March 20, 2019

By email: rule-comments@sec.gov

US Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: *Request for Comment on Earnings Releases and Quarterly Reports;* File Number S7-26-18

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, DC, the CAQ is affiliated with the American Institute of CPAs. This letter represents the observations of the CAQ but not necessarily the views of any specific firm, individual, or CAQ Governing Board member.

The CAQ appreciates the opportunity to share our views and provide input on the Securities and Exchange Commission's (Commission or SEC) *Request for Comment on Earnings Releases and Quarterly Reports* (Request for Comment).[1] The CAQ supports the Commission's efforts, as stated in the Request for Comment, to "enhance, or at a minimum maintain, the investor protection attributes of periodic disclosures while reducing administrative and other burdens on reporting companies associated with quarterly reporting."

Since auditors serve an important role in enhancing the quality and reliability of certain financial information disclosed in Commission filings, the profession has a strong interest in the success of the Commission's efforts. Therefore, we provide our comments through the lens of the public company audit profession. We urge the Commission to continue to engage in robust outreach efforts to a wide variety of investors, including main street and institutional investors, as they are the ultimate beneficiaries of company reporting.

[1] Request for Comment on Earnings Releases and Quarterly Reports*,* Release No. 33-10588; 34-84842; File No. S7-26-18.

As noted in the Commission's Request for Comment, the periodic reporting system may affect corporate decision making and strategic thinking. We believe the current periodic reporting system provides investors, management, and boards with reliable, timely, and important information. With a strategic mindset, companies and boards can use this information and align short-term actions with long-term goals.[2]

Benefits of Existing Safeguards Related to Form 10-Q

We believe the current requirements for interim reporting on Form 10-Q, including, but not limited to, (1) interim financial statements prepared under a consistent financial reporting framework (2) auditor involvement,[3] and (3) management certifications[4] (collectively referred to as Safeguards) instill discipline, rigor, and accountability in the financial reporting process. These Safeguards serve to strengthen the quality and reliability of interim financial information, which helps to protect investors.

Financial Reporting Framework

We believe investors benefit from the consistent and comparable interim financial statements prepared under Generally Accepted Accounting Principles in the United States (US GAAP) and Article 10 of Regulation S-X. In contrast, earnings releases are elective and there are no prescriptive requirements for the type or level of financial information to be disclosed, as long as the information does not contain material misstatements or omissions. As a result, the scope and timing of such disclosures in earnings releases vary significantly in practice.

Auditor Review of Interim Financial Statements in Form 10-Q

As the Commission notes in the Request for Comment, while the financial statements in Form 10-Q are unaudited, Regulation S-X specifies that the interim financial statements included in Form 10-Q must be reviewed by an auditor in accordance with Public Company Accounting Oversight Board (PCAOB) standards.[5] When the Commission adopted this requirement in December 1999, it noted the following:

> *[W]e believe that more discipline is needed for the quarterly financial reporting process. We believe that the reviews required will facilitate early identification and resolution of material accounting and reporting issues because the auditors will be involved earlier in the year. Early involvement of the auditors should reduce the likelihood of restatements or other year-end adjustments and enhance the reliability of financial information. In addition, as a result of changes in the markets, companies may be experiencing increasing pressure to "manage" interim financial results. Inappropriate earnings management could be deterred by imposing more discipline on the process of preparing interim financial information before filing such information with the Commission.*[6]

[2] See National Association of Corporate Directors (NACD) Blog, *Seven Principles for Understanding and Avoiding Short-Termism* by Cindy Fornelli and NACD's *Blue Ribbon Commission Report on The Board and Long-Term Value Creation*.
[3] Regulation S-X Rules 8-03 and 10-01(d).
[4] Sections 302 and 906 of the Sarbanes-Oxley Act of 2002 (SOX) and the Securities Exchange Act of 1934 (Exchange Act) Rule 13a-14(a) and S-K 601(b)(31).
[5] PCAOB Auditing Standard 4105, *Reviews of Interim Financial Information* (AS 4105).
[6] See Exchange Act Release No. 42266.

We also believe there is significant value to auditor involvement with related disclosures about internal control over financial reporting (ICFR)[7] during the auditor's quarterly review. An auditor's quarterly review procedures increase the likelihood that investors will receive timely information about material changes in ICFR. Since the Commission mandated auditor involvement with interim information, we believe that the process has contributed significantly to investor protection and confidence. Also, as discussed further below, during the auditor's quarterly review the auditor frequently performs audit procedures that may positively impact the effectiveness and efficiency of the annual audit.

Management Certifications

We believe investors benefit from quarterly certification requirements of SOX and SEC rules, which have increased the accountability of principal executive and financial officers and enhanced the quality of interim financial reporting included in Form 10-Q. These requirements do not apply to earnings releases.

Using the Earnings Release to Satisfy Some Form 10-Q Requirements

We are supportive of the Commission's objective of reducing administrative and other burdens on reporting companies associated with quarterly reporting while maintaining or enhancing investor protection, as the associated costs are ultimately borne by investors. We encourage the promotion of efficiency in periodic reporting by reducing unnecessary duplication of information that reporting companies disclose. However, allowing information disclosed in a company's earnings release to satisfy some of the requirements of Form 10-Q may present challenges we believe the Commission should consider.

While auditors may read a company's earnings release, auditors are not required to do so under professional standards. Any auditor involvement in the earnings release process is generally incidental to their required quarterly review of the interim financial statements to be included in Form 10-Q. While certain information included in earnings releases may be derived from draft interim financial statements expected to be included in the Form 10-Q, the auditor's review of the interim financial statements often is not complete at the date of the earnings release. Certain users may incorrectly assume a level of auditor involvement with the earnings release that is not required and may not have taken place (Expectations Gap).

If the supplemental approach[8] is utilized whereby information disclosed in a company's earnings release is used to satisfy a portion of the requirements of Form 10-Q, it could widen the Expectations Gap by creating confusion as to what information was reviewed by the auditor and when the review was completed. In addition, we believe there may be operational challenges if the supplemental approach were to be adopted, including, for example, if the required interim financial information subject to auditor review is included in the earnings release. In this situation, it is unclear what steps would need to be taken to address subsequent events that may occur and need to be recorded between the earnings release and issuance of the Form 10-Q. Further, it raises questions related to timing of management certifications if the information required for

[7] AS 4105.07 requires that "The auditor should perform limited procedures quarterly to provide a basis for determining whether he or she has become aware of any material modifications that, in the auditor's judgment, should be made to the disclosures about changes in internal control over financial reporting in order for the certifications to be accurate and to comply with the requirements of Section 302 of the Act."

[8] In the Request for Comment, the Commission seeks input on an option where, "a company would use its Form 10-Q to supplement a Form 8-K earnings release with additional material information required by the Form 10-Q not already presented in the Form 8-K or alternatively incorporate by reference disclosure from the Form 8-K earnings release into its Form 10-Q (the "Supplemental Approach")."

Form 10-Q can be disclosed in different documents, particularly if the interim financial statements are included in an earnings release.

Change in Frequency Considerations

Investor Protection

The CAQ supports the current quarterly periodic reporting process consistently applied by all domestic registrants. We believe scaling the frequency of reporting requirements for different categories of domestic reporting companies could be to the detriment of certain investors. However, should the Commission change the current frequency of interim reporting requirements for all domestic registrants, or only a subset of reporting companies, the SEC may want to consider the following observations:

- **Impact on financial reporting quality:** We believe that quarterly reporting has a positive impact on the quality of financial reporting due to the rigor, auditor involvement, management certifications, and associated processes and controls that are integral to the quarterly financial reporting process, as noted above. Further, many auditors elect to perform audit procedures on significant risks or material transactions during the quarter, rather than waiting until year-end to complete all audit procedures. This approach can result in the earlier identification and resolution of potential financial reporting issues. While the audits of many large organizations may necessitate auditor involvement throughout the year regardless of interim requirements, it is possible that some companies might not require, or desire, such frequent auditor involvement. Less frequent financial reporting and auditor involvement may reduce financial reporting quality for those entities.
- **ICFR considerations:** Many companies perform select internal controls specifically in conjunction with the preparation, review, and filing of their Form 10-Q. Frequency can be a contributing factor when considering the effectiveness of a control. There is a risk that a change in frequency of interim reporting could result in certain controls (e.g., financial closing and reporting controls) being performed less frequently. In addition, in instances where relevant controls fail and there are no compensating controls in place, there may be fewer opportunities to timely identify or remediate control deficiencies if these controls are performed less frequently.

Capital formation considerations

A change in frequency of interim reporting could impact the nature of work and the level of assurance that the auditor could provide at the request of an underwriter. We encourage the Commission to continue conducting outreach with underwriters to obtain further input regarding their views.

- **Comfort to underwriters on earnings release information**: Underwriters have historically expected that auditors have reviewed quarterly financial statements included or incorporated in an offering document. With reference to providing comfort on interim financial information, paragraph 37 of PCAOB Auditing Standard 6101, *Letters for Underwriters and Certain Other Requesting Parties* (AS 6101), states that "[w]hen the accountants have not conducted a review in accordance with AS 4105, the accountants may not comment in the form of negative assurance and are, therefore, limited to reporting the procedures performed and findings obtained." If limited earnings release information or other financial information which is not subject to an AS 4105 review is a part of the registration statement, the level of comfort auditors will be able to provide on this information to underwriters in a securities offering would be reduced.

- **Comfort to underwriters on changes through the comfort letter date**: Auditors are customarily asked to provide negative assurance related to changes in specified financial statement line items between the date of the most recent financial statements included in the offering documents and the date of the offering. AS 6101, paragraph 46 only allows for negative assurance as to subsequent changes in specified financial statement items as of a date less than 135 days from the end of the most recent period for which the auditor has performed an audit or a review; therefore, a change in frequency of interim reporting could impact the time period when auditors would be able to provide such negative assurance on subsequent changes. As a result, the level of comfort auditors are able to provide to underwriters in a securities offering would be reduced, unless the auditor was engaged to perform a review that is not required under the Securities Exchange Act. These incremental procedures, if not anticipated, could have timing implications on conducting an offering.

Other considerations

- **Impact on the larger ecosystem:** A change in frequency of reporting required by the SEC may not achieve the objective of reducing administrative and other burdens on reporting companies associated with quarterly reporting due to investor demands. Further, companies may be subject to regulatory requirements for certain industries. Lastly, as certain securities exchanges, such as the New York Stock Exchange, require compliance with SEC reporting requirements, we encourage continued outreach with such stakeholders.
- **Transition guidance:** Should the SEC change the periodic reporting requirements, we encourage the Commission to consider including detailed transition guidance in final rulemaking to address how registrants would comply with a change in frequency requirement.

Opportunities for Disclosure Effectiveness in Interim Reporting

We applaud Chairman Clayton's recent remarks[9] that disclosure requirements must be rooted in the principles of materiality, comparability, flexibility, efficiency, and responsibility. We also note that the Request for Comment asks for input regarding how the SEC can enhance, or at a minimum maintain, the investor protection attributes of periodic disclosures while reducing administrative and other burdens on reporting companies associated with quarterly reporting. To that end, we encourage the Commission to consider the following recommendations for improving the effectiveness and efficiency of the interim reporting process:

- **The SEC should work collaboratively with the Financial Accounting Standards Board (FASB) to holistically review and improve the effectiveness and efficiency of interim disclosures required by US GAAP.**

  As accounting standards have been revised or updated throughout the years, disclosure requirements for interim periods have expanded significantly. In a number of situations, the volume of disclosures required for interim periods is extensive and duplicative of that required for annual periods. This may at times be inconsistent with the underlying principle in Rule 10-01(a)(5) of Regulation S-X that permits the omission of certain footnote disclosures that substantially duplicate the disclosure contained in the most recent audited financial statements and instead focuses on disclosures where events subsequent to the end of the most recent fiscal year have occurred which have a significant impact on the company. Rule 10-01(a)(5) also includes a presumption that users of the interim

[9] SEC Chairman Jay Clayton's Remarks for Telephone Call with SEC Investor Advisory Committee Members on February 6, 2019.

financial information have read or have access to the audited annual financial statements for the preceding fiscal year.

While we acknowledge the FASB's recent efforts to address and improve interim reporting,[10] we encourage the SEC's active and ongoing participation in the FASB's Disclosure Framework Project on Interim Reporting.[11] Throughout this collaboration, we recommend that the SEC and FASB continue to consider input from investors and preparers regarding the usefulness of disclosures and whether the benefits of providing certain interim disclosures justify the costs. Rather than adding interim requirements as financial accounting standards are revised or updated, we recommend that the SEC and FASB work together to establish a holistic approach to interim reporting that reflects the principles in Rule 10-01(a)(5) of Regulation S-X. In that regard, we suggest that consideration be given to limiting interim financial statement disclosure requirements to 1) items that have changed materially since year-end and 2) material transactions. For example, we recommend that the FASB and SEC evaluate whether interim disclosures required by ASC 820, *Fair Value Measurement*, could be omitted in those situations where fair values have not changed materially since year-end and there have been no material transactions affecting the disclosure.

- **The SEC should allow greater flexibility in presenting Management's Discussion and Analysis (MD&A) disclosure for interim periods.**

  Although the SEC's 2003 MD&A Interpretive Release[12] provided principles-based guidance designed to elicit more informative and transparent MD&A that satisfies the principal objectives of MD&A, existing MD&A requirements still often result in a formulaic "Results of Operations" section, discussing all line item changes from the statements of operations periods presented, regardless of whether the information is repetitive or material. Similarly, the "Liquidity and Capital Resources" section often includes a discussion of changes between comparative periods in operating, investing, and financing cash flows along with a discussion of outstanding debt, regardless of whether material changes have occurred since year-end.

  Consistent with Chairman Clayton's remarks regarding the importance of materiality, flexibility and efficiency in disclosure requirements, we recommend that the SEC consider rulemaking that would explicitly allow management to exercise judgment in omitting certain year-to-date and/or quarterly comparisons from MD&A for interim periods if the information is consistent with prior trends or redundant to information provided elsewhere in the Form 10-Q. We also recommend that the SEC consider whether investors may be better served with a more open-ended discussion focused on material changes and known or expected trends.

Throughout these efforts, we encourage the Commission to continue conducting outreach with investors and preparers to obtain further input regarding disclosures that are most relevant and cost-effective.

* * *

---

[10] As demonstrated by recent additions to Chapter 8 of the *Conceptual Framework for Financial Reporting, Notes to Financial Statements.*

[11] See Disclosure Framework: Disclosures—Interim Reporting.

[12] See Interpretation: Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations (17 CFR Parts 211, 231 and 241).

We appreciate the opportunity to comment on the questions raised in the Request for Comment. As the Staff and Commission gather feedback from preparers, users, and other interested parties, we would be pleased to discuss our comments or answer any questions that the Staff or Commissioners may have regarding the views expressed in this letter.

Sincerely,

Cynthia M. Fornelli

Cynthia M. Fornelli
Executive Director
Center for Audit Quality

cc:

SEC
Jay Clayton, Chairman
Robert J. Jackson, Jr., Commissioner
Hester M. Peirce, Commissioner
Elad L. Roisman, Commissioner
William H. Hinman, Director, Division of Corporation Finance
Kyle Moffatt, Chief Accountant, Division of Corporation Finance
Wesley R. Bricker, Chief Accountant

PCAOB
William D. Duhnke III, Chairman
J. Robert Brown, Jr., Board Member
Duane M. DesParte, Board Member
Kathleen M. Hamm, Board Member
James G. Kaiser, Board Member
Megan Zietsman, Chief Auditor and Director of Professional Standards

FASB
Russell G. Golden, Chair
Susan M. Cosper, Technical Director