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Heads Up for the 2016 Form 10-K and Beyond:

Staff Guidance on "New GAAP" Transition Disclosures, Use of Non-GAAP Measures and Other Key Issues

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At three significant year-end conferences, members of the SEC's senior accounting and legal staff reinforced previously delivered guidance on several key financial reporting issues relevant to preparation of upcoming earnings releases, the 2016 Form 10-K and subsequent filings. We expect that the announced departures of SEC Chair Mary Jo White, Division of Corporation Finance Director Keith Higgins and Division of Enforcement Director Andrew Ceresney will not diminish the career staff's promised close scrutiny in the new year of how well companies are following this guidance. Whether or not the Enforcement Division's vigorous pursuit of accounting, internal controls and auditor independence cases will continue under the next administration is somewhat more difficult to predict, however, and will bear watching.

The financial reporting guidance discussed in this Alert is drawn from staff remarks delivered at Practising Law Institute's 48th Annual Institute on Securities Regulation held on November 2-4, the Fall Meeting of the ABA Committee on Federal Regulation of Securities held on November 18-19, and the AICPA National Conference on Current SEC & PCAOB Developments held on December 5-7, 2016. We also cover staff guidance for the next round of conflict minerals disclosure, which was delivered at the PLI conference. Throughout this Alert we provide practical tips in "***What to do Now?***" sections.

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I. "New GAAP" Transition Disclosures

Perhaps the most challenging set of financial reporting issues highlighted at the three major year-end conferences relates to the implementation of several important new GAAP standards: revenue recognition (to be effective in 2018; early adoption permitted), leases (2019), and financial instruments/credit losses (2018 for recognition and measurement; 2020 for credit losses). The issues fall into two basic categories: (1) the need to develop required "transition" disclosures for financial statement footnotes and, possibly, the MD&A, and (2) the need to update disclosure controls and procedures and internal control over financial reporting (ICFR) to ensure that the information needed for this disclosure – as well as full compliance with the new standards upon adoption -- is collected and elevated to the CEO and CFO in a timely manner and forms the basis for their mandatory certifications of periodic reports.

By far the staff's most pressing concern, as articulated at these conferences, is the degree to which companies are prepared for the sweeping new revenue recognition standard (ASU No. 2014-09, *Revenue from Contracts with Customers (Topic 606))*. As SEC Chief Accountant Wesley Bricker emphasized, almost every company's "top-line revenue," and thus the income statement items flowing from it, will be affected – beginning with fiscal 2016 for those companies opting for full retrospective adoption in early 2018. He cautioned that the new standard not only requires much more extensive and disaggregated footnote disclosure, but also may change the timing of revenue recognition and, therefore, of earnings. He noted with concern the results of a recent PwC survey suggesting that 8% of the public companies surveyed have not even started the technical assessment process, and about 75% of those surveyed have not started implementation efforts and therefore do not yet have a good handle on the implications of adoption for financial ratios and other metrics embedded in existing contracts.[1]

SAB 74 Disclosure

Staff Accounting Bulletin No. 74, Topic 11.M., *Disclosure of the Impact that Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period,* imposes financial statement footnote disclosure requirements in advance of a company's adoption of a new accounting standard. These disclosures may also be relevant to the MD&A if critical accounting estimates are involved (*e.g.,* known trends, events and uncertainties disclosure). With regard to revenue recognition and the other two looming "New GAAP" standards underscored at the conferences, the SEC staff expects to see the following in the upcoming SAB 74 disclosures (whether in the 2016 Form 10-K or quarterly reports on Form 10-Q): (1) quantitative disclosures of directional effects of adoption, if known, and the anticipated date and method of adoption (in the case of revenue recognition, full vs. modified retrospective); (2) qualitative information on the status of management's implementation efforts; and (3) any additional information, whether quantitative or qualitative, that may be necessary to enable investors to understand the company's progress on implementation.[2] In their remarks, Mr. Bricker and his SEC Office of the Chief Accountant ("OCA") colleagues seemed to suggest that the staff is also looking for disclosures beyond the plain language of SAB 74, such as: (1) enumeration of open items not yet addressed as part of a company's implementation plan; and (2) quantitative estimates of the effects on specific product categories or revenue streams if reasonably determinable, even if the overall revenue effects are not yet calculable.

Controls

The staff recognizes that SAB 74 disclosures are preliminary in nature and has indicated, fortunately, that it will not assume that subsequent changes in disclosed estimates as the effective date of a standard approaches necessarily reflect a control deficiency relating to prior disclosures. However, according to OCA staff member Sylvia Alicea, the company's disclosures should evolve over time and be consistent with information provided to the Audit Committee and investors. Moreover, "[a]s management completes portions of its implementation plan and develops an assessment of the anticipated impact, effective internal controls should be designed and implemented to timely

identify disclosure content and ensure that appropriately informative disclosure is made."[3] Bottom line, we expect the staff to pay close attention not only to the accounting policy footnote addressing the impact of adoption of the new GAAP – with a particular emphasis on revenue recognition – but also to a company's quarterly disclosures of any material changes to ICFR, given the magnitude of the implementation process that managers will be facing in 2017.

Both SEC Chief Accountants emphasized that Audit Committees need to be in the informational loop now, and that committee members should be asking their companies' outside auditors what they think of management's implementation efforts. This is consistent with the SEC's general focus, in the financial reporting and enforcement contexts, on the responsibilities of key "gatekeepers" – Audit Committees and outside auditors – and the importance of "tone at the top," including the quality of Audit Committee oversight as part of the control environment. Mr. Bricker pointedly observed in his AICPA keynote address: "Particularly for companies where implementation is lagging, preparers, their audit committees and auditors should discuss the reasons why [implementation is lagging] and provide informative disclosures to investors about the status so that investors can assess the implications of the information. Successful implementation requires companies to allocate sufficient resources and develop or engage appropriate financial reporting competencies."[4]

Implications of Adopting the New Revenue Recognition Standard on Shelf Registration (Forms S-3 and S-8):

Keith Higgins, the outgoing Director of the Division of Corporation Finance, and Division Deputy Chief Accountant Nili Shah, addressed company concerns regarding the impact of adoption of the new revenue recognition standard on shelf access to the capital markets in 2018. Those companies opting for the full retrospective transition method to adopt ASC Topic 606, for fiscal years beginning on or after December 15, 2017, must provide retrospectively recast financial statements for the most recent annual periods required to be included in registration statements. This would not be the case if a company were to choose the modified retrospective adoption method, which does not call for recasting any historical financial statements that pre-date adoption.

Consistent with the accounting staff's position outlined in Topic 13 of the Division of Corporation Finance's Financial Reporting Manual ("FRM"),[5] a calendar-year registrant that adopts new ASC 606 on January 1, 2018, and opts for full retrospective transition would have to recast its financial statements accordingly in the Form 10-Q for the first quarter of fiscal 2018. If the company were to file a new shelf registration statement after the Form 10-Q is filed, Item 11(b)(ii) of Form S-3 would require retrospective revision of pre-adoption audited financial statements incorporated by reference into the Form S-3. For purposes of our example, this would require the registrant to go back and recast the three-year historical financials included in its 2017 Form 10-K – which would encompass fiscal 2015. In contrast, if the company were to forego filing a new shelf registration statement post-adoption of ASC 606 in 2018, its fiscal 2018 Form 10-K (to be filed in early 2019) would go back only three fiscal years beginning with fiscal 2016. (FRM Section 13110.3). Ms. Shah advised companies that wish to avoid recasting the fiscal 2015 financial statements in this situation could invoke the "impracticability" exception in ASC Topic 250 (Accounting Changes and Error Corrections) – but she suggested advance consultation with the staff on specific fact patterns (without expressly stating that this is mandatory).

Companies with an effective shelf registration statement on file with the SEC prior to full retrospective adoption of ASC 606 in early 2018 may be more fortunate, because the Division accounting staff's analysis is different for shelf takedowns. As explained in the FRM (Section 13110.2), "a prospectus supplement used to update a delayed or continuous offering registered on Form S-3 (e.g., a shelf takedown) is not subject to the Item 11(b)(ii) updating requirements. Rather, registrants must update the prospectus in accordance with S-K Item 512(a) with respect to any fundamental change." Mr. Higgins helpfully noted that he would be "surprised" if anyone were to conclude that adoption of the new revenue standard represented a "fundamental change" within the meaning of the S-K Item 512(a) undertaking, and stated that the staff would not challenge management conclusions that adoption of ASC 606 did not rise to the level of a "fundamental change."

At the conferences, SEC staffers did not discuss the impact on Form S-8 shelf registration statements (for offerings under employee benefit plans) of the adoption by a company of the new revenue recognition standard. However, the Division of Corporation Finance has previously provided guidance for disclosing the impact of changes in accounting principles: "financial statements for which Item 11(b)(ii) of Form S-3 would require restatement may not necessarily need to be restated for incorporation by reference in a Form S-8." [6]

Implications of Adopting the New Revenue Recognition Standard on Segments

SEC Chief Accountant Bricker warned that changes in revenue recognition and measurement methodology could alter the reporting package provided to the Chief Operating Decision Maker ("CODM"), and therefore have an impact on segment determinations. The OCA and Division of Corporation Finance staff will be monitoring this space closely in 2017, as further discussed below, to see whether GAAP segment changes are warranted upon adoption of the new revenue recognition standard.

What To Do Now?

- **Follow a Multi-Disciplinary Process to Analyze the Impact of New GAAP.** The full impact of the new revenue recognition standard, and the other New GAAP on the relatively near horizon, may not be obvious at first glance. The new standards, particularly revenue recognition, may affect the financial ratios and other metrics in debt covenants, compensation arrangements and other existing contracts. Accordingly, companies should assemble a multi-disciplinary team including not only accounting and financial personnel but also IT, legal, tax, human resources and operations. In addition to searching for implications of the new revenue standard for specific products and revenue streams, the team should focus on consistency in the application of the new standard across all aspects of the business – whether in existing contracts, or contracts entered into following adoption.
- **Focus on ICFR.** Applying the COSO 2013 framework, critically review the control environment surrounding the application of each new accounting standard, the underlying systems needed for each such application and the disclosures of the impact of the new standard on the company's business.
- **Keep the Audit Committee Informed.** The Audit Committee must serve as the "gatekeeper" for the company's implementation of the New GAAP standards and oversee the cross-functional approach, updating of ICFR and evolving disclosures to be included in SEC filings. We recommend that the Audit Committee consider the practical guidance provided by the Center for Audit Quality, in a recent publication entitled Preparing for the New Revenue Recognition Standard (December 2016), which is available at www.caq.org.
- **Include Pre-Adoption Implementation Disclosure.** We suggest following the staff's lead in prioritizing revenue recognition transition disclosures. During implementation, even if no final measurement has been made with respect to the overall impact of adoption on the consolidated entity's total revenues, to the extent determinable for specific product categories and/or revenue streams, include quantitative disclosure, if reasonably estimable, and necessary qualitative disclosure. Note that the disclosure must provide investors with an understanding of the company's progress in implementing the new standard. For example, as suggested by one of the "Big Four" U.S. accounting firms in the case of the new revenue recognition standard, pre-adoption implementation disclosure might include a discussion, as applicable, of: (1) the expectation of more, less or similar performance obligations and whether revenue would be recognized earlier, later or remain the same; (2) the possibility of earlier revenue recognition for contingent amounts of variable consideration; (3) the need to recognize revenue later for certain contracts that previously were recognized over time using the percentage-of-completion model; and (4) recognition of revenue earlier because of revenue previously recognized under the completed-contract method that will be recognized over time under the new standard. [7]

II. Use of Non-GAAP Financial Measures

Much of the staff's air time at the three major conferences was devoted to the Division of Corporation Finance's May 2016 Compliance and Disclosure Interpretations ("CDIs") on the use of non-GAAP measures in earnings releases submitted to the SEC under cover of Form 8-K, Item 2.02, SEC filings (Item 10(e) of Regulation S-K) and all formal and informal company communications (Regulation G).[8] Division Chief Accountant Mark Kronforst struck an optimistic note, observing at the AICPA conference that companies had made substantial progress in addressing problems with undue non-GAAP prominence in earnings presentations. But companies should expect continuing heightened scrutiny of the following key elements of the updated CDIs (some of which are reflected in the examples of recent non-GAAP comments from the Division attached as Annex A):

- **Prominence:** In the staff's view, the GAAP number ALWAYS has to come first, including in the text of the earnings release and the GAAP reconciliation. To our knowledge, the necessity of having GAAP precede non-GAAP numbers in the mandated reconciliation was first mentioned at the AICPA conference (although comment letters raising this point reportedly have been issued).
- **Individually Tailored Non-GAAP Measures:** The staff is still seeing problems with management's use of individually tailored non-GAAP measures, such as adjusted revenue, that add in revenues whose recognition must be deferred to future periods under GAAP. Exceptions are those companies, like Microsoft, that wish to show the anticipated impact of their transition to the new GAAP revenue recognition standard (the example of a permissible presentation discussed at the AICPA conference, which Microsoft had cleared with the staff, was disclosure of Windows 10 revenue streams under the old and new standards; Microsoft will be an early adopter in July 2017).
- **Backing Out Normal Operating Expenses:** Another continuing problem area for the staff is backing out normal operating expenses from earnings. One example is marketing costs, the subject of the Groupon IPO controversy of a few years ago. While the Division is not on a mission to prevent companies from excluding recurring restructuring costs so long as they are not mischaracterized (*e.g.,* as non-recurring), staff members will raise comments if they see five-plus years' worth of these costs carved out of earnings. (Note in this regard that the staff does listen to earnings calls, and reviews website disclosures and prior earnings releases, of those companies whose documents are selected for review in order to gauge the consistency of management communications over time.) Regardless of whether these costs are described correctly as recurring, the question is, ultimately, whether such exclusions are misleading. The "bottom-line" message: it is misleading to exclude normal operating expenses, particularly those payable in cash, even if you do not mislabel them as non-recurring.
- **Stock Compensation Expenses.** According to Mr. Kronforst, the staff generally will not object to the exclusion of stock compensation expenses from non-GAAP earnings presentations. Despite this statement, he did appear intrigued by an explanation from Microsoft's Chief Accounting Officer, Frank Brod, of why that company does not exclude compensation expenses from GAAP earnings. Investors have not asked for this carve-out, Mr. Brod explained, and the company believes that compensation reflects the true cost of doing business.
- **Other Problematic Non-GAAP Measures:** Also discussed as misleading at the conferences: (a) "cherry-picking" by disclosing one-time gains but not losses in non-GAAP measures; and (b) non-GAAP presentations that include equity investee revenues in the consolidated entity's revenues on some theory of proportionate consolidation, because of management's lack of control of investees (by definition, if not consolidated). This has been a particular problem in the REIT industry. The staff also has objected to non-GAAP EPS numbers, and adjustments to accounting for inventory that were not in conformity with GAAP. Exclusions the SEC accounting staff members are still considering, but have not decided upon, are pension expenses and the cost of derivatives that do not qualify for hedge accounting.

The two Chief Accountants declined to discuss what one non-staff panelist described as the "800-pound elephant in the room" -- the recently reported spate of Enforcement Division letters that many companies have received asking for "voluntary production" of documentary support for non-GAAP earnings measures used in earnings releases that pre-dated the May 2016 CDIs. Another accounting panelist (a lawyer) observed that some companies have been confused by the different approaches taken by the Divisions of Enforcement and Corporation Finance. There seemed to be a common perception, on the part of speakers in private practice, that Corp Fin has been more flexible in allowing companies to come into compliance with the new CDIs, whereas Enforcement seems to be ignoring them and probing pre-May 2016 non-GAAP disclosures. When asked during the PLI enforcement panel about the non-GAAP "enforcement sweep," departing Director of Enforcement Andrew J. Ceresney also declined to comment because of the ongoing nature of the sweep, but reiterated that the Enforcement Division *also is focused* on reconciliations to GAAP of non-GAAP measures and the relative prominence of GAAP vs. non-GAAP presentations. Mr. Ceresney further noted that the SEC recently brought a case that he characterized as involving improper use of non-GAAP measures against a REIT.[9]

Controls

Many companies appear to be heeding outgoing Chair White's warning, delivered in a June 2016 speech, that Audit Committees must be vigilant in overseeing management's use of non-GAAP measures. For example, the DuPont VP and Controller, Jeanmarie Desmond, explained during the AICPA conference how management stepped back and took a hard look at the company's usage of non-GAAP measures in the wake of the May 2016 CDIs, reviewing them with the company's Audit Committee. Microsoft's Frank Brod likewise stated that his company's audit committee is very active and engaged in the oversight of non-GAAP disclosures, noting that the company adopted a policy for such usage that was approved by the Audit Committee and which, among other things, provides for Audit Committee review of earnings releases prior to their issuance.

These practices make good sense, given the applicability of the SEC's disclosure controls and procedures requirements to non-GAAP disclosures in earnings releases furnished to the SEC under cover of Form 8-K and other, non-filed corporate communications with investors. (Of course, the SEC's ICFR and disclosure controls and procedures requirements apply to GAAP calculations and disclosures presented in the financial statements and accompanying footnotes). On a reassuring note, Mr. Kronforst indicated that the staff will not view changes a company makes to implement the May 2016 CDIs as signaling a possible deficiency in prior period disclosure controls and procedures described as effective.

What to Do Now?

Management should discuss with the Audit Committee, on a regular basis, the SEC's evolving positions on the appropriate use of non-GAAP financial measures, as communicated through the Division of Corporation Finance's May 2016 CDIs and comment letters, as well as speeches from senior SEC officials and, however infrequent they might be, relevant agency enforcement cases. In connection with this dialogue, we recommend that the Audit Committee ask these questions formulated by Chair White:

- What are you trying to accomplish by using the measure?
- Do you use the measure consistently?
- Do you use the measure internally?
- What is the measure meant to communicate?
- Does the measure change quarter to quarter to get management to its expectations or is it a true, consistent measure of company performance?
- Is the quality of the numbers subject to strong ICFR (noting that the same level of Sarbanes-Oxley Act control review should be applied to non-GAAP measures as GAAP measures)?

- How does the company's non-GAAP measure differ from approaches taken by other companies?[10]

III. Other Staff Guidance for the 2016 Form 10-K and Beyond

Continued Focus on ICFR

The SEC staff continues to emphasize the need for timely and effective communication on ICFR matters between and among management, Audit Committees and the outside auditors. Marc Panucci, a new OCA Deputy Chief Accountant, highlighted a "pure" ICFR case brought in March 2016 against Magnum Hunter Resources Corporation, members of the company's management, the audit partner and an outside SOX consultant, based in major part on an inadequate evaluation of the severity of an identified control deficiency and the failure to enhance accounting resources as the company grew.[11] Three important takeaways from this case, from Mr. Panucci's perspective, are the following:

- First, management has the responsibility to carefully evaluate the severity of identified control deficiencies and to report, on a timely basis, all identified material weaknesses in ICFR. Any required disclosure should allow investors to understand the cause of the control deficiency and to assess the potential impact of the identified material weakness.

- Second, it is important to maintain competent and adequate accounting staff to reflect the company's transactions accurately and, as necessary, to augment internal resources with qualified external resources. Qualified accounting resources and appropriate processes and controls will be of particular importance in implementing the new accounting standards.

- Finally, management has to take responsibility for its assessment of ICFR. That responsibility cannot be outsourced to third party consultants. At the same time, however, third party consultants can play an important and critical role when assisting management in its evaluation of ICFR.

Kevin Stout, OCA Senior Associate Chief Accountant, encouraged Audit Committees and management of public companies to consider the results of PCAOB inspection findings with respect to ICFR audit deficiencies and examine whether any of these deficiencies might be attributable, at least in part, to management failures to identify in a timely manner the level and/or severity of control deficiencies. After noting some improvements in management "early warning" disclosures of material weaknesses prior to announcement of a restatement, Mr. Stout asked preparers to do their best to achieve a "meeting of the minds" with their external auditors on identification of the most significant risks of material misstatement through careful application of the SEC's 2007 interpretive guidance on management reporting on ICFR,[12] which is designed to "sync up" management's ICFR analytical framework with the PCAOB's Auditing Standard No. 5 (to be known, beginning on December 31, 2016, as AS 2201).

Tax Disclosures in MD&A

As part of the staff's continued focus on the "known trends and uncertainties" disclosure in MD&A, Nili Shah, the Division of Corporation Finance's Deputy Chief Accountant, singled out for critical comment companies' failure to heed staff comments in prior years regarding the importance of explaining to investors how current tax situations might affect future results. In particular, the staff wants to see disclosures aimed at helping investors understand the trends and uncertainties associated with changes in statutory and effective tax rates ("ETR"), the extent to which historical ETR is expected to be indicative of future tax rates, the effect of taxes on liquidity (impact of cash taxes paid), and uncertainties in tax positions. Another area the staff is targeting is the failure of some issuers to describe the reasons for reversing a tax valuation allowance in a given year – i.e., the possible sources of taxable income used

to support the reversal of valuation allowances on deferred tax assets. Unless the staff sees some improvement in the quality of forward-looking MD&A disclosures on tax matters, it will be issuing more comments in 2017.

Staff accountants in OCA and the Division of Corporation Finance frequently consult on the appropriateness of judgments companies appear to be making in accounting for income taxes. With regard to the key issue of recognizing deferred taxes on undistributed earnings of a foreign subsidiary, an OCA Professional Accounting Fellow, Brian Staniszewski, pointed to the presumption in the accounting literature (ASC Topic 740) that undistributed earnings of a foreign subsidiary will be transferred to the U.S. parent entity – leading to the parent's accrual of taxes on such earnings.[13] The staff continues to focus on whether and how that presumption can be overcome with specific evidence, especially in situations where disclosures made outside of the audited financial statements call into question -- or potentially contradict -- management assumptions regarding indefinite investment abroad.

Material Loss Contingencies: Disclosure at the "Reasonably Possible" Stage

The Division continues to see problems with respect to the absence of required financial statement footnote disclosure of potential material litigation loss contingencies at the "reasonably possible" stage (as required by the relevant GAAP standard, ASC Topic 450-20), and sudden accruals (hitting "probable" and "reasonably estimable" under 450-20 out of the blue, thus requiring a charge to net income) without having provided earlier warning in the footnotes and the MD&A as a known trend or uncertainty when material losses become reasonably possible. The staff highlighted as a cautionary tale the recent RPM International enforcement complaint, charging the General Counsel of that company with mishandling disclosures and accounting for material loss contingencies arising from an ongoing DOJ investigation into possible overcharging of the federal government and a related, sealed *qui tam* case.[14] The SEC alleged that the General Counsel, who also served as Chief Compliance Officer and oversaw the company's response to the DOJ investigation, failed to inform the company's CEO, CFO, Audit Committee and independent auditors of material facts about the progress of the investigation. Eventually the company had to restate its financial results for three quarters that spanned the DOJ investigation and filed amended SEC reports for those quarters, disclosing the investigation and related accruals, along with ICFR material weaknesses and ineffective disclosure controls and procedures.

Segments

Division of Corporation Finance Deputy Chief Accountant Nili Shah focused on two core aspects of this perennial staff accounting "hot button:" identification of operating segments and improper aggregation. Segment disclosures in the footnotes to the financial statements are based on a "management" approach," with segment definition tied to how the CODM actually views and operates the business. A company should evaluate -- and disclose in the segment footnote-- all relevant data points regarding the enterprise when performing a segment analysis, including (but not limited to) the CODM report, the organization chart, compensation arrangements and the internal budgeting process. The staff generally will object to a company's assertion that a business line or unit is not a separate operating segment because no shared operating costs are allocated to it, particularly where the availability of gross margins suggests that discrete financial information is available to the CODM to classify this unit as an operating segment.

With respect to aggregation of operating segments, Ms. Shah stressed the need for a holistic analysis of both quantitative and qualitative factors in light of the principles set forth in ASC Topic 280, to determine similarity of business activities across segments as a predicate to permissible aggregation. Just because there are quantitative similarities between operating segments does not mean that they are qualitatively similar business activities that should be combined; to the contrary, quantitative similarities may be merely "coincidental" and as such warrant more critical analysis of qualitative factors.

Another important point on segments was made by Mr. Kronforst, who cautioned companies to avoid "voluntarily expanding" their GAAP segment footnote to offer a "secondary" non-GAAP measure of profit or loss evaluated by the CODM. Since such disclosures are not mandated by GAAP, they fall within the scope of the SEC's non-GAAP rules (in the case of the segment footnote to the financial statements, this means Item 10(e) of Regulation S-K as well as Regulation G).

Finally, the staff noted the recently settled SEC administrative proceeding brought against PowerSecure International, in which the SEC alleged that the company failed to accurately identify and report its segments as required by GAAP, thus violating Regulation S-X. This in turn led to the company's failure to properly identify reporting units for purposes of goodwill impairment testing as required by other GAAP (ASC Topic 350). After discussions with the SEC staff, the company was permitted to use its fiscal 2015 Form 10-K to describe errors in prior period disclosures and revised its segment reporting disclosure to reflect corrected information for the affected fiscal years (2012-2014). The company also concluded in its 2015 Form 10-K that its disclosure controls and procedures for the three-year period were not effective due to a material weakness in ICFR identified in 2015 relating to its misapplication of GAAP. The SEC's order instituted cease-and-desist proceedings under the financial reporting, internal accounting controls and books-and-records provisions of the Exchange Act, and imposed a $470,000 civil penalty.[15]

Conflict Minerals Disclosure: Drafting Tips for the Next Report

At PLI, Deputy Division of Corporation Finance Director Shelley Parratt confirmed that the SEC Division of Corporation Finance's guidance of April 2014[16] remains in effect pending further notice from the federal district court to which the litigation has been remanded by the U.S. Court of Appeals for the D.C. Circuit. The possible rescission of the core Dodd-Frank conflict minerals disclosure obligation through enactment of such provisions as the Financial CHOICE Act is unlikely to materialize prior to the due date for Form SDs for calendar year 2016. Consistent with the April 2014 guidance, therefore, companies are not required to obtain an independent private-sector audit ("IPSA") for the calendar year 2016 reporting period unless they choose voluntarily to use the label "DRC Conflict free" in their Conflict Minerals Reports to describe products containing "necessary conflict minerals." Nor, for that matter, are companies required to use any of the terminology included in the challenged regulatory text of Form SD –in addition to "DRC Conflict free," the phrases "having not been found to be 'DRC Conflict free'" and "DRC conflict undeterminable."

Drafting tips offered by Ms. Parratt for the next round of Form SD filings:

- Some companies have identified smelters or refineries used to process conflict minerals by name and country location, without disclosing any information regarding the countries of origin of their "necessary conflict minerals." In the staff's view, this silence may imply – in some cases, incorrectly -- that the countries where these processing facilities are located are the countries of origin of such conflict minerals. To avoid misleading investors, companies should simply disclose, if true, that they do not know the countries of origin of their conflict minerals.
- Some companies have used terms of art such as "verified," "active" or "compliant" to describe smelters and refiners. The staff believes that companies should explain what these terms mean.
- Companies should not imply that their products are "DRC Conflict free" without providing the requisite IPSA. The example given by Ms. Parratt of what *not* to say: "After conducting due diligence, the company had no reason to believe that its conflict minerals came from a Covered Country."

ENDNOTES

[1] Wesley R. Bricker, SEC Chief Accountant, *Keynote Address before the AICPA Conference on Current SEC and PCAOB Developments* (Washington, D.C., Dec. 5, 2016)("Bricker AICPA Keynote"), available at https://www.sec.gov/News/Speech/keynote-address-2016-aicpa-conference-working-together.html, citing PwC, *2016 Revenue Recognition Survey: Readiness update, impacts and remaining challenges* (Oct. 2016), available at http://www.pwc/com/us/en/audit-assurance-services/accounting-advisory/revenue-recognition-survey.html.

[2] This is essentially the same guidance communicated by the SEC staff to the FASB's Emerging Issues Task Force ("EITF") in September 2016, according to an attendee: "Consistent with SAB Topic 11.M. [SAB 74], if a registrant does not know or cannot reasonably estimate the impact that adoption of the ASUs referenced above [revenue recognition, leases, credit losses], then in addition to making a statement to that effect, that registrant should consider additional qualitative financial statement disclosures to assist the reader in assessing the significance of the impact that the standard will have on the financial statements of the registrant when adopted." PwC, *EITF observer: synopsis of the September 22, 2016 meeting* at p. 2, available at http://www.pwc.com/us/en/cfodirect/assets/pdf/eitf-observer/eitf-observer-september-2016.pdf.

[3] For more detailed guidance from the OCA staff on implementation issues, see the written remarks delivered at the AICPA conference by Ms. Alicea (www.sec.gov/news/speech/alicea-2016-aicpa.html) and Ruth Uejio (www.sec.gov/news/speech/uejio-2016-aicpa.html).

[4] *See* Bricker AICPA Keynote, above.

[5] The FRM is available on the Division's webpage at https://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.shtml.

[6] *See* Securities Act Forms, Compliance and Disclosure Interpretations Question 126.40 (Aug. 14, 2009) ("The registrant is responsible for determining if there has been a material change [in the registrant's affairs] and, if so, the related information that is required to be disclosed in a Form S-8. Correspondingly, it is the auditor's responsibility to determine if it will issue a consent to use of its report in a Form S-8 if there has been a change in the financial statements in a subsequent Form 10-Q and the financial statements in the Form 10-K have not been retroactively restated."), available at https://www.sec.gov/divisions/corpfin/guidance/safinterp.htm. In our experience, many companies have determined that, prior to filing a new Form S-8, it is unnecessary to file restated financial statements to reflect a change in accounting principle (or change in segment presentation or discontinued operations).

[7] *See* Deloitte & Touche, Financial Reporting Alert 16-3 (September 22, 2016).

[8] *See* Compliance and Disclosure Interpretations on Non-GAAP Financial Measures (updated May 17, 2016), available at https://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm.

[9] *See* SEC Press Release No. 2016-180 (Sept. 8, 2016), available at https://www.sec.gov/news/pressrelease/2016-180.htm.

[10] *See* SEC Chair Mary Jo White, *Keynote Address at the 2015 AICPA National Conference: Maintaining High-Quality, Reliable Financial Reporting: A Shared and Weighty Responsibility* (Washington, D.C., Dec. 9, 2015), available at https://www.sec.gov/News/Speech/Keynote-2015-aicpa-white.html.

[11] *See* Remarks of Marc Panucci, OCA Deputy Chief Accountant, before the 2016 AICPA Conference on Current SEC and PCAOB Developments (Washington, D.C., Dec. 5, 2016)("Panucci Remarks"), available at https://www.sec.gov/news/speech/panucci-2016-aicpa.html, citing *In the Matter of Magnum Hunter Resources Corporation*, SEC Litigation Release No. 34-77345 (Mar. 10, 2016), available at https://www.sec.gov/litigation/admin/2016/34-77345.pdf.

[12] *See* SEC Rel. No. 33-8810 (June 20, 2007), available at http://www.sec.gov/rules/interp/2007/33-8810.pdf.

[13] *See* Remarks of Brian Staniszewski, OCA Professional Accounting Fellow, before the 2016 AICPA Conference on Current SEC and PCAOB Developments (Washington, D.C., Dec. 5, 2016), available at https://www.sec.gov/news/speech/staniszewski-2016-aicpa.html. .

[14] For a copy of the SEC complaint filed in federal district court, charging violations of the antifraud provisions of the federal securities laws, the Exchange Act reporting requirements and the books and records and internal controls provisions of the federal securities laws, see https://www.sec.gov/litigation/complaints/2016/comp23639.pdf.

[15] http://www.sec.gov/litigation/admin/2016/34-79256.pdf.

[16] *See* Public Statement of Division of Corporation Finance Director Keith F. Higgins on the Effect of the Recent Court of Appeals Decision on Conflict Minerals Disclosures (April 29, 2014), available at https://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370541681994.

Weil

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Appendix A – Examples of Recent Non-GAAP SEC Comments

Recurring Operating Expenses:

We note that you exclude restructuring charges and other restructuring associated costs in the calculation of your non-GAAP performance measures. Please explain to us why these are not normal, recurring cash operating expenses necessary to operate your business. See Question 100.01 of the updated Non-GAAP Compliance and Disclosure Interpretations issued on May 17, 2016. (Sealed Air, September 27, 2016); We note that you exclude incremental restructuring charges from your selected financial information and non-GAAP financial measures including your Non-GAAP core statement of operations. Please explain to us why these are not normal, recurring, cash operating expenses necessary to operate your business. See Question 100.01 of the updated Non-GAAP Compliance and Disclosure Interpretations issued on May 17, 2016. (Proctor & Gamble, September 26, 2016)

Prominence:

Please present the three major categories of the statement of cash flows with equal or greater prominence each time you present free cash flow. See Item 10(e)(1)(i)(a) of Regulation S-K and Questions 102.06 and 102.10 of the updated Non-GAAP Compliance and Disclosure Interpretations issued on May 17, 2016. (Vectrus, October 25, 2016)

Please revise your next earnings release to begin your reconciliations with GAAP results rather than non-GAAP results. See Question 102.10 of the updated Non-GAAP Compliance and Disclosure Interpretations issued on May 17, 2016. (FEDEX, September 28, 2016)

Individually tailored measures:

We have reviewed your response to prior comment one. Please explain to us why your presentation of Adjusted EBITDA excluding inventory revaluation does not represent an individually tailored measurement method substituted for that of GAAP. See Question 100.04 of the updated Non-GAAP Compliance and Disclosure Interpretations issued on May 17, 2016. (Trinseo, October 20, 2016)

Deferred Income Tax Expense:

We acknowledge your response to our prior comment 3. In your earnings release you indicate that you believe your presentation of non-GAAP net income provides investors with a more meaningful understanding of your ongoing and projected operating performance. When a measure is a performance measure, Question 102.11 of the updated Compliance and Disclosure Interpretations issued on May 17, 2016 requires inclusion of both current and deferred income tax expense. Since you believe it is important to investors to understand the cash taxes you actually pay, we would not object to separate disclosure of such amounts. Please revise your future press releases accordingly. (Acordia Therapeutics, October 5, 2016)