation of income tax expense or benefit and related disclosures reflect the proper application of the intraperiod tax allocation guidance, particularly when there is a loss from continuing operations and income from another source.

Resources

Financial reporting developments: Accounting for income taxes (SCORE No. BB1150), Ernst & Young, December 2009.

Uncertain tax positions

Summary of issues noted

The SEC staff continues to question whether registrants have appropriately considered and included all of the disclosures required by ASC 740 as they relate to uncertain tax positions. In particular, the SEC staff often issues comments when a registrant's uncertain tax position disclosures do not include a description of tax years that remain subject to examination for significant jurisdictions.

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: Accounting for income taxes (SCORE No. BB1150), Ernst & Young, December 2009.

Intangible assets

Recognition, measurement, amortization and impairment

Summary of issues noted

The SEC staff frequently requests that registrants provide the following information in their intangible asset disclosures:

- ▶ Information about intangible assets recognized as part of a business combination. The SEC staff's comments continue to 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.
- ▶ Explanation of how the useful lives were determined and the factors leading to the amortization method selected. The SEC staff especially focuses on acquired customer relationship intangible assets.
- ▶ Supplemental information on how indefinite-lived intangible assets were assessed for impairment.

After reviewing this information, the SEC staff often asks registrants to enhance their intangible asset disclosures.

Analysis of current issues

Intangible assets recognized in a business combination

ASC 805 requires a registrant to determine the fair value of identifiable assets acquired 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 also often requests that registrants explain how they determined the fair value of certain recognized intangible assets. Specifically, the SEC staff requests that registrants discuss in MD&A the valuation method and principal assumptions the registrant 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.

Useful life determination and amortization method

When determining the useful life of the identifiable intangible assets, registrants 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

The SEC staff frequently challenges whether additional intangible assets should have been recognized in a business combination.

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.

SEC staff comment letters also continue to focus on the useful life and amortization method of definite-lived customer-related intangible assets (e.g., customer lists, customer contracts and 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 financial statements. The SEC staff also challenges the amortization method chosen for these assets and often requests that registrants explain their key assumptions about the expected future cash flows from the acquired customer-related intangible asset to support their chosen amortization method.

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 of the registrant or its operating results (or that of the relevant segment) have declined significantly.

Intangible assets that are being amortized should be reviewed for impairment in accordance with ASC 360. Registrants should consider the effects that current economic conditions might have on the assessment of intangible assets for impairment.

Resources

Financial reporting developments: Business combinations – Accounting Standards Codification 805 (SCORE No. BB1616), Ernst & Young, September 2011.

Financial reporting developments: Intangibles – Goodwill and other – Accounting Standards Codification 350 (SCORE No. BB1499), Ernst & Young, November 2009.

Investments in debt and equity securities

Other-than-temporary impairments

The SEC staff has started asking registrants to provide more detailed disclosures about any state and local government securities held, as well as any exposure to European sovereign debt.

Summary of issues noted

The SEC staff continues to ask registrants about the methodology and analysis used in assessing whether an impairment is other than temporary. The SEC staff also focuses on registrants' compliance with ASC 320 disclosure requirements for securities and other-than-temporary impairments, and often questions why particular disclosures are missing and requests that registrants begin providing those disclosures in future filings. 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, the SEC staff also has started asking registrants to provide more detailed disclosures about any state and local government securities held, as well as any exposure to European sovereign debt.

Analysis of current issues

The SEC staff continues to challenge 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 continues to ask registrants to comply with all of the disclosure requirements for securities in 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).

In addition, when a registrant discloses information about third-party credit ratings for its fixed maturity investments, the SEC staff often questions whether the registrant performed independent due diligence procedures to determine whether the ratings assigned by the third-party credit rating agencies were reasonable as of the financial statement date. When such procedures were performed, the SEC staff asks the registrant to explain the procedures performed. When independent due diligence procedures were not performed, the SEC staff questions how the registrant determined that the ratings are reasonable.

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 in this assessment 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 in the near term. The SEC staff continues to request that registrants disclose the specific period of time the registrant considers "near term."

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 entire 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 with a focus on when the decision was made to sell a security. This question typically arises when a registrant disclosed it did not intend to sell a security in an unrealized loss position in one period and then sells the 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 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 an 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, among others, 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 has requested 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 requested 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 Greek and other European sovereign debt and has specifically asked registrants to explain why Greek government bonds were not considered impaired. In cases where registrants have past due receivables from product sales or services to government-owned or supported customers in Greece and certain other European countries (e.g., Italy, Portugal, Spain), the SEC staff also has requested information as to the aging of the receivables by country, the amount of the allowance for uncollectible accounts by country and the basis for the conclusion that the allowance adequately addresses the collectability of current and past-due receivables for these customers.

Resources

Technical line: Current economic conditions – financial reporting considerations (SCORE No. BB2170), Ernst & Young, 11 August 2011.

Financial reporting developments: Accounting for certain investments in debt and equity securities – Accounting Standards Codification 320 (SCORE No. BB0961), Ernst & Young, December 2009.

Pension and other postretirement employee benefit plans

Recognition of actuarial gains and losses

Summary of issues noted

Recent speeches indicate the SEC staff will focus on disclosures provided by registrants that have changed accounting policies for the recognition of actuarial gains and losses in net income.

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 does not result in less 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.

The SEC staff recently indicated that it is aware of a number of registrants that have changed their method of recognizing actuarial gains and losses, switching from the minimum amortization method to methods that accelerate recognition of such gains and losses. The SEC staff expects that registrants making an accounting policy change obtain a preferability letter from their auditors and provide all disclosures required by ASC 250. The SEC staff also recommends that registrants clearly disclose the new amortization method and, if a corridor-type approach is maintained, disclose how the corridor is calculated.

In addition, the SEC staff recommends that registrants immediately recognizing actuarial gains and losses in net income disclose the magnitude of any fourth quarter adjustments determined on the measurement date. Similarly, if market activity before the fourth quarter could potentially give rise to a significant fourth quarter adjustment, the SEC staff recommends that registrants include in MD&A a discussion foreshadowing the potential fourth quarter adjustment.

Resources

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

2010 SEC annual reports: Report to shareholders Form 10-K (SCORE No. CC0305), Ernst & Young, 2011.

The SEC staff will focus on disclosures about changes in accounting policies for the recognition of actuarial gains and losses in net income.

Assumptions underlying defined benefit costs and obligations

Summary of issues noted

The SEC staff continues to comment on critical accounting estimate disclosures surrounding the assumptions (e.g., the expected long-term rate of return on plan assets and the discount rate) used in estimating defined benefit pension and other postretirement benefit plan costs and obligations.

Analysis of current issues

Given the current economic environment, the performance of global stock markets and the low long-term interest rates, the SEC staff often asks registrants to disclose an analysis of the subjective judgments underlying the estimate of the expected long-term rate of return used to determine net periodic benefit cost. The SEC staff requests that registrants explain whether the expected long-term rate of return on benefit plan assets represents the historical return by asset class over a long-term market cycle (years). When a large percentage of a registrant's plan assets are held in equity securities, the SEC staff also requests that registrants discuss the effect that current stock market conditions have had or are expected to have on the plan assumptions and net periodic benefit cost.

To help it identify assumptions that are potentially inconsistent with market conditions, the SEC staff has begun using XBRL to compare assumptions used by registrants with similar characteristics. In addition, registrants are asked to provide in MD&A a sensitivity analysis that demonstrates how reasonably likely changes in the assumed long-term rate of return and discount rate would affect results of operations and funding obligations.

Resources

2010 SEC annual reports: Report to shareholders Form 10-K (SCORE No. CC0305), Ernst & Young, 2011.

Revenue recognition

Consideration given by (or received from) a vendor

Summary of issues noted

The SEC staff frequently challenges the accounting for and disclosure of rebates and allowances offered to customers.

Analysis of current issues

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.

Pursuant to ASC 605-50, cash consideration given by a vendor to a customer is presumed to be a reduction of the price of the products or services sold and, therefore, should be characterized as a reduction of revenue when recognized in the income statement. Similarly, pursuant to 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. ASC 605-50-45-2 includes specific conditions under which this presumption may be overcome. The SEC staff often challenges any classification of vendor consideration that is inconsistent with the presumption in ASC 605-50.

The SEC staff often requests that registrants disclose how they account for rebates and allowances offered to customers, including the accounting literature they followed, the amounts recognized in the income statement and whether those amounts have been recognized as a reduction of revenue or as an expense. In addition, the SEC staff requests that registrants receiving rebates and allowances (vendor allowances) in connection with the purchase of products or services from others make similar disclosures. The SEC staff requests that registrants receiving vendor allowances make additional disclosures about the program, including:

- ▶ The amount of vendor allowances received
- ▶ The amount of advertising reimbursements netted against gross advertising expenses
- ▶ The amount of vendor allowances accounted for as a reduction of cost of sales
- ▶ The number of vendors from which vendor allowances are received and the duration of the related agreements
- ▶ The terms and conditions of significant agreements with vendors

The SEC staff also requests that registrants discuss the effect that vendor allowances have on their results of operations in MD&A.

'Fixed or determinable' criterion of SAB Topic 13

Summary of issues noted

The SEC staff continues to issue comment letters asking registrants to explain how their revenue recognition policies comply with the requirement in SAB Topic 13 that arrangement consideration be fixed or determinable prior to recognition of revenue.

Analysis of current issues

The fixed or determinable criterion in SAB Topic 13 refers to whether the total consideration in an arrangement is either known or estimable with reasonable certainty. If a registrant cannot conclude at the outset of an arrangement that the fee is fixed or determinable, the revenue generally is recognized either as payments from the customer are received or as rights of return or other post-shipment rights lapse, assuming all of the other basic criteria outlined in SAB Topic 13 have been met.

The fixed or determinable analysis considers whether the fees will be reduced by the exercise of rights of return or refunds granted, either explicitly or implicitly, or by a future action of the vendor (e.g., by granting a future concession). The analysis does not consider whether the customer is able to pay the fees (probability of collection is a separate criterion in SAB Topic 13). When the arrangement fee is stated in a contract, this may help a registrant reach a conclusion whether the fee is fixed or determinable, but it is only the beginning of the assessment. The key is whether the vendor can reliably estimate the total fee that will be received from the arrangement. If the fee varies based on future events, the fee may not be determinable. Factors that an entity should consider when making this assessment include whether a vendor has the ability to estimate refunds and returns, whether a contract includes customer cancellation or termination provisions and whether a vendor will grant a concession to a customer.

Based on the information in the registrant's disclosures of its revenue transactions, the SEC staff often questions how registrants believe they have been able to meet the fixed or determinable criterion, particularly for arrangements that contain general rights of return or refund, other post-shipment rights or a history of concessions. The SEC staff also asks for an explanation or enhanced disclosures when a registrant has deferred revenue because the fixed or determinable criterion was not met for certain revenue arrangements.

The accounting for arrangements that contain rights of return or refund, cancellation or termination provisions or any other post-shipment rights, as well as arrangements for which the registrant has a history of granting concessions, requires significant judgment. These arrangements warrant robust disclosures in the financial statements to enable users to understand the nature of the revenue transactions. In particular, the SEC staff continues to ask registrants to provide more detail in MD&A about their revenue recognition accounting policies, critical accounting estimates and judgments made in evaluating whether the fixed or determinable criterion has been met for sales made to distributors and resellers. The SEC staff generally asks that the revised disclosures discuss the material terms of agreements with distributors and resellers, including the significant payment terms and any rights of return, price protection, sales incentives or other post-shipment obligations related to the arrangements.

Gross versus net presentation of revenue

Summary of issues noted


The SEC staff often questions how registrants determine whether to present revenue on a gross basis or on a net basis. Notably, the SEC staff has challenged registrants on their conclusions that net revenue reporting is appropriate nearly as often as it has challenged registrants on their conclusions that gross reporting is appropriate.

Analysis of current issues

In many revenue-generating arrangements, a registrant may assist a supplier in the fulfillment of obligations to deliver goods or services to a customer (e.g., it may store and ship goods on behalf of a supplier). In these circumstances, a registrant must determine whether it should report revenue 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 a 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.

The revenue recognition guidance on principal and agent considerations applies to revenue transactions in all industries unless specific guidance is provided in other authoritative literature. The guidance does not provide any bright lines or objective factors for registrants to consider. Rather, it provides indicators suggesting gross or net reporting that often require registrants to apply considerable judgment based on their specific facts and circumstances. Individually, none of the indicators is presumptive or determinative; all of the indicators should be analyzed in their totality to determine whether the preponderance of evidence supports gross or net revenue reporting. ASC 605-45 provides specific indicators that may support gross revenue reporting.

The SEC staff frequently requests that registrants provide their analyses of each of the indicators identified in ASC 605-45 to support their conclusions that either gross revenue reporting or net revenue reporting is appropriate. Many of these analyses require significant judgment based on the facts and circumstances of a registrant's arrangement with its supplier. It 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 principal and agent considerations, disclosures should be considered in the financial statements that discuss the various criteria management evaluated in determining whether those revenues should be reported on a gross or net basis.



The SEC staff often requests that registrants provide analyses to support their conclusions that either gross revenue reporting or net revenue reporting is appropriate.

Multiple-element arrangements

The SEC staff frequently requests a detailed explanation of how estimated selling price is determined.

Summary of issues noted

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

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).

ASU 2009-13 revised the guidance in ASC 605-25 and, as part of that revision, expanded disclosure requirements for multiple-element arrangements. Registrants were required to adopt the provisions of ASU 2009-13, including the expanded disclosure requirements, for fiscal years beginning after 15 June 2010 (1 January 2011 for calendar-year companies), although early adoption was permitted.

The overall objective of the revised guidance is that disclosures provide “both qualitative and quantitative information regarding the significant judgments made about the application of this Subtopic and changes in those judgments or in the application of this Subtopic that may significantly affect the timing or amount of revenue recognition.” ASC 605-25-50-2 includes specific disclosure requirements to assist entities in applying this objective. In addition, ASC 605-25-50-1 states that a vendor also should disclose other qualitative and quantitative information, as necessary, to comply with the overall disclosure objective.

The SEC staff frequently requests registrants to expand their disclosures by, for example, providing 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. The SEC staff also requests that registrants disclose in their accounting policy disclosures how consideration is allocated to the separate units of account within multiple-element arrangements.

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

Resources

Financial reporting developments: Revenue recognition – Multiple element arrangements (SCORE No. BB1843), Ernst & Young, June 2011.

Segment reporting

Identification and aggregation of operating segments and entity-wide disclosures

The SEC staff may request that a registrant provide them with the information given to its CODM to evaluate its identification of operating segments.

Summary of issues noted

Segment reporting continues to be a common area of focus in SEC comment letters. The SEC staff frequently challenges registrants' conclusions on identifying and aggregating operating segments. Registrants also are questioned with increasing frequency about their 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 continues to routinely expand its review of public information available about a registrant beyond information in public filings, including registrant earnings calls, registrant websites and industry or analyst presentations. The SEC staff has asked registrants to explain any perceived inconsistencies between the manner in which the business is described in public information and their segment footnote. Addressing the perceived inconsistencies often results in multiple rounds of comments on segment reporting, particularly if registrants submit a less than robust initial response.

Identification of operating segments

The segment reporting accounting 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 as to operating segment determinations 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 in their comment letter response.

The identification of a registrant's 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 the identification of (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 registrants' identification of operating segments, the SEC staff continues to request 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, 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.

Identifying operating segments also affects goodwill impairment testing. Incorrectly identifying operating segments may result in more reporting units and may trigger additional goodwill impairment testing and recognition. For further discussion, 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.⁶

To be consistent with the objective and basic principles of ASC 280, the aggregation should help users make more informed judgments about the registrant by improving their understanding of the registrant's performance and its 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 (e.g., similar long-term average gross margins). The similarity of the economic characteristics should be evaluated based on both future projections and current indicators (ASC 280-10-55-7A). For 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.

In the comment letter process, the SEC staff looks closely at gross margins, operating margins or other measures of operating performance provided to the CODM or disclosed publicly when challenging the aggregation of operating segments. The SEC staff continues to request 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 has suggested that a difference in current or expected gross margin percentages of greater than 10% (i.e., a relative difference between margins of operating segments that exceeds 10%, not 10 percentage points) creates a presumption that segments do not have similar economic characteristics and, thus, should not be aggregated. 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

⁶ 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).

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.

In the comment letter process, the SEC staff often requests that registrants that have not disclosed disaggregated revenue information do so or provide an explanation as to why such disclosure was not necessary. The SEC staff challenges a lack of such disclosure when the registrant's publicly disclosed information indicates that its reportable segments contain a range of different products or services.

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 other disclosures about foreign locations that are made elsewhere by the registrant.

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 is a concentration of sales to a particular customer.

Resources

Financial reporting developments: Segment reporting – Accounting Standards Codification 280 (SCORE No. BB0698), Ernst & Young, November 2009.

Share-based payments

Valuation of pre-IPO equity securities

The SEC staff challenges the fair value of equity securities shortly before an IPO that are significantly less than IPO prices.

Summary of issues noted

The SEC staff challenges estimates of fair value of equity securities underlying awards issued in the 12-month period before an initial public offering (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 (often referred to as “cheap stock” because the value of the underlying stock at the date of grant is below the ultimate IPO price). In many cases, IPO prices significantly exceed the estimated fair value of equity securities shortly before the IPO. As a result, the SEC staff challenges such valuations and the related disclosures in the financial statement and MD&A.

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 non-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 prior to the IPO regardless of whether a contemporaneous independent valuation has been obtained. 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 time line, 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.

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 continues to comment 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 disclosures 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 others are subjective (e.g., expected term, expected volatility). ASC 718-10-50-2(f) (2) requires that registrants provide a discussion of each significant assumption used during the year to estimate the fair value of share-based awards. These disclosures should include the method of 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 of an option to exercise.

New registrants that have "plain vanilla" options, as defined in SAB Topic 14.D.2, may not have sufficient historical employee exercise data available to estimate the expected term of employee share options. Other registrants with plain vanilla options also may, in certain circumstances, have insufficient historical employee exercise data available. In these situations, registrants 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 regarding 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 continues to question use of the simplified method when historical data may appear to be available or the characteristics of the awards are other than plain vanilla (e.g., a modified option's exercise price may be more or less than the share price on the modification date).

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 entities. 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 similar volatility assumptions are disclosed from period to period.

SAB Topic 14.D.1 provides guidance related to the expected volatility assumptions used to estimate the grant date fair value of share-based awards. The SEC staff believes that registrants should disclose in their critical 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.

Presentation and disclosure

Summary of issues noted

The SEC staff comments when disclosures required by ASC 718 (e.g., general terms of an award, method used for measuring compensation cost from an award) have been omitted without explanation. The SEC staff also comments when total share-based payment expense is presented in any form on the face of the income statement.

Analysis of current issues

Required disclosures

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

The SEC staff often comments when any of the minimum information identified by ASC 718-10-50-2 has been omitted. If any of the required disclosures have not been provided, the SEC staff expects registrants to disclose why they have elected not to provide the information.

Presentation on the income statement

Share-based payment expense may relate to multiple lines in the statement of operations (e.g., cost of sales or selling, general and administrative expense). The SEC staff continues to object to the disclosure of total share-based payment expense as a separate line item on the face of the income statement. The SEC staff frequently comments that this type of disclosure may give the impression that the nature of the expense related to share-based compensation is different from cash compensation paid to the same employees.

SAB Topic 14.F addresses the SEC staff's views regarding classification of compensation expense associated with share-based payment arrangements. The SEC staff believes a registrant should present the expense related to share-based payment arrangements in the same line or lines as cash compensation paid to the same employees. Registrants also should consider disclosing the amount of expense related to share-based payment arrangements included in specific line items in the financial statements, and disclosure of this information might be appropriate in a parenthetical note to the appropriate income statement line items, in the reconciliation of net income to net cash flows from operating activities under the indirect method or in MD&A.

Resources

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

Modifications

Summary of issues noted

The SEC staff asks registrants to provide supplemental information on how they accounted for modifications of share-based payments, including a description of the specific types of modifications made, the amount of compensation cost recognized, how the cost of the modification was measured and the accounting literature that supports the conclusions presented.

Analysis of current issues

Registrants sometimes modify vesting conditions tied to their operating results or share price performance. Examples of changes to vesting conditions include the acceleration of vesting periods, adjustments to vesting performance targets and the extension of vesting periods in exchange for lowering the exercise price of out-of-the-money options. In many cases, the SEC staff questions the accounting for these and other types of modifications to share-based payments when registrants' disclosures are unclear.

The modification of a share-based payment may result in incremental compensation cost that will need to be recognized together with any remaining unrecognized compensation cost measured on the original grant date. Incremental fair value is calculated based on the fair value of the modified award in excess of the fair value of the original award measured immediately before its terms are modified, based on current circumstances. The value of the original (pre-modification) award must be estimated based on current assumptions, without regard to the assumptions made on the grant date.

ASC 718-20-55-107 through 55-108 require registrants that are modifying the vesting conditions of a share-based payment award to determine at the modification date whether the original vesting conditions were expected to be satisfied (i.e., was the award probable or improbable of vesting). If the award was probable of vesting at the modification date, the cumulative compensation cost (the total expense over the term of the award) for the modified award will at least equal the grant-date fair value of the original award. When a modification occurs, the SEC staff expects that a registrant's disclosure will include a description of each significant modification, including the modification terms, number of employees affected and the total incremental compensation cost, if any, that resulted from applying modification accounting.

Resources

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

Appendix A: Industry supplements

Banking supplement

The SEC staff continues to focus on financial institutions. The SEC Division of Corporation Finance recently split its existing 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 (for further discussion, please refer to the SEC review process and best practices section in Appendix C of this publication). In this supplement, we analyze specific 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 of this publication that also may be relevant to registrants in the banking industry.

Impact of new or pending regulations

Summary of issues noted

The SEC staff asks for more detail in MD&A or the notes to financial statements related to the impact and potential effect of new or pending regulations on a registrant's financial position and results of operations.

Analysis of current issues

The SEC staff has focused particular attention on disclosures about the following new and pending regulations:

- ▶ The Dodd-Frank Wall Street Reform and Consumer Protection Act, especially the potential effects of the Volcker Rule on proprietary trading activities, including which of the registrant's activities would be affected and detail on aspects of a registrant's business that are similar to but do not meet the definition of "proprietary trading activities"
- ▶ Quantitative effect on expenses due to Federal Deposit Insurance Corporation (FDIC) assessment increases
- ▶ Quantitative effect on revenues due to debit interchange fee limits

Resources

2010 SEC annual reports: Reports to shareholders Form 10-K (SCORE No. CC0305), Ernst & Young, 2011.

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. Home equity loan portfolios and the use of third-party appraisals are among the SEC staff's areas of focus.

Analysis of current issues

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:

- ▶ When net income from operations is largely driven by a decrease in the provision for credit losses or the reversal of previously established allowances, the SEC staff expects a prominent discussion of this fact and an affirmative statement that declines in the provision for credit losses are likely not sustainable (if applicable).
- ▶ The SEC staff asks registrants to discuss how they 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 SEC staff requests that registrants provide disclosure about how existing macroeconomic factors (e.g., unemployment rates) are considered when adjusting historical loss rates or risk ratings.
- ▶ The SEC staff often requests that registrants provide 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.
- ▶ The SEC staff also asks for enhanced disclosure regarding the extent to which registrants intend for 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 also expects enhanced disclosures about home equity loans, given the associated risks (e.g., the potential lack of transparency regarding the performance of senior lien loans) and that many home equity loans and lines have revolving periods and (or) periods during which non-amortizing payments are made. Enhanced disclosure requests 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

Registrants should continue to enhance disclosures about the allowance for credit losses, particularly regarding significant components of their estimation methodology and impact of any changes.

- ▶ 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 than first lien loans)

Lending institutions often measure impairment of a loan by estimating the value of the underlying collateral. Often, the value of collateral is supported by a third-party appraisal. The SEC staff asks registrants to disclose and clarify their policies on the use of such appraisals, specifically:

- ▶ How and when updated 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
- ▶ How the appraisals are validated and whether (and why) any adjustments are made to the appraiser's conclusion

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, in the aftermath of the global economic crisis, the FASB issued ASU 2010-20 to provide financial statement users with greater transparency about the credit quality of an entity's financing receivables. Following implementation of the disclosures required by ASU 2010-20, the SEC staff has frequently commented on compliance with the disclosure requirements including:

- ▶ Credit quality disclosures at the level of disaggregation required by ASU 2010-20 (i.e., by portfolio segment for some disclosures, by class of financing receivables for other disclosures).
- ▶ When only one credit quality indicator is identified for a class of financing receivables (e.g., delinquency), the SEC staff asks for clarification and suggests that additional characteristics (e.g., FICO scores, loan-to-value ratios) may meet the definition of a credit quality indicator for a given class of financing receivables.
- ▶ The SEC staff emphasizes that the 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 include which loans were subject to the updates and a discussion of why those particular loans were subject of the updates.
- ▶ When a registrant uses an internally assigned risk rating as its credit quality indicator for a class of financing receivables, the SEC staff often requests additional disclosure of the date or range of dates when such risk ratings were most recently updated.

Registrants are expected to align their credit quality disclosures with credit quality metrics used by management.

Modifications, including troubled debt restructurings (TDRs)

Summary of issues noted

The SEC staff frequently asks for additional detail about the qualitative and quantitative aspects of modification programs.

Analysis of current issues

Given the general increase in loan modifications, the SEC staff asks financial institutions to enhance their disclosures to explain the details of workout programs, including types of programs used and quantification of modified loans. The SEC staff suggests that entities 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
- ▶ A discussion of the registrant's success with the different types of modifications (e.g., redefault or recidivism rates)
- ▶ Information about recidivism rates on modifications, and how such rates are considered in the allowance for loan loss calculation for modifications identified as TDRs as well as those not considered TDRs
- ▶ Whether the existence of any guarantees or insurance results in the exclusion of a loan from disclosure as a TDR and, if they are excluded, the amount of such loans
- ▶ When a credit card loan is modified and results in specific impairment, disclosure of the accounting policy regarding the rate used to measure impairment

The SEC staff also requests explanations for modifications that are not being accounted for as TDRs, including the triggers or factors reviewed to identify the loans for modification and key features and success rates of the modification programs. Further, the SEC staff suggests that registrants consider disclosure of the nonaccrual policy for restructured loans (that are not considered troubled) and its effects on past due statistics.

Resources

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.

2010 SEC annual reports: Reports to shareholders Form 10-K (SCORE No. CC0305), Ernst & Young, 2011.

Hot Topic: FASB requires new disclosures about financing receivables and the allowance for credit losses (SCORE No. BB1976), Ernst & Young, 23 July 2010.

Loss-sharing agreements

Summary of issues noted

For registrants that have entered into loss-sharing agreements with the FDIC in connection with acquisitions of failed financial institutions, the SEC staff focuses on how the registrants have accounted for and disclosed the loss-share agreements. The SEC staff also focuses on loss-sharing arrangements between registrants and other entities besides the FDIC.

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 also 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 that the loss-sharing agreement will be presented as a separate asset on the balance sheet rather than included with the indemnified items.

Mortgage and foreclosure-related activities

Summary of issues noted

The SEC staff emphasizes disclosure requirements for mortgage and foreclosure-related activities.

Analysis of current issues

In October 2010, the SEC staff issued a “Dear CFO” letter requesting information about accounting and disclosure issues related to potential risks and costs associated with mortgage and foreclosure-related activities.⁷ In that letter, the SEC staff suggested disclosures to consider and provided reminders about existing requirements, including:

- ▶ The implications of various representations and warranties regarding mortgages made to purchasers of those mortgages
- ▶ Known trends, demands, commitments, events or uncertainties that the registrant reasonably expects to have a material impact on the registrant (e.g., suspending foreclosure pending further review)
- ▶ Accruing for and disclosing litigation and other contingencies
- ▶ Quantitative and qualitative discussion of the reasonably possible outcome of litigation and other contingencies

⁷ The “Dear CFO Letter” is available on the SEC website at <http://www.sec.gov/divisions/corpfin/guidance/cfoforeclosure1010.htm>.

- ▶ Providing 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 in predicting 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.

Insurance supplement

The SEC staff's areas of focus on insurance companies include accounting and disclosure for significant judgments and estimates, especially those using valuation models and subject to a high degree of uncertainty.

In this supplement, we analyze specific 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 of this publication that also may be relevant to registrants in the insurance industry.

Investments in joint ventures, partnerships and limited liability companies

Summary of issues noted

The SEC staff asks registrants in the insurance industry to explain why investments in joint ventures, partnerships and limited liability companies (e.g., alternative investments) in which the registrant has a minor ownership interest (generally less than 3% to 5%) are reported using the cost method of accounting rather than at fair value or under the equity method.

Analysis of current issues

Many registrants in the insurance industry have investments in joint ventures, partnerships and limited liability companies. While most account for these investments under the equity method, the SEC staff has identified insurers that use the cost method of accounting, which is prohibited for insurance entities under ASC 944-325-30-1. This guidance says, "Investments in equity securities that are not within the scope of Subtopic 320-10 or 958-320 because they do not have readily determinable fair values shall be reported at fair value." Although a registrant could argue that an investment is not an equity security, this assertion may be difficult to sustain and would need to be validated by the registrant's legal counsel.

The SEC staff's increased focus on alternative investments likely results from the effect a change in value of these investments can have on the financial statements. Although alternative investments held by a registrant may not be material to the balance sheet, they can have a material effect on the income statement. Given the nature of these investments, there can be large fluctuations in their earnings, creating significant volatility in the registrant's income statement.

Property and casualty loss reserves and loss adjustment expense reserves

Summary of issues noted

The SEC staff continues to issue comments aimed at improving the quality and usefulness of disclosures about 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. The SEC staff frequently requests that registrants provide more information about the process for developing 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.

Analysis of current issues

For property and casualty loss reserves, registrants typically disclose the methods used and changes in reserve estimates in MD&A. These disclosures tend to provide general information about reserve development as it relates to 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 be different from what was expected and whether current trends are expected to continue. The SEC staff specifically requests that registrants disclose how management determined that the period in which the reserve change is recognized is the appropriate period and why recognition was not required in an earlier period. In addition, the SEC staff asks registrants to provide quantitative information in MD&A about reasonably likely future changes in key assumptions, as opposed to changes based on arbitrary percentages (e.g., plus or minus 5%).

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

Resources

2010 SEC annual reports: Reports to shareholders Form 10-K (SCORE No. CC0305), Ernst & Young, 2011.

Reinsurance agreements

Summary of issues noted

The SEC staff raises questions about registrants' reinsurance agreements, focusing on disclosure of the key terms of the agreements as well as the effect of the agreements on the current-period financial statements and on future operating results. The SEC staff also continues to remind 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.

Analysis of current issues

Entering into a new reinsurance agreement can significantly affect the financial statements of insurers; however, the effects of these agreements are not always explicitly disclosed in the financial statements. Registrants should consider whether the material effects of all reinsurance agreements are disclosed in their filings, either in MD&A or financial statement disclosures. Disclosures should include the current-period effect of the agreements (in MD&A or financial statements) and the likely effect 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, key terms of the agreement and relevant assumptions underlying key estimates made by the registrant.

Resources

2010 SEC annual reports: Reports to shareholders Form 10-K (SCORE No. CC0305), Ernst & Young, 2011.

Life sciences supplement

In the following supplement, we analyze specific trends in SEC staff comment letters related to the life sciences industry. The topics in this supplement should be considered in conjunction with the topics in the main section and other appendices of this publication 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. The SEC staff often challenges the ability of registrants 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 continues to request that registrants provide enhanced disclosure of 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 section 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 so registrants must determine whether revenue should be recognized upon delivery of products to customers. Among the criteria that must be met to recognize revenue upon delivery, selling prices must be fixed or determinable, so 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 registrants about their ability to make reasonable estimates when they have 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 MD&A, recent press releases, marketing materials and recent management presentations that indicate a product is new, novel or unique in some aspect. 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 upon additional information received, the SEC staff may request that registrants expand MD&A and critical accounting estimates disclosures.

Disclosures

Often the judgments and assumptions registrants make when they estimate product returns and other revenue deductions 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 continues to ask 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 the financial statement periods 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 it estimates each revenue deduction. For example, the SEC staff may request that registrants describe 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 or in excess of the customers' ordinary demand and introductions of new and generic competitive products. The SEC staff also may request that registrants discuss 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 related to qualitative factors a registrant considers when it estimates each revenue deduction. For example, the SEC staff may ask registrants to enhance their disclosure by including a discussion accompanied by detailed quantitative information by product, including the total amount of product in sales dollars 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 in estimating each revenue deduction. For example, the SEC staff may ask registrants to disclose a range of reasonably likely estimates or other types of sensitivity analyses.
- ▶ The underlying business reasons for material period-to-period fluctuations for each type of reduction of gross revenue, including the effect that changes in estimates have on revenues and obligations.

The SEC staff requests separate disclosure of each arrangement and each milestone for significant arrangements.

Milestone method disclosures

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 605-28-50-2, which, if elected, is effective on a prospective basis for milestones achieved in fiscal years, and interim periods within those years, beginning on or after 15 June 2010⁸.

Analysis of current issues

Registrants in the life sciences industry 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. If the milestone method is elected, registrants must provide the following additional disclosures about 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 entity considered in determining whether milestones are substantive
- ▶ The amount of consideration recognized during the period for those milestones

These enhanced disclosures are required for life sciences registrants that have elected the milestone method of revenue recognition. Further, the enhanced disclosure requirements are written such that certain of the revised disclosures are required at the individual milestone level. As a result, there have been comments from the SEC staff on the adequacy of disclosures for each arrangement and each milestone under ASC 605-28-50-2. Many registrants, especially those with multiple arrangements and numerous milestones within each arrangement, may prefer to include revised disclosures on an aggregated basis in an effort to improve their usefulness. Recent SEC staff comments and responses have consistently requested separate disclosures for each arrangement and each milestone. This is an emerging issue and it is currently unclear whether the SEC staff will accept aggregated disclosure.

⁸ Registrants may elect to adopt this guidance retrospectively if they apply it consistently in all periods presented.

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

Registrants in the life sciences industry often enter into arrangements with counterparties that include multiple elements, such as the license of intellectual property, research and development (R&D) 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, disclosures provided by life sciences registrants should provide sufficient information so users of the financial statements can understand the relevant factors considered by management in accounting for significant multiple-element arrangements. For further discussion, please refer to the Multiple-element arrangements topic in the Revenue recognition section of this publication.

Resources

2010 SEC annual reports: Reports to shareholders Form 10-K (SCORE No. CC0305), Ernst & Young, 2011.

Technical Line: Accounting for product returns in the life sciences industry (SCORE No. BB1596), Ernst & Young, 3 October 2008.

Collaboration arrangement disclosures

Summary of issues noted

The SEC staff frequently requests that registrants expand their disclosures related to collaboration arrangements, including 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 has requested 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 identified the following specific items related to collaboration arrangements that registrants should consider disclosing:

- ▶ 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 to the extent their occurrence is reasonably possible. If occurrence of potential payments is 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 regarding contractual obligations tables.

Furthermore, if registrants have omitted disclosure of certain aspects of collaboration arrangements (e.g., specific royalty rates or the possibility that milestones might be achieved) for confidentiality purposes, the SEC staff has generally challenged whether such disclosures should be provided. The SEC staff often challenges whether concerns related to confidentiality outweigh the needs of financial statement users.

Exhibits

Item 601 of Regulation S-K contains instructions for the preparation 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 an exhibit if the registrant's business is substantially dependent on the contract (e.g., sales contracts with significant customers, contracts with suppliers for significant components to 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 the significance of a collaboration arrangement without a filed exhibit, the SEC staff specifically challenges 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

2010 SEC annual reports: Report to shareholders Form 10-K (SCORE No. CC0305), Ernst & Young, 2011.

Disclosures related to acquired IPR&D assets

Summary of issues noted

The SEC staff continues to challenge registrants on the identification and valuation of in-process research and development (IPR&D) projects. The SEC staff frequently issues comments requesting 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.

The SEC staff continues to issue comment letters requesting that registrants in the life sciences industry that have recently completed business combinations provide additional information to the SEC staff and, in some cases, provide additional disclosures about acquired IPR&D assets. Registrants may be asked to provide additional information explaining 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 TPA⁹ 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 regarding the measurement of and disclosure for 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 it is not completed timely
- ▶ Appraisal method used to value projects
- ▶ Significant appraisal assumptions, such as:
 - ▶ Period in which material net cash inflows from significant projects are expected to begin
 - ▶ Material anticipated changes from historical pricing, margins and expense levels
 - ▶ The risk-adjusted discount rate applied to the project's cash flows

⁹ ASC Topic 805 and ASC Topic 820 supersede certain 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.

- ▶ In periods after the acquisition, the status of efforts to complete the projects and the impact of any delays on the expected investment return, results of operations and financial condition

Resources

Financial reporting developments: Business combinations – Accounting Standards Codification 805 (SCORE No. BB1616), Ernst & Young, September 2011.

Disclosures related to material patents

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 if the SEC staff perceives such disclosures as inadequate, it will request detailed 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 continues to issue comment letters requesting 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 additional 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 patent and the jurisdiction in which the patent was requested.

Resources

2010 SEC annual reports: Reports to shareholders Form 10-K (SCORE No. CC0305), Ernst & Young, 2011.

Research and development expenses

Summary of issues noted

The SEC staff frequently asks registrants in the life sciences industry to provide more detailed disclosures in MD&A regarding their R&D activities. Specifically, the SEC staff focuses on the status of major R&D projects and the related 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, it may be the single largest expense on the income statement. Accordingly, the SEC staff has focused on the MD&A disclosures involving R&D expenses in the life sciences industry. Financial Reporting Release No. 501.01, *Information Outside of Financial Statements, Evaluation of Disclosures – Interpretive Guidance* (FRR 501.01), states “The MD&A requirements are intended to provide, in one section of a filing, material historical and prospective textual disclosure enabling investors and other users to assess the financial condition and results of operations of the registrant, with particular emphasis on the registrant’s prospects for the future.” In light of the significance of R&D expense to registrants, the SEC staff may issue comment letters asking 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 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 further requests that a registrant not tracking 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 by any other means than by total R&D expense, the SEC staff often 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.

Resources

2010 SEC annual reports: Reports to shareholders Form 10-K (SCORE No. CC0305), Ernst & Young, 2011.

Media and entertainment supplement

In the following supplement, we analyze specific trends in SEC staff comment letters related to the media and entertainment industry. The topics in this supplement should be considered in conjunction with the topics in the main section and other appendices of this publication that also may be relevant to registrants in the media and entertainment industry.

Cable franchise rights and broadcast licenses

Summary of issues noted

The SEC staff continues to ask registrants to provide additional detail regarding how fair value is determined for cable franchise rights and Federal Communications Commission (FCC) broadcast licenses.

Analysis of current issues

Cable operators generally operate their systems under nonexclusive franchise rights issued by state or local governments. Cable franchise rights are typically terminable only if the cable operator fails to comply with material provisions of the agreement.

Radio and television broadcasters are issued licenses by the FCC typically for a fixed period of time, but the renewal of the license is routine unless there has been a serious violation by the licensee. As the renewal process is typically perfunctory, cable franchise rights and FCC broadcast licenses are usually recorded as indefinite-lived intangible assets that, in accordance with ASC 350, are tested for impairment annually or more frequently if events or changes in circumstances indicate that the asset may be impaired. Changes in the political, regulatory and economic environments could affect the useful life of the cable franchise rights or FCC broadcast license.

The SEC staff asks registrants to describe the methodology¹⁰ used to determine the fair value of the cable franchise rights or FCC broadcast license acquired in a business combination. The SEC staff requests additional disclosure related to the method and significant assumptions used to determine the fair value, including:

- ▶ A qualitative and quantitative description of the significant estimates and assumptions used in the valuation method to determine the fair value
- ▶ An explanation of how the free cash flow model isolates the cash flows associated with the license
- ▶ A description of the consideration the registrant gave to using a hypothetical build-up or start-up method to estimate the fair value of the cable franchise rights or FCC license

For further discussion, please refer to the Intangible assets section of this publication.

Resources

Financial reporting developments: Intangibles – Goodwill and other – Accounting Standards Codification 350 (SCORE No. BB1499), Ernst & Young, November 2009.

¹⁰ Many registrants in the industry use a multi-period excess earnings method (MPEEM) to value cable franchise rights and other identified intangible assets such as FCC broadcast licenses. While the SEC staff has not objected to a registrant using the MPEEM method, it has indicated its preference is for a registrant to use the Greenfield method.

The SEC staff continues to ask registrants to describe the methodology used in determining fair value of cable franchise rights.

Consolidation of local marketing agreements

Summary of issues noted

The SEC staff has recently been asking broadcasters that have entered 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 generally apply to such 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 pursuant to an 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 not violate FCC standards.

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

LMAs may contain provisions for certain put and (or) call options on the station's assets at a future date. Additionally, other contractual provisions may protect against a decrease in the fair value of the station assets. These terms should be evaluated carefully against 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 related to the determination of which party has the power to direct the activities of a VIE 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.

Mining and metals supplement

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

Mine safety

Summary of issues noted

The SEC staff has begun issuing comments about the completeness of the mine safety disclosures in response to Section 1503 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act). Section 1503 of the Act, which took effect on 20 August 2010, requires a registrant that is an operator, or that has a subsidiary that is an operator, of a coal or other mine in the US to disclose in its periodic SEC reports (e.g., Forms 10-K and 10-Q) information about specified health and safety violations, orders and citations, related assessments and legal actions and mining-related fatalities.

Analysis of current issues

The SEC staff requests that registrants supplement disclosures, typically in future filings, to clarify the different levels of violations that may be identified by inspectors and the process of resolving such violations. As violations may result in a monetary fine and (or) loss of production, the SEC staff also asks registrants to disclose the loss exposure in the financial statements under ASC 450, as well as in MD&A.

The SEC staff reviews risk factors that discuss substantial costs and exposures under federal, state and local health and safety laws, regulations and enforcement policies. Registrants may be asked to explain how they monitor safety performance and to disclose the financial impact of any accidents reported. The SEC staff asks for disclosure of the potential penalties or actions in each jurisdiction for violations of occupational health and safety laws or regulations, including foreign jurisdictions.

The SEC staff also asks registrants to explain the extent to which the registrant uses capital expenditures, safety programs, and statistical or other measures (including those reported to the Mine Safety and Health Administration or any other agency or regulatory body) to monitor compliance with health and safety regulations. The SEC staff expects disclosures of actual results and any benchmarks or targets used. In addition, the SEC staff may request registrants to disclose the occupational injury and frequency rates used to measure compliance, including providing safety statistics, such as the reportable injury, lost-time and fatal injury frequency rates in a table for each location over the last three years.

Resources

Mining and metals: SEC proposes rule to implement Section 1503 (Mine safety) of the Dodd-Frank Act (EYG No. ER0020), Ernst & Young, December 2010.

Reserves

Summary of issues noted

Item 1202(a)(8) of Regulation S-K requires a third-party report to be filed 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) includes specific 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

The SEC staff may ask for supplemental information, for review by an SEC staff engineer, such as updated reserve reports that establish the legal, technical and economic feasibility of the mineralization designated as reserves, under paragraph (c) of Industry Guide 7 and Rule 12b-4 of Regulation 12B. The SEC staff questions the pricing used in reserve estimates and compares this pricing with MD&A disclosures about anticipated cost per ton. The SEC staff also asks registrants to explain how the determinations of economic reserves were made as defined in Section (a) of Industry Guide 7.

Oil and gas supplement

In the following supplement, we analyze specific trends in SEC staff comment letters related to the oil and gas industry. As the SEC issued new rules required to be adopted by registrants in the oil and gas industry for annual reports filed after 31 December 2009, many of the SEC staff's comments relate to the disclosures required by these rules. The topics in this supplement should be considered in conjunction with the topics in the main section and other appendices of this publication that also may be relevant to registrants in the oil and gas industry.

Reserves

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. In the second year of its three-year review cycle for registrants since adoption of this rule, the SEC staff continues to frequently issue comments 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 the financial statements and:

- ▶ Information included in MD&A
- ▶ Certain quantified statistics, such as the ability to recalculate one thousand cubic feet (of gas) equivalent (MCFE) and barrel of oil equivalent (BOE)
- ▶ Prior filings (e.g., the current year versus the prior year)
- ▶ Other available information (e.g., if information is publicly available elsewhere such as a website or other working interest owners' public filings)
- ▶ 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&DIs) available at <http://www.sec.gov/divisions/corpfin/guidance/oilandgas-interp.htm>.

The SEC staff requests that registrants with a large percentage of 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 additions and other material changes due to revisions, drilling, improved recovery or acquisitions and divestitures 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 they have a basis for meeting the criteria of reasonable certainty necessary to book proved reserves. The SEC staff not only looks to see that a plan is in place, but also that 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 uses historical conversion rates to challenge current classification. Registrants should challenge whether it is reasonably certain that projects will be completed and whether classification as a PUD reserve remains appropriate. Disclosures should include a detailed discussion of the projects, including 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. 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.

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 year-over-year reserves table. The SEC staff 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).

Other areas of focus

Item 1207 of Regulation S-K requires disclosure of material information concerning the estimated availability of oil and gas from any principal sources if the registrant is committed to provide a fixed and determinable quantity of oil or gas in the near future under existing contracts or agreements. The SEC staff asks whether such commitments exist for a registrant and, if so, reminds the registrant to provide these required disclosures.

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 near term.

Disclosure about the changes in standardized measure of future cash flows requires inclusion of previously estimated development costs incurred, if material (ASC 932-235-50-35g). The SEC staff often requests that registrants expand their disclosures to present this line item separately in their rollforward if they have not done so.

The SEC staff also questions registrants that have not provided 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.

Item 1202(a)(4) of Regulation S-K requires separate disclosure of material reserves for various products. 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 disclosure when such reserves approach 10% of total proved reserves. In accordance with Item 1202(a)(2), the SEC staff requests registrants that disclose reserves on an equivalent basis to state (e.g., in a footnote to the reserves table) the basis for conversion to an equivalent basis and also that there may be a large difference in price between an equivalent volume of oil versus an equivalent volume of natural gas or natural gas liquids.

The SEC staff questions whether registrants appropriately disaggregate their geographic areas and in some cases requests only confirmation that no country 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. Additionally, the SEC staff continues to remind registrants that Item 1204 of Regulation S-K requires disclosure of production, production prices and production costs for each geographic area and for each 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.

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) includes specific 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 continues to question the use of the term "generally accepted petroleum engineering and evaluation principles" or similar terms in the third-party reports filed. The SEC staff has indicated that it was unaware of a compilation of such principles and has asked registrants to obtain an updated third-party report that omits such a term.

The SEC staff also questions third-party reports that include language suggesting that their use is restricted to the registrant. Because the report is required to be filed in a public document, the SEC staff comments that the limitation on the report's use is not appropriate and requests that registrants obtain and file a revised third-party report without such a restriction.

The SEC staff comment letters also remind registrants that a discussion of the primary economic assumptions is required in the report and ask 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. Additionally, the SEC staff requests confirmation from registrants that there was no aggregate difference greater than 10% between the reserves estimates disclosed by the registrant and those of the third party and requests a statement to that effect in the third-party reports.

The SEC staff continues to request 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 reserve estimation efforts, including the qualifications and experience of the internal technical person who oversees the reserve estimates.

Offshore exploration and production disclosures

Summary of issues noted

Since the events that occurred in the Gulf of Mexico, the SEC staff has increased its focus on the adequacy of MD&A disclosures involving offshore exploration and production activities, including risk factors, implications to liquidity and potential changes to business as a result of regulatory and legislative activities.

Analysis of current issues

The SEC staff frequently requests enhanced disclosure by registrants that are involved in offshore oil and gas producing activities. These requests include:

- ▶ Insurance coverage and whether it would cover claims made by or on behalf of individuals who are not employees, and whether there are indemnifications by the rig operator if there is a spill
- ▶ Insurance policy limits
- ▶ The extent to which insurance covers environmental damage
- ▶ Further information about risks for which the registrant is insured related to offshore operations

In addition, the SEC staff asks registrants to provide information on the remediation plans and procedures they have in place to address the environmental effects if there is an oil spill or leak from offshore operations. The SEC staff also requests that registrants quantify the effect of changes to the regulatory environment (e.g., increased safety and inspection certification requirements) on their results of operations.

The SEC staff also requests increased disclosure by registrants that are rig operators and other service and equipment providers (e.g., manufacturers of equipment used in drilling). An example of information requested is insurance coverage with respect to any liability related to potential events, including the types of claims covered, applicable policy limits and deductibles. The SEC staff has requested that the disclosures include coverage and policy limits for environmental damage. The SEC staff also requests MD&A disclosure of indemnification obligations and their material terms.

Resources

2010 SEC annual reports: Reports to shareholders Form 10-K (SCORE No. CC0305), Ernst & Young, 2011.

Hydraulic fracturing

The SEC staff has asked registrants that use hydraulic fracturing to assess the adequacy of their disclosures related to potential environmental contamination.

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 that employ hydraulic fracturing to disclose all material information regarding any potential liability that might result if a connection is established between environmental contamination and the registrant's operations. Specifically, the SEC staff asks registrants that use hydraulic fracturing (i.e., fracking) to assess the adequacy of their disclosures related to the following:

- ▶ The location of fracking activities
- ▶ The acreage subject to fracking
- ▶ The percentage of reserves subject to fracking
- ▶ The anticipated costs and funding associated with fracking activities
- ▶ Whether there have been any incidents, citations or suits related to fracking operations for environmental concerns, and if so, the registrant's response
- ▶ State permitting requirements to which the registrant is subject
- ▶ Insurance coverage in place, including deductibles and policy limits

The SEC staff also requests that registrants disclose the steps they have taken to minimize any potential environmental impact, including such practices as:

- ▶ Steps to ensure that drilling, casing and cementing adhere to known best practices
- ▶ Monitoring the rate and pressure of the fracturing treatment in real time for any abrupt change in rate or pressure
- ▶ Evaluating the environmental impact of additives to the fracking fluid
- ▶ Minimizing the use of water and (or) disposing of it in a way that minimizes the effect on nearby surface water

The SEC staff asks registrants to expand their disclosures related to instances when the isolation of the wellbore, including the fracking fluid pumped through it, may not be successful, including such possible occurrences as:

- ▶ An improper cement job or other imperfections in well construction creating conditions whereby the hydraulic fracturing fluid and naturally occurring substances mobilized by the fracturing treatment leak into the surrounding geologic formation
- ▶ A well, even if properly constructed, failing over time due to downhole stresses and corrosion

- ▶ During the fracturing process, fluid leakage occurring, whereby some of the fracking fluid flows through the artificially created fractures into the micropore or pore spaces within the formation, existing natural fractures in the formation or small fractures opened into the formation by pressure in the induced fracture

The SEC staff asks registrants to provide it with 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 fracking is used. The SEC staff also asks registrants about the total amount of water used in fracturing operations as well as the amount of water that is recovered.

Most recently, certain registrants with shale gas operations have received subpoenas from the SEC's Enforcement Division requesting documents and information about the actual performance of shale gas wells against forecasted or projected performance and the propriety of decline curves for the wells as well as the calculation and public disclosure of full-cycle margins.

Provider care supplement

In the following supplement, we analyze specific trends in SEC staff comment letters related to the provider care industry. The topics in this supplement should be considered in conjunction with the topics in the main section and other appendices of this publication that also may be relevant to registrants in the provider care industry.

Critical accounting estimates

Summary of issues noted

The SEC staff asks that registrants in the provider care industry expand management's discussion and analysis of critical accounting estimates, particularly about the allowance for doubtful accounts for patient accounts receivable and net patient service revenue.

Analysis of current issues

The SEC staff requests that registrants disclose additional detail about their estimation process for the allowance for doubtful accounts for patient accounts receivable. Registrants may be asked to provide a table disaggregating accounts receivable by payor type and aging. Although the payor mix and aging categories may be based on the registrant's own reporting practices, the SEC staff expects that, at a minimum, self-pay receivables would be classified separately from other categories. Also, the SEC staff asks the registrant to disclose receivables pending approval from third-party payors (e.g., Medicaid pending), including information about how these amounts have been classified in its aging categories and in which payor classification they have been grouped. If amounts are classified outside of the self-pay category, the SEC staff asks that registrants explain why this classification is appropriate and disclose the historical percentage of amounts that get reclassified into the self-pay category.

The SEC staff also asks provider care registrants to disclose changes in estimated reserves (e.g., for contractual adjustments) originally recognized in prior periods. The SEC staff requests these disclosures for each reserve for each period presented, unless such change in estimate is immaterial. Registrants also may be asked to provide greater insight into the factors considered and assumptions used in estimating contractual and other adjustments to revenue.

The SEC staff's comments reflect a desire for greater transparency in management's discussion and analysis of critical accounting estimate processes and judgments used to determine net patient service revenue and the allowance for doubtful accounts for patient accounts receivable. ASU 2011-07, issued by the FASB in July 2011, also reflects the objective of providing users with a better understanding of how health care entities recognize patient service revenue and assess 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. Registrants should pay particular attention to compliance with these new financial statement disclosure requirements, as they are effective for fiscal periods beginning after 15 December 2011.

Resources

2010 SEC annual reports: Report to shareholders Form 10-K (SCORE No. CC0305), Ernst & Young, 2011.

Real estate supplement

In the following supplement, we analyze specific trends in SEC staff comment letters related to the real estate industry. The topics in this supplement should be considered in conjunction with the topics in the main section and other appendices of this publication that also may be relevant to registrants in the real estate industry.

Below-market operating leases acquired in a business combination

The SEC staff may ask registrants to explain how management determines the fair value and related amortization periods for below-market leases.

Summary of issue noted

In connection with properties acquired in a business combination, the SEC staff 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 renewals when estimating the fair value of below-market 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 pursuant to the provisions of ASC 820.

The SEC staff asks for additional information as to 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.

Capitalization rate disclosure

Summary of issues noted

The SEC staff has increased its focus on property valuation metrics such as capitalization rates (cap rate).

Analysis of current issues

The cap rate is the ratio of the expected net operating income of a property to its fair value. It is used as a real estate industry appraisal measure for stabilized properties, which are often valued by dividing net operating income by prevailing market cap rates.

The SEC staff requests that registrants disclose weighted average cap rates for acquisitions and dispositions of properties during the period. In addition, the SEC staff asks registrants to describe how they calculated cap rates, including the calculation of net operating income.

Cost capitalization

Summary of issues noted

The SEC staff requests enhanced disclosures about registrants' cost capitalization policies within the MD&A discussion of critical accounting estimates.

Analysis of current issues

Given that the application of the Real Estate Project Costs subsection of ASC Topic 970 is subject to significant judgment and there may be diversity in how those judgments are applied throughout the industry, the SEC staff is focused on transparent disclosure in this area.

In particular, the SEC staff comments focus on expanded disclosure of the types of soft costs that are capitalized. The SEC staff pays particular attention to capitalized indirect costs and interest. The SEC staff requests more transparency about the methodology utilized to allocate indirect costs and the amount of indirect personnel and administrative costs that are capitalized in each year presented. In addition, the SEC staff requests that a registrant quantify payroll costs and other overhead costs it capitalized.

Resources

2010 SEC annual reports: Reports to shareholders Form 10-K (SCORE No. CC0305), Ernst & Young, 2011.

Funds from operations (FFO)

Summary of issues noted

The SEC staff requests that registrants identify whether management considers 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, among other adjustments, excluding gains or losses on asset sales and adding back depreciation and amortization. Further, the SEC staff clarified that FFO may be presented on a basis other than that defined by NAREIT, if such a departure from the NAREIT definition is clearly disclosed in the registrant's filing.

Resources

2010 SEC annual reports: Reports to shareholders Form 10-K (SCORE No. CC0305), Ernst & Young, 2011.

Retail and consumer products supplement

In the following supplement, we analyze specific trends in SEC staff comment letters related to the retail and consumer products industries. The topics in this supplement should be considered in conjunction with the topics in the main section and other appendices of this publication that also may be relevant to registrants in the retail and consumer products industries.

Accounting for and disclosure of gift card breakage

Summary of issues noted

The SEC staff continues to request 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 also is interested in expanding the 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 (or) services during a redemption period, which may be specified or unspecified in duration. 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 as to how it should account for the breakage that is expected to or does occur.

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 into income any unused balances. 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:

- (1) Breakage is not estimated and recognized into income and therefore is carried on the balance sheet as a liability (i.e., deferred revenue) indefinitely.
- (2) 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 either (1) as gift cards are used for the purchase of goods or services (the "redemption recognition" method) or (2) 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 "delayed recognition" method).

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 continues to expect 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 in establishing the estimate
- ▶ The sensitivity of the estimates to changes in the underlying assumptions, customers' redemption patterns, seasonality or other factors
- ▶ 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 reported and also consider whether the estimates used to determine breakage should be discussed as a critical accounting estimate in MD&A.

Critical accounting estimates

Summary of issues noted

The SEC staff continues to request that registrants provide additional disclosures for 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 of the estimates and judgments in the valuation of 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 regarding 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 need to be recorded.

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

Resources

2010 SEC annual reports: Report to shareholders Form 10-K (SCORE No. CC0305), Ernst & Young, 2011.

Technology supplement

In the following supplement, we analyze specific trends in SEC staff comment letters related to the technology industry. The topics in this supplement should be considered in conjunction with the topics in the main section and other appendices of this publication that also may be relevant to registrants in the technology industry.

Inventory valuation

Summary of issues noted

Due to continued economic weakness and the potential increased risk of obsolescence, the SEC staff issues comments seeking clarification from registrants of their accounting estimates used to evaluate the carrying value of inventory. Registrants may be asked to provide additional information about the assumptions used to evaluate the carrying value of inventory, such as estimates of future demand and the accuracy of estimates used in the past. In addition, the SEC staff asks registrants to clarify the accounting treatment of inventory that had been previously written down.

Analysis of current issues

Many technology companies that manufacture or sell tangible goods face the risk of inventory obsolescence due to the rapid pace of innovation. ASC 330-10-35 provides guidance on the subsequent measurement and recognition for inventory items and states that a departure from using the cost basis to price inventory is required when the utility of the goods is no longer greater or equal to its cost. When there is evidence that the utility of goods will be less than cost, whether due to deterioration, obsolescence, changes in price levels or other causes, the difference should be recognized as a loss in the current period.

Determining the net realizable value of inventory may require significant judgment, and registrants must consider all facts and circumstances present in the market to determine if the utility of an inventory item has diminished below its carrying value. Factors to consider include historical and projected customer demand, pricing trends, the introduction of new or competing products, susceptibility to external factors (e.g., technological obsolescence), general economic conditions and other company-specific facts and circumstances. Registrants should consider disclosing the manner in which any write-downs are determined. When write-downs are significant, registrants should disclose the loss amount, and consider separately displaying the write-downs in the income statement as part of cost of goods sold.

Additionally, ASC 330-10-35 states that when goods are written-down below cost at the close of the fiscal year, the reduced amount is considered to be a new cost basis for purposes of subsequent accounting. Therefore write-downs are not reversed even if there is a recovery in market value prior to the inventory's sale or disposition. During the review process, the SEC staff may request that a registrant confirm that they followed this guidance when there appeared to be a recovery in the market value of previously written-down inventory.

Revenue recognition – VSOE of fair value

The SEC staff consistently asks for clarification of how various factors were considered by the registrant when evaluating VSOE for post-contract customer support.

Summary of issues noted

For transactions within the scope of the software revenue recognition guidance (ASC 985-605), the SEC staff continues to pose questions about 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, allowing the SEC staff to better assess the effectiveness of those processes and the vendor's conclusions. The SEC staff also continues to ask 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, as 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
- ▶ When stated renewal rates are above or below the "normal" range, how the arrangement consideration is allocated to PCS
- ▶ How negative pricing pressures on PCS renewal rates affect the assertion that stated contractual prices are substantive and within a narrow range

Resources

Financial reporting developments: Software – Revenue recognition, Accounting Standards Codification 985-605 (SCORE No. BB1946), Ernst & Young, April 2010.

Adoption of ASU 2009-14 for certain revenue arrangements that include software elements

Summary of issues noted

ASU 2009-14 modified the software revenue recognition guidance in ASC 985-605, with the amended guidance effective for fiscal years beginning on or after 15 June 2010 (i.e., the first quarter of 2011 for calendar year-end registrants). While the revised guidance allowed for early adoption, most registrants adopted it in their current fiscal year.

The changes in the guidance significantly affect how registrants account for revenue arrangements containing both hardware and software elements and are an area of recent SEC focus. 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 revises 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 require considerable professional judgment. ASU 2009-14 provides several indicators and examples for a registrant to consider when performing its analysis.

The SEC staff continues to seek clarification from registrants as to whether software components are considered essential to the functionality of a product. In addition, when the software components are determined to be nonessential to a product's functionality (and therefore within the scope of ASC 985-605), the SEC staff may seek clarification on how the total arrangement consideration is allocated among the non-essential software components and the hardware components. The arrangement consideration should be allocated to each separate unit of accounting of the non-essential software components and hardware components as a group 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, April 2010.

Reseller arrangements

Summary of issues noted

The SEC staff continues to ask registrants to provide more information including enhanced disclosure in future filings regarding their revenue recognition policies for sales to resellers and to disclose the key terms of those arrangements.

Analysis of current issues

Resellers, which may also be described as value-added resellers (VARs), distributors and channel partners, may be a significant source of recurring sales for a registrant. In some cases, a reseller may represent a registrant's only distribution channel for a specific product or geographic region. Accordingly, registrants may provide resellers with greater rights (e.g., stock rotation rights and price protection) than those it would provide to end customers to maintain a mutually beneficial relationship. Additionally, a registrant may provide concessions it is not contractually obligated to provide if a reseller is unable to sell delivered products to end customers.

The SEC staff continues to ask registrants to clarify in their disclosures whether they recognize revenue at the point when the product is delivered to the reseller (sell-in method) or at the point when the reseller sells the product on to its own customers (sell-through method). The SEC staff typically asks registrants to identify the basis for their accounting policy. Additionally, registrants using the sell-through method may be asked to describe the accounting treatment for inventory held by resellers, including impairment considerations.

The SEC staff often asks registrants to revise their subsequent filings to disclose the significant terms included in the arrangements with resellers, the nature and extent of return rights and price protection privileges, the qualitative and quantitative factors considered when making estimates of future product returns and price credits and clarification of the methodology used to calculate these estimates.

Resources

Financial reporting developments: Software – Revenue recognition, Accounting Standards Codification 985-605 (SCORE No. BB1946), Ernst & Young, April 2010.

Telecommunications supplement

In the following supplement, we analyze specific trends in SEC staff comment letters related to the telecommunications industry. The topics in this supplement should be considered in conjunction with the topics in the main section and other appendices of this publication that also may be relevant to registrants in the telecommunications industry.

Intangible assets – wireless licenses

Summary of issues noted

The SEC staff continues to ask registrants to provide additional disclosure regarding how they determine fair value for wireless licenses.

Analysis of current issues

Telecommunications registrants obtain licenses from the Federal Communications Commission (FCC) to operate their wireless communications services. These wireless licenses are issued for fixed periods of time, but renewal is typically routine, with nominal cost. Because there are usually no other political, regulatory or environmental factors that limit their useful lives, wireless licenses are commonly recorded as indefinite-lived intangible assets and, in accordance with ASC 350, are tested for impairment annually or more frequently if events or changes in circumstances indicate that the asset may be impaired.

The SEC staff asks registrants to describe the methodology used to determine the fair value of the wireless licenses acquired in a business combination. The SEC staff also requests additional disclosure related to the method and significant assumptions used to determine the fair value, including:

- ▶ A qualitative and quantitative description of the significant estimates and assumptions used in the valuation method to determine the fair value
- ▶ An explanation of how the free cash flow model isolates the cash flows associated with the license
- ▶ A description of the consideration the registrant gave to using a hypothetical build-up or start-up method to estimate the fair value of the wireless license

For further discussion, please refer to the Intangible assets section of this publication.

Resources

Financial reporting developments: Intangibles – Goodwill and other – Accounting Standards Codification 350 (SCORE No. BB1499), Ernst & Young, November 2009.

The SEC staff still requests additional disclosure about determining fair value of wireless licenses.

Appendix B: Foreign private issuers supplement

The SEC staff's comments to Foreign Private Issuers (FPIs) often are similar in nature to those received by domestic registrants. Therefore, many of the topics in the main and industry supplement sections of this publication are equally relevant for FPIs, such as:

- ▶ Risk factors
- ▶ MD&A matters, including comments on critical accounting estimates, results of operations and liquidity
- ▶ Accounting for significant accounts, including financial instruments, investments, intangibles, accruals that require judgment and contingencies, whether in accordance with US GAAP or IFRS
- ▶ Operating items, including revenue recognition, hedging, and impairment, whether in accordance with US GAAP or IFRS
- ▶ Oil, gas and mining reserves

Below are topics and specific matters that the SEC staff routinely asks FPIs about in the comment process. Certain of these topics, including activities with countries designated as state sponsors of terrorism, disclosure controls and procedures and US GAAP expertise, also apply to domestic registrants but have been included in this supplement as they are more frequently noted by the SEC staff in their review of FPI filings.

Activities with countries designated as state sponsors of terrorism

Summary of issues noted

The SEC staff regularly 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

The 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 disclosure of additional information if it constitutes material information that is necessary to make a registrant's disclosure in its filings not misleading, given the registrant's facts and circumstances. As a result, the SEC staff has frequently requested registrants to provide, and based on materiality to disclose, the following information regarding state sponsors of terrorism:

- ▶ 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 of designated state sponsors of terrorism

- ▶ Whether there are offices, facilities, equipment, ground services, sales agents or other employees in such a country
- ▶ 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 Department of Commerce's Commerce Control List
- ▶ Whether operations in or with state sponsors of terrorism constitute a material risk:
 - ▶ Materiality should be addressed in quantitative terms, including the approximate dollar amount of any revenues, assets and liabilities associated with such sponsors for the last several years and subsequent interim periods
 - ▶ Materiality should be addressed using 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 values; it should be addressed taking into consideration that various investors have proposed or adopted divestment or similar initiatives regarding investment in companies associated with designated state sponsors of terrorism

Corruption

Summary of issues noted

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

Analysis of current issues

The number of SEC enforcement cases has increased significantly in recent years, and FPIs are often targets. When an FPI is subject to a regulatory or judicial action, the outcome as well as root cause should be closely evaluated by the registrant for potential financial reporting implications. The SEC staff challenges the propriety and completeness of disclosures in the FPI's filings and financial statements. Sections of the filing often affected include: risk factors, legal proceedings, MD&A and financial statement disclosures.

Disclosure control and procedures

Summary of issues noted

The SEC staff frequently asks FPIs to more clearly and completely define disclosure controls and procedures in their evaluations. The SEC staff also asks FPIs to confirm whether information required to be disclosed by the registrant is accumulated and communicated to its management to allow timely decisions regarding required disclosures.

Analysis of current issues

The SEC defines disclosure controls and procedures as "controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports that it files or submits under the [Exchange Act] is recorded, processed, summarized and reported, within the time periods

specified in the Commission's rules and forms." Some FPIs have disclosed that they have such disclosure controls and procedures, but have not stated their procedures using the exact words described in the rules. The SEC requires that disclosure adhere to the exact wording provided in the Exchange Act.

Registrants also often include statements such as "even effective controls and procedures would only provide reasonable assurance of achieving the control objectives." The SEC staff routinely asks companies to clearly state that their "disclosure controls and procedures are designed to provide reasonable assurance of achieving their objectives and that the principal executive officer and principal financial officer concluded that the disclosure controls and procedures are effective at that reasonable assurance level."

Further, the SEC staff asks FPIs to confirm that their disclosure controls and procedures "ensure that information required to be disclosed by the Company is accumulated and communicated to its management to allow timely decisions regarding required disclosure."

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 frequently comments on when it expects differences, but no differences are identified in the reconciliation. In addition, when reconciling items are presented multiple times in the filing, the SEC staff frequently identifies inconsistencies between those various instances.

Analysis of current issues

When an expected reconciling item between home-country GAAP and US GAAP is not disclosed, the SEC staff asks why not. The SEC staff also continues to focus on business combination and goodwill accounting differences between home-country and US GAAP and frequently asks registrants to clarify the reconciliation adjustments between the two GAAPs. In recent comment letters, the SEC staff has focused on the following topics related to business combinations:

- ▶ Intangible assets acquired and amortization periods
- ▶ Net income attributable to noncontrolling and controlling shareholders
- ▶ Goodwill amortization and how the tax effect of the amortization is recognized
- ▶ Goodwill impairment

The SEC staff also frequently asks registrants to expand the details in their reconciliations for differences in business combination accounting between the GAAPs and to provide summarized US GAAP information.

Other areas of interest by the SEC staff related to the differences between home-country GAAP and US GAAP include the nature of non-operating expenses, asset retirement obligations and pension accounting.

Non-GAAP financial measures

Summary of issues noted

The SEC staff frequently challenges FPIs on whether non-GAAP financial measures disclosed in the filing are required or expressly permitted by local accounting and disclosure standards. In these cases, the non-GAAP measures may be presented pursuant to a Regulation G exemption without significant additional disclosure. 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.

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 considers non-GAAP financial measures. The SEC staff evaluates all non-GAAP items, including percentages, shares and per share amounts. When such non-GAAP items are presented and do not appear to qualify for the Regulation G exemption, the SEC staff asks FPIs to address the following:

- ▶ Whether such item is required or permitted by the issuer's reporting framework
- ▶ The literature that the company relied on to prove that the issuer's reporting framework either requires or permits the use of such item
- ▶ When permitted, the economic substance behind management's decision to use such item

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

- ▶ An explanation of how the item provides meaningful information to investors
- ▶ The manner in which management uses the non-GAAP item to conduct or evaluate its business
- ▶ Whether it is probable that the financial impact of recurring items (if any) that are excluded from non-GAAP measures will disappear or become immaterial in the near term and the basis for such conclusion
- ▶ The material limitations associated with use of the non-GAAP measure as compared to the use of the most directly comparable GAAP measures and the manner in which management compensates for these limitations when using the non-GAAP financial measures
- ▶ 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 non-GAAP measure titles and descriptions that are the same as, or similar to, titles or descriptions used in US GAAP or IFRS.

Principal executive and financial officer certifications

Summary of issues noted

The SEC staff often observes missing or incomplete information about principal executive and financial officer certifications in FPI filings. The SEC staff frequently requests that FPIs file certifications by principal executive and financial officers as an exhibit to Form 20-F rather than in the body of the filing.

Analysis of current issues

Section 906 of the Sarbanes-Oxley Act requires a separate certification by the CEO and CFO (or their equivalent) to “accompany” each periodic report that includes financial statements. SEC rules require that such certifications by principal executive and principal financial officers be filed with Form 20-F as exhibits.

FPIs are prone to mistakenly file only a principal executive’s certification or only a principal financial officer’s certification rather than both. Additionally, FPIs often incorrectly file these certifications in the body of the filing rather than in the exhibits, and the SEC staff often will request that such FPIs correct and amend previously submitted documents. The SEC staff considers annual reports on Form 20-F not to have been filed in a timely manner when required certifications (both the principal executive and financial officers) were omitted.

US GAAP expertise

Summary of issues noted

The SEC staff frequently asks FPIs to provide the background of those involved in financial reporting and also to describe the qualifications of an audit committee financial expert.

Analysis of current issues

Under a relatively recent initiative, the SEC staff has been requesting that FPIs, particularly those reporting under US GAAP, provide background information on individuals who are primarily responsible for the preparation of its books and 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 information about individual(s) identified in the inquiry:

- ▶ What role he or she plays in preparing the financial statements and evaluating the effectiveness of internal control
- ▶ What relevant education and ongoing training he or she has had relating to US GAAP and SEC reporting
- ▶ Whether he or she holds and maintains any professional designations such as US Certified Public Accountant or Certified Management Accountant
- ▶ His or her professional experience, including experience in preparing or auditing financial statements prepared in accordance with US GAAP and evaluating effectiveness of internal control over financial reporting
- ▶ The nature of his or her contractual or other relationship to the company

When no members of management have experience with US GAAP, the SEC staff also questions how effective internal controls over financial reporting exist to prepare financial statements in accordance with US GAAP. In those situations, the SEC staff expects such a registrant to explain how it achieves effective internal control over financial reporting (e.g., 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 qualification of its employees who perform the services
- ▶ How and why it is qualified to prepare the financial statements or evaluate the internal control over financial reporting
- ▶ Total amount of 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 related to the effectiveness of internal control
- ▶ Discuss how the company plans to remedy the material weakness
- ▶ Disclose the impact of this weakness on management's conclusion regarding disclosure controls and procedures
- ▶ Consider addressing 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.

Appendix C: SEC review process and best practices

The Division of Corporation Finance (DCF) of the SEC selectively reviews filings made under the Securities Act of 1933 and the Securities Exchange Act of 1934 to monitor and enhance compliance with the applicable disclosure and accounting requirements. In its filing reviews, the DCF concentrates its resources on disclosures and applicable accounting standards that may be in conflict with SEC rules or in need of additional explanation or clarity.

Required and selective review

As required by the Sarbanes-Oxley Act of 2002, the DCF staff undertakes some level of review of every registrant at least once every three years and reviews many registrants more frequently. In addition, the DCF staff generally reviews all IPOs and Form 8-Ks on Items 4.01 and 4.02 and selectively reviews other transactional filings, such as those made in connection with a business combination transaction, proxy statements or other public offerings. In many cases, the DCF staff will conduct a preliminary review prior to determining what level of further review to conduct, as discussed below.

Due to the increased regulation affecting the banking industry, last year the DCF created a new office within its disclosure operations that is specifically responsible for the review of large financial institutions. This office, Assistant Director's Office 12 (AD 12) – Financial Services II, is currently assigned to perform reviews on approximately 60 of the largest banks and certain government sponsored entities. The number of registrants assigned to AD 12 is expected to increase over time. The DCF staff has commented that the filing review process for registrants assigned to AD 12 is consistent with registrants assigned to other offices, but there are "continuous reviews" of some registrants assigned to AD 12 (e.g., reviewing and commenting on each filing, as well as intervening press releases). It is expected that the DCF staff in AD 12 will be discussing accounting and disclosure implications of reported events and developments on a real-time basis with registrants via telephone. Sometimes these discussions may resolve the DCF staff's questions without the need to issue a formal comment letter or receive a written response from the registrant.

Levels of review

If the 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 the DCF staff examines the entire filing for compliance with the applicable requirements of the federal securities laws and regulations
- ▶ A financial statement review in which the DCF staff examines the financial statements and related disclosure, such as Management's Discussion and Analysis of Financial Condition and Results of Operations, for compliance with the applicable accounting standards and the disclosure requirements of the federal securities laws and regulations

The DCF created a new office within its disclosure operations that is specifically responsible for the review of large financial institutions.

- ▶ A targeted issue review in which the DCF staff examines the filing for one or more specific items of disclosure for compliance with the applicable accounting standards or the disclosure requirements of the federal securities laws and regulations

When the DCF staff believes that a registrant can enhance its disclosure or improve its compliance with the applicable disclosure requirements, it provides the registrant with comments. The range of possible comments is broad and depends on the issues that arise in a particular filing review. The DCF staff completes many filing reviews without issuing any comments. In such cases, the registrants will not receive any notification that their SEC filings were reviewed.

In addition to an initial reviewer, at least one other senior DCF staff member typically reviews a filing and proposed comments to help achieve consistency in comments across filing reviews.

DCF staff comments

The DCF staff views the comment process as a dialogue with a registrant about its disclosures. The DCF staff's comments are in response to a registrant's disclosure and other public information (e.g., company websites, press releases, analyst calls) and are based on the DCF staff's understanding of that registrant's facts and circumstances. To send comment letters to registrants, the DCF staff has traditionally used facsimile, but has recently begun using electronic mail. In their comments, the DCF staff may request that a registrant provide additional supplemental information in order to better evaluate the registrant's disclosure, revise or supplement disclosure in the registrant's SEC filing(s), or provide additional or different disclosure in a future filing with the SEC.

Best practices for registrant responses to comments

A registrant generally responds to each comment in a letter to the 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 be supported by 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.
- ▶ If revisions were being made to a filing as a result of a comment from the DCF staff, responses should indicate specifically where these revisions were made.
- ▶ Responses should be checked for accuracy by appropriate internal personnel and professional advisors (e.g., legal counsel and independent auditors).

Registrants should not assume that because the 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 the DCF staff beyond the existing disclosure may help the DCF staff better understand the accounting and

disclosure and could resolve the comment. To facilitate such responses to the SEC staff, registrants should maintain contemporaneous documentation of significant accounting decisions. Judgment applied and documented contemporaneously is more persuasive than a retrospective defense of the accounting only following receipt of a DCF staff comment.

Depending on the nature of the issue, the DCF staff's concerns and the registrant's response, the DCF staff may issue additional 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 through all appropriate levels of review. Registrants also may consider contacting the DCF staff if additional clarification is needed on a comment. In general, the DCF staff is open to registrants being proactive throughout the comment process (e.g., by sharing proposed revisions to filings with the DCF staff prior to filing them).



The DCF staff is open to working with registrants throughout the comment process.

Closing a filing review

When a registrant has satisfactorily resolved all the DCF staff's comments on an Exchange Act registration statement, a periodic or current report or a preliminary proxy statement, the DCF staff provides the registrant with a "no further comment" letter to confirm that its review of the filing is complete.

To increase the transparency of the review process, when the DCF staff completes a filing review, it makes its comment letters and registrant responses to those comment letters public on the SEC's EDGAR system. The DCF staff makes this correspondence public no earlier than 45 days after it has completed its review of a periodic or current report or declared a registration statement effective.

Reconsideration process

While the DCF staff and registrant may ultimately disagree with the final outcome of a comment, a registrant should, in any instance it wishes, seek reconsideration of a comment by other SEC staff, including those within the DCF's Office of the Chief Accountant (DCF-OCA).

The DCF staff members, at all levels, are available to discuss disclosure and financial statement presentation matters with a registrant and its legal, accounting and other advisors. A registrant may request that the DCF staff reconsider a comment or reconsider a DCF staff member's view of the registrant's response to a comment at any point in the filing review process. The 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 request the SEC's Office of the Chief Accountant (OCA) to reconsider an accounting conclusion expressed by the staff in the DCF. Generally, the OCA addresses questions concerning the application of generally accepted accounting principles while the DCF resolves matters concerning the age, form and content of financial statements required to be included in a filing. The staff in the DCF will often consult initially with the DCF-OCA and then with the OCA. A registrant would initiate a reconsideration by the OCA by informing the staff in the DCF of its intention to request such reconsideration. In these circumstances, a registrant does not need to make a submission directly to the OCA if all of the relevant information is contained in comment letter responses from the registrant to the DCF, although a separate submission to the OCA may serve to expedite the process. Further discussion of the procedures for consulting with the OCA are set forth on the SEC's website at <http://www.sec.gov/info/accountants/ocasubguidance.htm>.

Disclosure requirements

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

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

The disclosure must be sufficient to disclose the substance of the comments. DCF staff comments that have been resolved, including those that the DCF staff and 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.

Appendix D: Abbreviations

Abbreviation	FASB Accounting Standards Codification
ASC 230	FASB ASC Topic 230, <i>Statement of Cash Flows</i>
ASC 235	FASB ASC Topic 235, <i>Notes to Financial Statements</i>
ASC 250	FASB ASC Topic 250, <i>Accounting Changes and Error Corrections</i>
ASC 275	FASB ASC Topic 275, <i>Risks and Uncertainties</i>
ASC 280	FASB ASC Topic 280, <i>Segment Reporting</i>
ASC 310	FASB ASC Topic 310, <i>Receivables</i>
ASC 320	FASB ASC Topic 320, <i>Investments – Debt and Equity Securities</i>
ASC 330	FASB ASC Topic 330, <i>Inventory</i>
ASC 350	FASB ASC Topic 350, <i>Intangibles–Goodwill and Other</i>
ASC 360	FASB ASC Topic 360, <i>Property, Plant, and Equipment</i>
ASC 450	FASB ASC Topic 450, <i>Contingencies</i>
ASC 470	FASB ASC Topic 470, <i>Debt</i>
ASC 480	FASB ASC Topic 480, <i>Distinguishing Liabilities from Equity</i>
ASC 605-25	FASB ASC Topic 605-25, <i>Revenue – Multiple-Element Arrangements</i>
ASC 605-28	FASB ASC Topic 605-25, <i>Revenue – Milestone Method</i>
ASC 605-45	FASB ASC Topic 605-45, <i>Revenue – Principal Agent Considerations</i>
ASC 605-50	FASB ASC Topic 605-50, <i>Revenue – Customer Payments and Incentives</i>
ASC 715	FASB ASC Topic 715, <i>Compensation – Retirement Benefits</i>
ASC 718	FASB ASC Topic 718, <i>Compensation – Stock Compensation</i>
ASC 740	FASB ASC Topic 740, <i>Income Taxes</i>
ASC 805	FASB ASC Topic 805, <i>Business Combinations</i>
ASC 810	FASB ASC Topic 810, <i>Consolidation</i>
ASC 815	FASB ASC Topic 815, <i>Derivatives and Hedging</i>
ASC 820	FASB ASC Topic 820, <i>Fair Value Measurement</i>
ASC 860	FASB ASC Topic 860, <i>Transfers and Servicing</i>
ASC 932	FASB ASC Topic 932, <i>Extractive Activities – Oil and Gas</i>
ASC 944	FASB ASC Topic 944, <i>Financial Services – Insurance</i>
ASC 958	FASB ASC Topic 958, <i>Not-for-Profit Entities</i>
ASC 970	FASB ASC Topic 970, <i>Real Estate – General</i>
ASC 985-605	FASB ASC Topic 985-605, <i>Revenue Recognition [Software]</i>

Abbreviation	Other Authoritative Standards
ASU 2009-13	Accounting Standards Update No. 2009-13, <i>Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements—a consensus of the FASB Emerging Issues Task Force</i>
ASU 2009-14	Accounting Standards Update No. 2009-14, <i>Software (Topic 985): Certain Revenue Arrangements That Include Software Elements—a consensus of the FASB Emerging Issues Task Force</i>
ASU 2010-06	Accounting Standards Update No. 2010-06, <i>Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements</i>
ASU 2010-20	Accounting Standards Update No. 2010-20, <i>Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses, July 2010</i>
ASU 2011-07	Accounting Standards Update No. 2011-07, <i>Health Care Entities (Topic 954): Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities (a consensus of the FASB Emerging Issues Task Force)</i>
FSP APB 14-1	FASB Staff Position APB 14-1, <i>Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)</i>
SAB Topic 1-M	SEC Staff Accounting Bulletin Topic 1-M, <i>Materiality</i>
SAB Topic 11-B	SEC Staff Accounting Bulletin Topic 11-B, <i>Depreciation and Depletion Excluded from Cost of Sales</i>
SAB Topic 13	SEC Staff Accounting Bulletin Topic 13, <i>Revenue Recognition</i>
SAB Topic 14	SEC Staff Accounting Bulletin Topic 14, <i>Share-Based Payment</i>



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