CENTER FOR AUDIT QUALITY

Serving Investors, Public Company Auditors & the Markets

July 21, 2016

By email: rule-comments@sec.gov

U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Release No. 33-10064, *Business and Financial Disclosure Required by Regulation S-K*

Dear Office of the Secretary:

The Center for Audit Quality ("CAQ") is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high quality performance by public company auditors; convenes and collaborates with other stakeholders to advance the discussion of critical issues requiring action and intervention; and advocates policies and standards that promote public company auditors' objectivity, effectiveness, and responsiveness to dynamic market conditions. Based in Washington, D.C., the CAQ is affiliated with the American Institute of CPAs.

The CAQ appreciates the opportunity to comment on the Securities and Exchange Commission's ("Commission" or "SEC") Concept Release on the Business and Financial Disclosure Required by Regulation S-K (the "Concept Release").[1] This letter represents the observations of the CAQ but not necessarily the views of any specific firm, individual, or CAQ Governing Board member.

We provide our comments through the lens of the public company audit profession. Since auditors play an important role in enhancing the quality, rigor, and reliability of financial information disclosed in Commission filings, the profession has a strong interest in the success of the Commission's Disclosure Effectiveness Initiative. In general, we believe that a principles-based disclosure regime, supplemented with guidance or considerations on how to apply the principles, will promote the disclosure of meaningful and relevant information.

We also support a disclosure regime that can be consistently applied to all registrants. Different reporting requirements for differently-sized registrants may result in unnecessary confusion and complexity in the disclosure framework. While providing certain accommodations, such as filing due dates, to different classes of issuers may be appropriate, we believe the use of principles-based disclosure requirements mitigates the need for reporting requirements based on

[1] *Business and Financial Disclosure Required by Regulation S-K,* Release No. 33-10064 (Apr. 13, 2016) [81 FR 23916 (Apr. 22, 2016)].

the size of the registrant. As smaller reporting companies often have less complex business structures and financial reporting issues, we expect that less extensive disclosures should be necessary for them to communicate material information that satisfies the specified disclosure objectives.

The flexibility offered by such a framework should encourage registrants to tailor disclosures to their facts and circumstances and reduce redundant and overlapping disclosures.

We encourage the Commission to conduct further extensive outreach and engagement with investors and other users of Commission filings to understand their views on how business and financial disclosures can be improved.[2] Since not all investors will necessarily participate in the comment letter process, we encourage the Commission to solicit feedback from investors using a broad range of methods, including in-person forums, such as roundtables, and in web-enabled forums, such as chatrooms and bulletin boards.

I. Principles-Based Disclosure Framework with Clear Disclosure Objectives

We support a principles-based disclosure framework that articulates clear and understandable disclosure objectives, supplemented by guidance on how to apply the principles. We believe this approach would allow registrants to more effectively communicate material information to investors that is focused, relevant, and appropriate for a registrant's particular facts and circumstances.

The existing disclosure regime in Regulation S-K is composed of line-item requirements that largely do not specify the purpose or objective of the disclosure requirement. While it is possible for preparers to consult the proposing and adopting releases for the various S-K Items for more insight into the Commission's rationale, doing so may not be efficient or realistic, particularly for those S-K Items that were adopted decades ago. Without a clear statement of the purpose or objective of the requirement, it can be challenging for preparers to assess whether their disclosures are sufficient or material, and disclosures that comply with the prescriptive requirements still may not provide investors with the most appropriate information given the disclosure's objective. For example, disclosing the number of employees may help some investors understand the size, scale or labor intensity of operations, but companies with different or changing employment practices may need to provide additional context for this information to be meaningful or useful to investors.

We encourage the Commission to articulate and embed objectives in the requirements by topical disclosure area. The objectives should focus on information that is relevant to the company's risks and performance prospects. These would act as guidelines and be sufficiently flexible to adapt disclosures to a company's individual facts and circumstances and to changing markets and business models.

[2] Since 2007, the CAQ has commissioned an annual survey of U.S. investors, which we call our Main Street Investor Survey, as part of our efforts to enhance the understanding of and confidence in capital markets. In the 2015 Main Street Investor Survey, 1,012 individual investors were asked about the factors that may affect their investment decision making process. Interestingly, two of the top three factors identified by these investors are not required to be disclosed under Regulation S-K: outlook for the sector or industry the company is in and strategy for future company growth. (See *The CAQ's Ninth Annual Main Street Investor Survey: Investor of the Future,* (Sept. 2015), available at: http://thecaq.org/docs/default-source/reports-and-publications/caq2015mainstreetinvestorsurvey.pdf?sfvrsn=4.)

II. <u>Management's Discussion and Analysis ("MD&A")</u>

Principles-Based

As the Commission considers possible changes to the requirements of MD&A, we believe that a principles-based disclosure framework should be maintained. The Commission has long recognized that for MD&A to be informative, Item 303 cannot be overly prescriptive. For many years, MD&A had been principles-based. However, after 2002, the Commission adopted prescriptive rules in Items 303(a)(4) and (a)(5) regarding "Off-Balance Sheet Arrangements" and "Tabular Disclosure of Contractual Obligations," respectively (see further discussion below). We recommend that the Commission return to focusing on the disclosure objectives the Commission believes are important and avoid prescriptive guidance as to the form and style of information. Flexibility is paramount to preventing disclosures from becoming stale and stagnant or simply not informative. We have provided more specific recommendations below based on what we have observed to be challenges for registrants.

Consolidation of Guidance

The Concept Release notes that interpretive guidance relating to MD&A is contained in multiple different sources. Much of the Commission's guidance has been brought together in Section 501 of the Codification of Financial Reporting Policies. We encourage the Commission to include <u>all</u> applicable Commission rules and interpretive guidance in one place that can be updated on a regular basis; if any published guidance is no longer applicable, then the Commission should eliminate it.

Results of Operations

Registrants, other than smaller reporting companies, are required to analyze the results of operations for the three-year period covered by the financial statements. There are situations where a comparison of historical information may not be informative to a user of the financial statements because of significant changes to the entity during the periods for which information is presented. For example:

- the registrant – as successor – has prepared financial statements using a different basis compared to the predecessor;
- the registrant has made one or more very significant acquisitions;
- the registrant has made one or more very significant dispositions that are not accounted for as discontinued operations; or
- changes in fiscal year end.

In lieu of mandating a discussion of historical information, we recommend that the Commission provide registrants the flexibility to present comparative information in a manner that will be most useful to investors based upon the particular facts and circumstances. For example, flexibility might be achieved by adapting the pro forma financial information requirements of Article 11 of Regulation S-X to MD&A when appropriate to facilitate the analysis.

Table of Contractual Obligations

Existing accounting standards require disclosure concerning a registrant's obligations and commitments to make future payments under contracts, such as guarantees, debt, purchase commitments, lease agreements, and other long-term liabilities. Hence, a substantial amount of the disclosure required by Item 303(a)(5) is repetitive of what is required to be included in the financial statements under Generally Accepted Accounting Principles ("GAAP") (see Appendix A). In addition, it is unclear whether this particular disclosure provides a full picture of a registrant's liquidity needs. A registrant can have a large amount of contractual obligations or a small amount, neither of which may necessarily provide a reader with information about the registrant's ability to generate liquidity, its contractual obligations at any other point in time, or a complete picture of its expected uses of cash. Accordingly, we recommend that the Commission consider whether Item 303(a)(5) is necessary or appropriate, given its limited utility and the areas of redundancy with GAAP. Clearly articulated objectives about a liquidity discussion under a principles-based framework should eliminate the need for this specific requirement.

Critical Accounting Estimates

We believe it would be worthwhile to incorporate any requirement for disclosure about critical accounting estimates into Item 303 – but the requirement should be principles-based. As discussed in the AICPA's response to the Commission's critical accounting proposing release from 2002,[3] we believe any new requirement should provide the objective that should be achieved with the disclosure. To the extent needed to supplement disclosure already provided in the GAAP financial statements, disclosures regarding critical accounting estimates should provide an understanding of the estimation process and the areas in which changes in the estimation process or resulting conclusions could have a material impact on the financial statements.

Immaterial Errors

We do not believe a registrant should be required to disclose the nature of its assessment of errors that are determined to be immaterial and not corrected within the financial statements. These items are evaluated on a quantitative and qualitative basis consistent with Staff Accounting Bulletin Topic 1:M. By definition, these amounts are not material and disclosure of immaterial information would not be necessary for investors. Requiring disclosure of immaterial information would be inconsistent with many of the Commission's stated objectives about providing investors with material information and avoiding unnecessary, immaterial information. We believe such disclosure is unnecessary and should not be required.

Auditor Involvement

While the auditor is responsible for reading MD&A as part of its professional responsibility under Public Company Accounting Oversight Board ("PCAOB") Auditing Standard (AS) 2710, *Other Information in Documents Containing Audited Financial Statements* (PCAOB AS 2710), the scope of this work is substantially less than an audit or review of MD&A. If an issuer chooses to have its MD&A audited or reviewed, PCAOB Attestation Standard ("AT") 701. *Management's Discussion and Analysis,* provides the applicable guidance. Despite the existence of the standard, there have only been a very limited number of situations in which a report by an auditor on MD&A has been included in a filing with the Commission. It is common for an auditor to provide comfort to the underwriters on many of the numerical disclosures in MD&A in connection with offerings of securities, but not to provide comfort on the adequacy of disclosure or whether any material facts have been omitted. (It should be noted that this comfort is provided to underwriters as part of their due diligence process and not made available to investors.) We believe the Commission should consult with investors and other users of Commission filings to get

[3] *Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies*, Release No. 33-8098 (May 10, 2002) [67 FR 35620 (May 20, 2002)].

feedback on whether greater auditor involvement with MD&A would be beneficial to them. If, based on this input, the Commission determines that greater auditor involvement would be beneficial, the audit profession stands ready to provide assurance on MD&A.

III. Description of Business

Principles-Based

As with MD&A, we believe that the Description of Business section would be an ideal candidate for the principles-based disclosure framework described above: a statement of the disclosure objectives for the Description of Business section, supplemented by a non-exclusive list of disclosures or considerations that may be appropriate to achieve the stated objectives. Because of the highly prescriptive nature of Item 101, many of the disclosures currently enumerated in the Description of Business section may not be material or are redundant. For example, Item 101(c)(1)(viii) currently requires disclosure of backlog information for all public companies, even for industries where such information may not be meaningful or relevant. Registrants should be required to provide such information only when it is material to the registrant or promotes an understanding of the registrant's business. A principles-based disclosure framework would allow registrants to omit disclosures when they are not useful, meaningful or relevant.

Elaborating on the number of employees example discussed above (in Section I): instead of the line-item requirement in Item 101(c)(xiii) to disclose the number of employees, the Commission could articulate a disclosure objective with respect to the registrant's human resources strategy and the other human capital factors that have or may materially affect the registrant's business. A non-exclusive list could specify various human capital and workforce factors that may be considered to meet the objective, such as (i) the types of human capital relied on (for example, salaried versus hourly), (ii) the proportion of union and non-union employees, (iii) whether and how current labor relations may potentially result in work stoppages that could materially affect operations, (iv) the proportion of outsourced versus statutory employees, (v) turnover in the workforce and the implications of labor shortages and wage pressures, (vi) the implications of shifts in the geographic location of human resources, and (vii) how the need for specialized skills may affect the company's operations.

Company Profile Page

Item 101 currently requires a mix of disclosures that include both information that changes materially from period-to-period as well as more static, general information. Examples of static, general information required by Item 101 currently include the description of business, segments, industry, principal products and services, intellectual property, and regulation. For many registrants, these disclosures do not change materially over the course of several periods, absent a specific event or transaction. We suggest that the Commission consider establishing a separate company profile page on EDGAR for disclosure of this static information. Such a repository could be created and maintained by the registrant within EDGAR, and updated by the registrant when material changes occur. Investors could be alerted of any such changes by a Form 8-K filing. We believe this approach would allow for the removal of repetitive information from a company's annual report and allow for increased focus on the information that changes materially from period to period.

Overlap between Regulation S-K and GAAP

Item 101 currently requires certain disclosures that are largely duplicative of GAAP (e.g., research and development expense, segment disclosures, etc.), which results in redundant disclosures. We are aware that the Commission has proposed rules to address these and other redundancies. We have provided in

Appendix A a separate schedule of duplicative requirements between Regulation S-K, the Industry Guides and GAAP and we will provide further comments about other areas of redundancies in our response letter to that proposal. We encourage the Commission to work with the Financial Accounting Standards Board (FASB) to eliminate the existing redundancies and continue to monitor evolving accounting standards to limit future instances of overlapping and duplicative disclosures.

IV. Risk Factors

We agree that risk factor disclosures pursuant to Item 503(c) could be improved. We also recognize, however, that risk factor disclosures look the way they do for various reasons, including that registrants are seeking the fullest scope of forward-looking statements liability protections under the Private Securities Litigation Reform Act. We do not believe that requiring registrants to reduce the length or number of risk factors included in a filing would be appropriate; any such limit would be arbitrary, and any rationale for such limit – e.g., disclosures are just too long – would not justify the loss of (1) the potential benefits to investors that can accrue from the disclosure of certain risk factors or (2) liability protections to registrants.[4]

To enhance the usefulness of risk factor disclosure, we recommend that the Commission consider whether to encourage registrants to list the risk factors based on their view of priority.[5] The Commission notes that it proposed such a requirement when it considered the Plain English rulemaking but decided not to adopt such requirement "in response to comments received from investors."[6] We believe that the Commission should revisit this approach for the following reasons: not all risks are equal in significance, and no one is better situated than management to inform investors as to which risks are more significant to the company than others. Indeed, a registrant's failure to prioritize the risks disclosed creates the possibility that investors will misunderstand or misjudge the significance of any particular risk factor. For example, as the Commission observes, a generic risk factor that is commonly disclosed is dependence upon a registrant's management team. Encouraging companies to list risk factors in order of priority would result in a considerably different understanding of that risk factor for the registrant that puts it first as compared to the registrant that puts it last. We believe the Commission should consider an approach consistent with Form 20-F instructions, which states:

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[4] See certain academic studies cited in the Concept Release. Concept Release, 81 FR at 23956, fn 492 (describing academic studies that noted that risk factor disclosure is informative and that the public availability of this information decreases information asymmetry among investors).

[5] In November 2014, the CAQ and the Institute for Corporate Responsibility at the George Washington University School of Business published its report summarizing the recommendations of The Initiative on Rethinking Financial Disclosure (the "Initiative"), a research project comprised of eight GW graduate students who were assigned to investigate current corporate disclosures, identify the drivers of ineffective communication and formulate recommendations to improve corporate transparency. The Initiative made the following recommendations on risk factor disclosures:

> "The macro-environmental and industrial elements that are non-company-specific factors affect most companies in the same industry and remain nearly constant year to year. Currently, these factors are listed in random order under Item 1A, and their sequence may even change from year to year. The moderately educated investor can feel lost among so many risk factors and may find it difficult to evaluate the significance of each. Even analysts and institutional investors must spend significant time analyzing the list of risk factors to identify changes, if any, and to determine the relative influence of each factor on the company's performance. Disclosure of the risk factors by company-specific and non-company-specific strata reduces these inefficiencies and provides for clear, concise, comprehensive disclosure." See *Initiative on Rethinking Financial Disclosure* (Nov. 2014), available at: http://www.thecaq.org/docs/reports-and-publications/initiative-on-rethinking-financial-disclosure-report---november-2014.pdf?sfvrsn=4.

[6] Concept Release, 81 FR at 23960.

> *Risk factors. The document shall prominently disclose risk factors that are specific to the company or its industry and make an offering speculative or one of high risk, in a section headed "Risk Factors." Companies are encouraged, but not required, to list the risk factors in the order of their priority to the company. Among other things, such factors may include, for example: the nature of the business in which it is engaged or proposes to engage; factors relating to the countries in which it operates; the absence of profitable operations in recent periods; the financial position of the company; the possible absence of a liquid trading market for the company's securities; reliance on the expertise of management; potential dilution; unusual competitive conditions; pending expiration of material patents, trademarks or contracts; or dependence on a limited number of customers or suppliers. The Risk Factors section is intended to be a summary of more detailed discussion contained elsewhere in the document.*

In addition, registrants should be encouraged to disclose how or whether they address any particular risk factor. While this need not be required disclosure,[7] how risks are being managed is important information for investors to understand, including the absence of risk management or risk mitigation. In our view, such disclosure would have the opposite effect of "dilut[ing] investors' perception of the magnitude of the risk," which has been the Staff's justification to date for discouraging issuers from providing such disclosure.[8] It would also give investors the opportunity to evaluate registrants on how effectively they are managing risks. Finally, the ability to disclose how risks are mitigated may result in more specific and tailored disclosures about the risks themselves, thereby reducing generic risk factor disclosures. For example, the United Kingdom allows a discussion to provide information about how a company mitigates its various items included in risk factors section. It even provides guidance on how to address this conflict with United States practice. [9]

In terms of how Item 503(c) is currently drafted, we believe it would benefit significantly from a disclosure objective statement and from including examples of risk factors applicable to well-established Exchange Act registrants. The examples provided in Item 503(c)(1)-(5) appear to be geared to a company that is about to have its Initial Public Offering (IPO).

V. Key Performance Indicators

In our view, the Commission should focus on the needs of investors and on the views of industry groups in assessing whether to encourage the disclosure of key performance indicators ("KPIs"). In doing so, the Commission may consider developing a framework of KPIs and other metrics that can be evaluated by each registrant to determine whether they would be meaningful disclosure to investors. At a CAQ workshop held in March 2012[10] to explore how the auditor's role might evolve to meet the needs of investors, the CAQ observed that investors place significant value on KPIs, as they "allow management more flexibility to tell the story behind the GAAP disclosures and identify key metrics for the company." The following is from the summary of the discussions held at the workshop:

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[7] Particularly if, as pointed out by the Commission, risk mitigation strategies involve confidential or proprietary information and disclosure could result in competitive harm. Id.

[8] Id.

[9] See https://www.fca.org.uk/static/documents/ukla/knowledge-base/tn-621.2.pdf

[10] The workshop was moderated by Alan Beller and John White, both former Directors of the Division of Corporation Finance, and more than half of the 35 participants were investors or buy-side analysts. Center for Audit Quality, *Summary of Workshop on the Evolving Role of the Auditor,* at 3, available at http://thecaq.org/docs/reports-and-publications/workshopevolvingroleoftheauditor.pdf?sfvrsn=2 ("Workshop Summary").

> "There was agreement that KPIs are 'the metrics that matter most' to investors. … [T]here was concern that issuers selectively choose KPIs that present the most optimistic view of a company's results. Often, the KPIs disclosed change from period to period without any discussion, leaving investors to investigate or surmise why such measures were no longer disclosed or whether the omission is an indication of underlying problems. Accordingly, investors stated that a requirement for issuers to explain why a particular KPI was changed or dropped (e.g., require that KPIs be used for two periods or explain why they no longer are deemed important), and how KPIs are defined, would be helpful."

We recommend that the Commission encourage KPIs to be disclosed in a registrant's Commission filings so that they are subject to disclosure controls and procedures as well as to the liability framework of the Securities Exchange Act of 1934 ("Exchange Act") and the Securities Act of 1933 ("Securities Act"), thereby enhancing the likelihood that the KPIs will be accurate and not misleading.[11] Consistent with our views expressed throughout this letter, any efforts by the Commission to encourage the disclosure of KPIs should be articulated using principles-based standards, emphasizing materiality rather than prescriptive line-item requirements and providing flexibility for registrants to tailor their disclosures to provide KPIs relevant to the facts and circumstances of their business or industry. We note that "investors asked for more consistency in…[KPIs] reported by management from period to period in MD&A and earnings releases, and improvements in comparability across companies in specific industries (although they acknowledged that some KPIs are company-specific)."[12]

VI. Sustainability and Environmental, Social and Governance Disclosures

As with KPIs, investors and other stakeholders are best positioned to provide meaningful input to the Commission as to whether requiring disclosures about sustainability or environmental, social or governance issues (collectively, "ESG") would build trust in the U.S. capital markets and promote capital formation. We do note with interest that institutional investors have seemingly become increasingly interested in ESG disclosures, including through the following observations:

- Large institutional investors, such as Blackrock and State Street Global Advisors, have publicly stated their expectation that registrants provide ESG disclosures.[13]

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[11] We recognize, however, that participants in our March 2012 workshop expressed the view that "'regulated disclosures' often become less flexible and candid." Participants also noted that, at the outset, use of KPIs might best be driven by industry groups. Workshop Summary, at 6.

[12] Id. at 3.

[13] See, e.g., BlackRock, *Global Corporate Governance and Engagement Principles* at 7(noting that key performance indicators in relation to social, ethical, and environmental issues "should also be disclosed and performance against them discussed, along with any peer group benchmarking and verification processes in place"), available at https://www.blackrock.com/corporate/en-br/literature/fact-sheet/blk-responsible-investment-1engprinciples-global-122011.pdf; State Street Global Advisors ("SSGA"), *2016 Global Proxy Voting and Engagement Principles* at 5 (noting that "SSGA encourages companies to be transparent about the environmental and social risks and opportunities they face and adopt robust policies and processes to manage such issues…." In their public reporting, we expect companies to disclose information on relevant management tools and material environmental and social performance metrics."), available at https://www.ssga.com/investment-topics/environmental-social-governance/2016/Global-Proxy-Voting-and-Engagement-Principles-20160301.pdf.

- Pension funds, including outside of the United States, have also indicated that they are interested in and expect ESG disclosures.[14]

- ESG proposals constituted the largest category of shareholder proposals submitted to registrants in the 2015 proxy season.[15]

- Trends in European disclosure practices suggest broader movement in at least some other major capital markets towards required ESG disclosure.[16]

- For its 2015 Annual Report, GE published an integrated report to shareholders, which integrates reporting on performance, compensation, board oversight and sustainability, among other topics, and includes a mix of quantitative data points and qualitative narrative disclosures concerning corporate objectives with respect to ESG concerns.[17]

- A growing number of large institutional investors are choosing to divest from certain companies whose profiles do not align with the investors' ESG commitments, irrespective of these companies' current financial performance.[18]

If the Commission were to propose disclosure requirements for ESG matters, we recommend that the Commission provide principles-based objectives that emphasize materiality as a touchstone for the disclosure. The lack of materiality thresholds or de minimis exceptions can result in significant compliance

[14] For example, the California State Teachers' Retirement System ("CalSTRS") has stated the following: "The CalSTRS Board has endorsed the Principles for Responsible Investment ("PRI"). As such, CalSTRS has incorporated the PRI and other ESG principles into its investment policies and practices. Along with the PRI, CalSTRS works closely with organizations such as the Carbon Disclosure Project ("CDP") and Ceres to improve the transparency and disclosure of environmental risk data by corporations," available at: http://www.calstrs.com/sustainability-risk-management-0. Norges Bank Investment Management, the investment management division of the Norwegian central bank and adviser to the Norwegian government pension fund, has stated: "Norges Bank Investment Management expects companies to identify and address the material sustainability challenges and opportunities they face," available at https://www.nbim.no/en/responsibility/standard-setting/submissions/response-to-the-consultation-paper-on-sustainability-reporting-comply-or-explain/.

[15] Georgeson, *2015 Annual Corporate Governance Review*, at 11 ("However, when considered by category, environmental and social topics continued to represent the largest proposal type…. All the other prominent subcategories of E&S proposals saw an increase: climate change and greenhouse gas emissions (34 proposals in 2015 versus 28 proposals in 2014), labor and human rights (10 in 2015 versus eight in 2014), and sustainability reporting (19 in 2015 versus 13 in 2014)."), available at: http://www.computershare-na.com/sharedweb/georgeson/acgr/acgr2015.pdf.

[16] In 2014 the European Commission issued a directive to its member states to pass laws by 2016 requiring "large undertakings" to provide a broad range of non-financial disclosures, including disclosures relating to key performance indicators, environmental data, human rights, anti-corruption measures, and other ESG-related concerns. Available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0095&from=EN.

[17] See *GE 2015 Integrated Summary Report*, available at https://www.ge.com/ar2015/assets/pdf/GE_AR15_Integrated_Summary_Report.pdf.

[18] See, e.g., Damian Carrington and Emma Howard, "Institutions worth $2.6 trillion have now pulled investments out of fossil fuels," The Guardian, Sept. 22, 2015, available at http://www.theguardian.com/environment/2015/sep/22/leonardo-dicaprio-joins-26tn-fossil-fuel-divestment-movement; and "Fight the power: Investors are being pressed to sell their holdings in coal, oil and gas," The Economist, June 27, 2015, available at: http://www.economist.com/news/finance-and-economics/21656204-investors-are-being-pressed-sell-their-holdings-coal-oil-and-gas-fight.

costs for registrants, disclosure that is often boilerplate, and, for many investors, no meaningful increase in material investment and voting information.

We note that ESG disclosure frameworks have been developed both globally and domestically. Global and domestic frameworks include, among others: the Global Reporting Initiative ("GRI") fourth generation of guidelines, or G4, certain standards under the International Organization for Standardization ("ISO") 14000 series, and the International Integrated Reporting Council ("IIRC") framework for integrated non-financial and financial reporting and the Sustainability Accounting Standards Board ("SASB"). Some of these frameworks, which are used voluntarily by some registrants, address such topics as energy and water management, hazardous waste, product safety, ethics and materials sourcing. Should the Commission hear broad-based support from investors that a standardized framework of ESG metrics would be beneficial, the aforementioned frameworks may serve as starting points for the discussion.

We recommend the Commission consult with investors and other users to obtain input as to whether auditor involvement would be beneficial to them. If, based on feedback from investors and other stakeholders, the Commission determines that auditor involvement would be beneficial, the audit profession stands ready to play a meaningful role in providing assurance as to the accuracy and reliability of KPIs and ESG information, particularly with respect to information that is, in part, derived from the financial statements or subject to Internal Controls over Financial Reporting ("ICFR"). If the Commission determines that auditor involvement would be beneficial, we encourage the Commission to coordinate with the PCAOB to evaluate the current attestation standards and determine whether new or revised standards would be necessary.

VII. Cross-Referencing/Hyperlinks/Registrant Websites

We are supportive of the Commission's objective to obtain more effective disclosure overall, and we encourage streamlining of information included in documents filed with the SEC using mechanisms such as hyperlinks and cross-referencing but believe there are challenges should the Commission proceed. We believe it is important for the Commission to consider the professional requirements and legal limitations when an auditor is associated with "other information" contained in a document that includes the independent auditor's report. PCAOB AS 2710 addresses the auditor's responsibility with respect to other information in documents containing audited financial statements and the related auditor's report. With respect to other information, PCAOB AS 2710.04 states the following:

> "The auditor's responsibility with respect to information in a document does not extend beyond the financial information identified in his report, and the auditor has no obligation to perform any procedures to corroborate other information contained in a document. However, he should read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements."

Should the auditor's reading of the document uncover other information materially inconsistent with information, or the manner of its presentation, appearing in the financial statements, then the auditor is required to determine whether the financial statements or the auditor's report require revisions; if no revision to the financial statements or auditor's report is required, then the auditor should request the client to revise the other information.[19]

[19] The PCAOB has proposed amendments to PCAOB AS 2710 (Rulemaking Docket No. 034) and the proposed standard is included in the PCAOB's 2016 standard-setting agenda, available at: http://pcaobus.org/Standards/Documents/2016Q1-standard-setting-agenda.pdf.

Due to these responsibilities, it is important for the auditor to understand what this "other information" is in any given filing that includes audited financial statements and the related auditor's report. The introduction of external hyperlinks, which are not common in today's filings, could make it difficult to define what constitutes "the document" referred to in PCAOB AS 2710.04.[20]

An external hyperlink could pose problems with respect to an auditor's ability to fulfill its responsibilities under AS 2710 if the externally hyperlinked information changes over time. Some questions for the Commission to consider include: how is it clear what is included in "the document"; how are changes in the hyperlinked materials monitored over time; and how would the SEC monitor and maintain oversight of this external information? Although the PCAOB's proposed standard, consistent with current standards, states that it is not intended that information on a company's website be considered "other information," a change in SEC rules (for example, permitting incorporation by reference of website material into an Exchange Act or Securities Act filing) may modify what is considered "filed."

Similarly, PCAOB AS 4101 (formerly PCAOB AU 711), *Responsibilities Regarding Filings under Federal Securities Statutes,* provides requirements with respect to the auditor's procedures and responsibilities in connection with a Securities Act registration statement. Hyperlinks to company websites could bring into question what documents constitute the registration statement, making it unclear what information is subject to Section 11 liability and whether there would be incremental liability to the auditor.

In the event external hyperlinking is encouraged, we believe it will be critical for "the document" to be well defined and to fall within a registrant's system of disclosure controls and procedures in order to provide appropriate parameters for auditor involvement. We encourage the Commission to work closely with the PCAOB in rulemaking and standard-setting in this regard. In this instance, we believe legal certainty and definitiveness are needed in determining what constitutes "the document" for purposes of fulfilling the auditor's responsibilities under PCAOB AS 2710.

With respect to cross-referencing, it is currently common for companies to cross-reference within their Commission filings to other sections in that same Commission filing.[21] Commission rules generally allow such use of cross-referencing; however, it is rare to see cross references within the audited financial statement footnotes to other sections in the Form 10-K because of the need to be clear on what disclosures are covered by the auditor's report.[22] Expanded use of this type of cross-reference may be

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[20] Whether a registrant will be subject to antifraud liability for third-party information that is hyperlinked to in a Commission filing will depend on whether a registrant has "explicitly or implicitly approved or endorsed the statement of a third party such that the company should be liable for that statement." Refer to *Commission Guidance on the Use of Company Websites*, Release No. 34-58288 (Aug. 1, 2008) [73 FR 45862 (Aug. 7, 2008)], at 45870.

[21] Interim Final Rule, *Form 10-K Summary* specifies that cross-referencing to exhibits filed with Form 10-K is permitted.

[22] In 2012, the CAQ sponsored two forums on financial statement disclosure effectiveness, in which participants discussed the overlap between the notes to the financial statements and in MD&A and whether cross-referencing might be an effective way to address the overlap issue. See *Financial Statement Disclosure Effectiveness: Forum Observations Summary*, at 4, available at: http://www.thecaq.org/docs/audit-committees/caq_fasb_fsde.pdf?sfvrsn=0 ("The second forum was not in favor of cross-referencing as a tool to address overlap due to concerns related to audit responsibility (when referencing from the notes to MD&A) and loss of safe harbor protections (when referencing from MD&A to the notes). Some participants at both forums encouraged the SEC and the FASB to agree on where a particular disclosure should be presented and only require it once. However, a minority of participants felt that MD&A and the notes should each stand on their own, and opposed cross-referencing.").

cumbersome for readers in determining what pieces of financial information form a set of audited or reviewed financial statements.

VIII. Selected Financial Data

Item 301 requires registrants to disclose specific items for each of the registrant's last five fiscal years and any additional fiscal years necessary to keep the information from being misleading.[23] The requirement to provide selected financial data for the annual periods presented prior to those included in the audited financial statements ("Years 4 and 5") may create challenges for non-Emerging Growth Company ("EGC") issuers conducting IPOs and for registrants when the audited financial statements are revised to reflect a retrospective change. The Commission staff expects all periods presented in the selected financial data to be presented on a basis consistent with the audited financial statements, including Years 4 and 5.[24] As a result of the challenges encountered when applying this requirement, the SEC staff has provided relief in the past. For example, accommodations are available to foreign private issuers in certain situations.[25] Additionally, the Commission staff has granted relief from providing Years 4 and 5 in circumstances where such information was not readily available without undue cost or effort. The Staff has also indicated that registrants applying the new revenue recognition standard using the full retrospective method are not required to retrospectively revise Years 4 and 5, provided there is adequate disclosure about the lack of comparability.[26]

Therefore, we suggest the Commission consider whether the benefits of developing this information for Years 4 and 5 outweigh the incremental cost and effort, particularly considering Years 4 and 5 may be less meaningful to investors.

Auditor Involvement

PCAOB AS 2710 requires the auditor to read the selected financial data and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements on which the auditor has reported. In addition, an auditor may be engaged to report on selected financial data in accordance with PCAOB AS 3315, *Reporting on Condensed Financial Statements and Selected Financial Data*. The objective of such an engagement is for the auditor to report whether, in the auditor's opinion, the information set forth in the selected financial data is fairly stated in all material respects in relation to the complete financial statements from which it has been derived. PCAOB AS 3315 engagements are not common.

We recommend that the Commission consult with investors and other users to obtain input as to whether greater auditor involvement with selected financial data would be beneficial to them. If, based on this input, the Commission determines that greater auditor involvement would be beneficial, the audit profession stands ready to provide additional assurance. We encourage continued coordination between the Commission and the PCAOB taking into account the PCAOB's potential changes to its standards

[23] The Jumpstart Our Business Startups Act ("JOBS Act") permits emerging growth companies to elect whether to include as little as two years of selected financial data.

[24] Refer to Division of Corporation Finance - Financial Reporting Manual section 1610.1.

[25] Refer to Item 3.A.1 of Form 20-F which states "Selected financial data for either or both of the earliest two years of the five-year period may be omitted… if the company represents to the host country regulator that such information cannot be provided, or cannot be provided on a restated basis, without unreasonable effort or expense." [emphasis added]

[26] See Highlights of Sept. 23, 2014 Joint Meeting with SEC Staff and SEC Regulations Committee, available at: http://thecaq.org/docs/sec-regulation-committee-hightlights/secregulationscommitteeseptember23-2014jointmeetinghighlights.pdf?sfvrsn=2.

addressing auditor involvement with other information in documents containing audited financial statements.

IX. Supplementary Financial Information

Item 302 requires most registrants to disclose selected quarterly financial data for each full quarter within the two most recent fiscal years ("supplementary financial information"). While the requirement to provide supplementary financial information does not appear to be burdensome in most cases, the Commission should consider modifying the requirement for newly public companies in Commission filings after an IPO registration statement. In a Form S-1 for an IPO, a registrant may provide interim financial information on a year-to-date basis; however, supplementary financial information is not required because the registrant does not yet have a class of securities registered pursuant to Sections 12(b) or (g) of the Exchange Act. In most cases, supplementary financial information would not be required until the registrant files its first annual report on Form 10-K. However, if a newly public company files a registration statement for a follow-on offering after its IPO, supplementary financial information is required in the follow-on Form S-1 even if the registrant has not yet filed its first annual report.[27] As a result, selected quarterly data may need to be presented for interim periods preceding those presented in an IPO registration statement or in quarterly reports on Form 10-Q for which financial statements had not yet been prepared or subject to a review by the auditor.

We recommend that the Commission consider whether the benefits of preparing supplementary financial information outweigh the incremental cost and effort for newly public companies, considering that such information is not required in a Form S-1 for an IPO. We further recommend that the Commission consider allowing a newly public company to wait until its second annual report on Form 10-K to present supplementary financial data. Alternatively, the Commission could allow new registrants to present supplementary financial data in registration statements and annual reports that "builds" from the quarterly financial statements that have been separately filed on Forms 10-Q. For example, the supplementary financial information could include (1) year-to-date information for any interim periods disclosed in an IPO registration statement and (2) quarterly information for those periods that are included in subsequently filed Form 10-Qs or derived from the annual financial statements. This "building up" approach would be similar to the approach permitted for EGCs to comply with the selected financial data requirement of Item 301. Year-to-date information could subsequently be replaced with quarterly information as the company files its quarterly reports on Form 10-Q. These proposed accommodations could facilitate capital formation and efficient markets by reducing costs of compliance for newly public companies while not harming investors by reducing pertinent financial data.

Auditor Involvement

Article 10 of Regulation S-X (17 CFR 210.10-01(d)) requires interim financial information included in quarterly reports on Form 10-Q to be reviewed by an independent public accountant under PCAOB AS 4105, *Reviews of Interim Information* (PCAOB AS 4105). In addition, the auditor is required to perform a review of fourth quarter interim financial information required to be included in supplementary financial information even though a quarterly report on Form 10-Q is not required for such period. Therefore, supplementary financial information is generally subject to an interim review in accordance with PCAOB AS 4105. We recommend that the Commission consult with investors and other users to obtain input as to whether greater auditor involvement with supplementary financial information (beyond quarterly reviews currently performed) would be beneficial to them.

[27] Refer to Highlights of the March 31, 2015 SEC Regulations Committee— Joint Meeting with SEC Staff.

X. Quantitative and Qualitative Disclosures about Market Risk

In our view, Item 305 is relevant primarily for large financial services institutions and certain commodity institutions that are engaged in market making activities or actively use derivative instruments as part of their risk management practices and that have the capacity to informatively disclose the institution's tailored risk management activities and market risk exposures. Less sophisticated institutions often lean towards providing standardized descriptions of market risk, which provide little clarity regarding the unique market risks and risk management activities that the institution is exposed to and/or engaged in.

In addition, Item 305 does not appear to be as relevant for non-financial services entities, given that these registrants are primarily involved in derivative trading as a means to hedge their underlying business risks. The correlation between the risk reduction from this derivative hedging activity and the underlying market risks from these registrants' business activities is not fully contemplated in Item 305, which makes it less relevant and meaningful for these institutions as compared to financial institutions and sophisticated commodity enterprises.

We also recognize that the disclosure requirements contained in GAAP have significantly changed since Item 305 took effect in 1997. Specifically, Accounting Standard Codification ("ASC") No. 815 – *Derivatives and Hedging*, ASC 820 – *Fair Value Measurement*, and ASC 825 – *Financial Instruments* require disclosures that are substantially similar to the information required to be disclosed by Item 305. For certain sophisticated financial services institutions, Item 305 provides additional clarity to the requirements contained in GAAP as they relate to market risk and risk management activities. However, for less sophisticated financial services institutions and nonfinancial services entities, which often use standardized methods to qualitatively and quantitatively provide disclosures about market risk, Item 305 may be redundant with the GAAP disclosure requirements.

Management's views regarding the registrant's market risk and risk management activities appear to be most relevant to the users of the financial statements. In an effort to make Item 305 more meaningful for a broader range of registrants, the Commission should consider whether investors and other users would welcome less standardization and more opportunities for registrants to tailor their disclosures to appropriately reflect their holistic market risk exposures and corresponding risk management activities.

XI. Executive Summaries

We support the use of executive summaries and layering techniques, particularly for the MD&A, Risk Factors and Description of Business sections of the filing. Investors can benefit from management's effort to highlight the most important information in the filing. The use of executive summaries promotes the efficient delivery and consumption of information.

XII. Preferability Letters

When the Commission amended Form 10-Q in 1975 to require an accountant's letter stating whether a change in accounting principle is, in the accountant's judgment, preferable, an auditor's review of a registrant's interim period financial statements included in Form 10-Q was not required. Accordingly, the requirement to file a preferability letter in a Form 10-Q caused registrants to involve their independent auditors when making voluntary changes in accounting principles during interim periods. However, in 2000, the Commission adopted rules requiring independent auditor review of quarterly financial statements in Form 10-Q. Hence, auditors now evaluate the preferability of changes in accounting principles when they perform these reviews. Moreover, as referenced in the Concept Release, there are now more prescriptive accounting and auditing standards such as ASC 250, *Accounting Changes and Error Corrections*, and AS 2820, *Evaluating Consistency of Financial Statements*.

In light of these developments and improvements in the consideration and reporting of voluntary changes in accounting principles, we acknowledge that the objective of the preferability letter overlaps with the objectives of GAAP and PCAOB reporting standards. When registrants change an accounting principle, they are already required to establish preferability and auditors are required to assess the change as part of their interim reviews and audits of the financial statements.

As noted in the Concept Release, the form and content of preferability letters vary as there are no content requirements in Item 601 other than stating that the change was preferable. We believe investors and other users would have the best insight to provide input on the value of preferability letters and whether additional or more detailed information would be helpful to them. We note that ASC 250 requires registrants to disclose detailed aspects of the nature of and reason for a change in (1) accounting principle, including an explanation of why it is considered preferable, and (2) the method of applying the change, including a description of the prior period information that has been retrospectively adjusted, the effect of the change on income from continuing operations, net income, and any other affected financial statement line item and per-share amounts for all periods presented, and the cumulative effect of the change on retained earnings as of the beginning of the earliest period presented.

With respect to whether the auditor's report should highlight whether a change in accounting principle is preferable under the circumstances, we note that the PCAOB's auditor reporting model proposals[28] contemplate changes to the content of the auditor's report. The Commission may wish to consider the PCAOB's proposed changes and coordinate with it about the specificity of certain audit matters in audit reports as part of its consideration of this question.

XIII. Industry Guides

Since the Industry Guides were published, GAAP has been promulgated in ways that render some of the Industry Guides redundant or unnecessary. Appendix A details the areas of overlap. We recommend that the Commission update the Industry Guides, at a minimum, to eliminate GAAP redundancy and to evaluate whether other financial disclosures currently required by the Industry Guides have been previously considered and rejected by the FASB as unnecessary or not cost beneficial to produce. Other reasons for updating the Industry Guides include consideration of more recent related guidance provided by the Staff[29] and modernization in general based on current business models and risks. The Commission recently proposed rules to modernize the disclosure requirements for mining properties which includes the related guidance in Industry Guide 7. In addition, we understand that the Staff has already begun a project to review the requirements in Industry Guide 3. We look forward to seeing the results of these projects.

If the Commission continues to require industry-specific disclosure, we believe it would be helpful for the rules and regulations applicable to each industry be put in one place (e.g., combine the requirements in Article 7 of Regulation S-X, *Insurance Companies*, with Industry Guide 6, *Disclosures Concerning Unpaid Claims and Claim Adjustment Expenses of Property-Casualty Insurance Underwriters*). Also, the

[28] PCAOB Release No. 2013-005 and No. 2016-00X

[29] See, e.g., *CF Disclosure Guidance, Topic 6: Staff Observations Regarding Disclosures of Non-Traded Real Estate Investment Trusts*, which elaborates on Industry Guide 5.

Commission should revise the various Securities Act and Exchange Act forms that require Industry Guide information to include specific instructions for inclusion of the information.

XIV. <u>Cost-Benefit Analysis/Considerations</u>

We strongly support the Commission's efforts in conducting cost-benefit analyses on proposed rules to make better informed decisions about whether to require public companies to provide disclosure. In our view, the quality and rigor of the Commission's cost-benefit analyses have improved significantly since the creation of the Division of Economic and Risk Analysis in 2009.

We encourage the Commission to engage with investors and other users of Commission filings to understand how they value certain types of information and the benefits they derive from such information.

* * *

In conclusion, the CAQ supports the Commission's efforts to improve the quality and effectiveness of disclosures and appreciates the opportunity to comment on the Concept Release. We would be pleased to discuss our comments or answer any questions that the Commission may have regarding the recommendations expressed in this letter, Appendix A or other matters related to its Disclosure Effectiveness Initiative.

Sincerely,

Cynthia M. Fornelli
Executive Director
Center for Audit Quality

<u>SEC</u>
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Michael S. Piwowar, Commissioner
Kara M. Stein, Commissioner
Keith Higgins, Director, Division of Corporation Finance
Mark Kronforst, Chief Accountant, Division of Corporation Finance
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S-K			US GAAP	
Topic	**S-K Ref**		**ASC Reference**	**Requirement**
S-K Item 101 Description of Business				
Financial information about segments	Item 101(b)		ASC 280-10-50-20 through 50-22	Segment reporting
Revenue by class of similar products or services	Item 101(1)(c)(i)		ASC 280-10-50-40 and potentially ASC 606	Segment reporting and potentially Revenue recognition
Dependence on single customer	Item 101(1)(c)(vii)		ASC 280-10-50-42	Segment reporting
Government contracts subject to renegotiation or termination	Item 101(1)(c)(ix)		ASC 912-275-50	Contractors - federal government
Company-sponsored research & development	Item 101(1)(c)(xi)		ASC 730-10-50 and 730-20-50	Research and development
Information about geographic areas	Item 101(d)		ASC 280-10-50-41	Segment reporting
S-K Item 202 Description of securities				
(A) Capital Stock - rights, obligations and provisions			ASC 505-10-50	Rights, privileges, requirements of securities outstanding
(B) Debt securities			ASC 505-10-50	Rights, privileges, requirements of securities outstanding
(C) Warrants and rights			ASC 505-10-50	Rights, privileges, requirements of securities outstanding
(D) Other securities			ASC 505-10-50	Rights, privileges, requirements of securities outstanding
S-K Item 301 Selected Financial Data				
S-K Item 302 Supplementary financial information				
S-K Item 303 MD&A				
Off-balance sheet arrangements	Item 303(a)(4)(ii)(a)		ASC 460-10-50	Guarantees
Contractual obligations	Item 303(a)(5)		ASC 470-10-50 ASC 840-10-50 ASC 440-10-50 ASC 410, 420, 450, 710	Debt Leases Purchase commitments Other long-term obligations
S-K Item 305 Quantitative and qualitative disclosures about Market Risk				
No overlap				
S-K Item 601 Exhibits				
Statement re: computation of per share earnings			ASC 260-10-50	Detailed computation of basic and diluted earnings per share is required by GAAP.

Letter re: Change in Accounting Principles			ASC 250-10-45-12	Preferability
S-K Item 703 Purchases of equity securities by the issuer and affiliated purchasers				
No overlap				
Industry Guide: Bank Holding				
II. Investment Portfolio				
A. Book Value of Investments			ASC 320-10-50	Disclosures - Investments and Debt Securities
B. Maturities of Investments Over Specified Periods			ASC 320-10-50	Disclosures - Investments and Debt Securities
III. Loan Portfolio				
A. Types of Loans			ASC 310-10-50	Disclosures - Receivables
B. Maturities and Sensitivities of Loans to Changes in Interest Rates			ASC 310-10-50	Disclosures - Receivables
C. Risk Elements				
1. Nonaccrual, Past Due and Restructured Loans			ASC 310-10-50 ASC 310-40	Disclosures - Receivables Troubled Debt Restructurings
2. Potential Problem Loans			ASC 310-10-50 ASC 310-40	Disclosures - Receivables Troubled Debt Restructurings
4. Loan Concentrations			ASC 310-10-50 ASC 275-10-50	Disclosures - Receivables Risks and Uncertainties
IV. Summary of Loss Experience				
A. Analysis of Loss Experience			ASC 310-10-50	Disclosures - Receivables
B. Further Breakdown of the Allowance for Loan Losses			ASC 310-10-50	Disclosures - Receivables
V. Deposits				
A. Time Deposits- Excess of $100,000 and By Maturity Period - Domestic			ASC 470-10-50 and 942-405-50	Debt - Disclosures
B. Time Deposits- Excess of $100,000 and By Maturity Period - Foreign			ASC 470-10-50 and 942-405-50	Debt - Disclosures
Industry Guide: Oil & Gas				
No overlap				
Industry Guide: Real Estate				
No overlap				
Industry Guide: Insurance				
Description of a Business - 2.A.(1)			ASC 944-40-50-3	
Description of a Business - 2.A.(3)			ASC 944-40-50-4F; ASC 944-40-50-4I	

Disclosures - Reconciliation - 2.B.(1)(a) - 2.B.(1).(c) and 2.B.(1)(e)			ASC 944-40-50-3	
Disclosures - Claims Development - 2.B.(2)(a) - 2.B.(2)(c)			ASC 944-40-50-4A	**NOTE:** Although the disclosure requirement overlaps between SEC and the FASB, the level of aggregation between the two disclosures is different.
Industry Guide: Mining				
No overlap				