CAQ SEC Regulations Committee Highlights

September 24, 2019 – Joint Meeting with SEC Staff

SEC Offices – Washington, DC

I. ATTENDANCE

SEC Regulations Committee	Securities and Exchange Commission	Observers and Guests
Steven Jacobs, Chair Jonathan Guthart, Vice-Chair Brad Davidson Rich Davisson Kendra Decker Fred Frank Paula Hamric John May Lisa Mitrovich Dan Morrill Steve Neiheisel Terry Spidell Mary Stone Greg Wright	***Staff from the Division of Corporation Finance (Division) and Office of Chief Accountant***	Polia Nair, EY Annette Schumacher Barr, CAQ Observer Anita Doutt, CAQ Observer

II. CURRENT FINANCIAL REPORTING MATTERS

A. Financial statement requirements in a Form S-4 and/or merger proxy for a non-reporting target merging with a public operating company in a reverse merger

The Committee members and staff discussed financial statement requirements in an S-4 and/or merger proxy for a non-reporting target merging with a public operating company in a transaction that is accounted for as a reverse merger. Registrants may consult the staff if they are unclear on the requirements for their facts and circumstances. The staff is currently reviewing the reporting requirements for target company financial statements (i.e., timing of adoption of new accounting standards, audit report, etc.) in various scenarios (including special purpose acquisition company mergers and other mergers with public shells) and the impact that certain factors, (e.g. the filing status of the registrant and characteristics of the operating company)may have on these requirements.

B. Impact on Article 11 conclusions for master limited partnership (MLP) drop down transactions previously accounted for as common control business combinations or asset acquisitions under ASC 805, *Business Combinations,* and now accounted for as failed sale-leaseback transactions under ASC 842, *Leases*

The Master Limited Partnership (MLP) structure, where a publicly traded MLP is controlled and consolidated by a public oil and gas company, is common in that industry. In those structures, the parent company may regularly drop down assets to the MLP and concurrently enter into a leasing or service arrangement for use of the assets. While such transactions are eliminated in consolidation in the parent company's financial statements, they have historically been accounted for by the MLP as a common control acquisition (either of a business, prior to the recent amendments to the definition of a business, or of assets), and concurrent operating lease. The lease was an operating lease under legacy US GAAP (ASC 840), as the underlying assets were real estate with no title transfer at the end of the lease term. Such transactions have historically triggered the need for a Form 8-K under Item 2.01, if significant, and would require an evaluation of Article 11 to consider whether a business was acquired for S-X reporting purposes (many companies would preclear if concluding that the transaction was not a business).

Subsequent to the adoption of ASC 842, both the seller-lessee (parent company) and buyer-lessor (i.e., the MLP) are required to apply ASC 842 and certain provisions of ASC 606, *Revenue from Contracts with Customers,* to determine whether to account for a sale and leaseback transaction as a sale by seller-lessee and purchase by buyer-lessor of an asset. If control of an underlying asset passes to the buyer-lessor, the transaction is accounted for as a sale by seller-lessee and a purchase by buyer-lessor and a lease by both parties. If not, the transaction is accounted for as a financing by both parties. Sale and leaseback transactions among entities under common control are also subject to ASC 842-40's sale and leaseback guidance.

When the transaction is not accounted for as a sale, the MLP will record a financing receivable on its balance sheet and recognize interest income in the income statement and reduce the receivable by the principal payments rather than recording the assets on its balance sheet and related revenue on the income statement. In many situations, the assets being leased to the parent are real estate assets of a specialized nature that will be classified as finance-type leases under ASC 842. These transactions may also include a non-lease component, where the MLP will recognize a fixed service revenue from the parent for operating the assets. The MLP will also enter into an operating agreement with the parent, in which the parent will operate the assets on the MLP's behalf.

The Committee members asked the SEC staff whether the change in accounting for the transaction as an acquisition of either assets or a business versus a financing transaction impacts a conclusion that there has been an acquisition as contemplated in Item 2.01 of Form 8-K and whether it would constitute the acquisition of a "business" as defined in Article 11 of Regulation S-X.

The staff continues to believe these transactions are within the scope of Item 2.01 reporting on Form 8-K notwithstanding the change in accounting under ASC 842. Registrants entering into these arrangements may continue to contact the staff when warranted by their facts and circumstances. Generally an inquiry is either a request for interpretation of the definition of a business under Article 11 or a request for relief under Rule 3-13 of Regulation S-X.

C. Contractual Obligations Table upon adoption of ASC 842

All registrants except Smaller Reporting Companies (SRCs) are required to disclose in their annual reports, registration statements and proxy statements all of their contractual obligations as of their latest fiscal year-end balance sheet date in a tabular format, pursuant to instructions in Item 303(a)(5) of Regulation S-K. The 2003 adopting release that introduced the contractual obligations tabular disclosure in Management's Discussion and Analysis (MD&A) defined the first three categories of cash outflows by reference to US GAAP – long-term debt as defined in ASC 470, *Debt*, and capital lease obligations and operating lease obligations as defined in ASC 840. Section 9240.6 of the Financial Reporting Manual (FRM) further states that information disclosed in the table with respect to long-term debt and capital and operating lease obligations "should be consistent with the disclosures provided in the financial statements."

The staff stated that it did not expect a change in the lease accounting model to change historical practice that the cash outflows in the contractual obligations table would be consistent with U.S. GAAP disclosures (i.e., disclosures under ASC 840 or ASC 842, when adopted). If, however, these amounts do not adequately capture liquidity needs and expected future cash outflows, registrants should consider whether incremental footnote disclosures are necessary, as discussed in Section

9240.7 of the FRM as well as the Commission's 2010 Guidance on Presentation of Liquidity and Capital Resources Disclosures in Management's Discussion and Analysis.

The Committee members believe this view also applies to the preparation of the Contractual Obligations Table under Item 5.F. of Form 20-F, regardless of whether the financial statements are prepared in accordance with International Financial Reporting Standards (IFRS) or US GAAP.

D. Recast Selected Financial Data for a Retrospective Accounting Change

The Committee members asked the staff how the recent removal of the guidance in FRM 1610 impacts the historical position of the need to recast years 4 and 5 in the selected financial data table upon a retrospective accounting change, other than the adoption of ASC 606. Prior to its deletion, FRM 1610.1 stated "The staff generally expects all periods presented in selected financial data to be presented on a basis consistent with the annual financial statements." In the meeting, the staff recommended that registrants look to the provisions of Item 301 of Regulation S-K, which may require exercising judgment in determining whether years 4 and 5 of the selected financial data table should be recast or whether additional explanatory disclosures would be sufficient to explain factors that materially affect the comparability of information reflected in the selected financial data.

E. Applicability of FRM 2025.3 for a SPAC to use pro forma information to measure significance for S-X 3-05 financial statements after the acquisition of its predecessor

The Committee members asked the staff whether a SPAC (or blank check company), which is a shell company as defined in Exchange Act Rule 12b-2, can avail itself of the accommodation in FRM 2025.3 to use pro forma information to measure significance for Regulation S-X 3-05 financial statements of a subsequent acquisition, despite the guidance in FRM 2025.9 that requires a shell company that conducts an **acquisition** of its predecessor (accounted for as a business combination in which the SPAC is the accounting acquirer) and a second target in the same year to use the shell company's prior year standalone financial statements on file to measure significance of the second target. The staff indicated that generally it would not expect such a registrant to apply FRM 2025.3 in this fact pattern. While the guidance in FRM 2025.9 still applies, registrants may consult with the staff and request relief under S-X Rule 3-13 where such information required by S-X Rule 3-05 is not material to the total mix of information available to investors.

F. Non-GAAP measures

Committee members and the staff continued their discussion of company disclosures of non-GAAP financial measures. Specifically, the following topics were discussed:

- **Disclosure of Non-GAAP margins.** The staff observed that it is seeing an increased number of disclosures containing non-GAAP margins (e.g., contribution margins) and noted that presentation of such measures is only acceptable, depending on the facts and circumstances, if the registrant also discloses a reconciliation from the non-GAAP measure to Gross Margin, as defined in GAAP (the most directly comparable GAAP financial measure) even if gross margin is not separately presented in the financial statements.
- **Overall observations regarding Non-GAAP measures**. The staff continues to observe the use of non-GAAP measures based upon individually tailored accounting principles and/or that include multiple significant adjustments to earnings. The staff reminded the committee members that there should be internal controls surrounding the non-GAAP process and engagement of audit committees.
- **Non-GAAP measures regarding Current Expected Credit Losses (CECL)**. The staff discussed the potential of new non-GAAP measures due to the adoption of ASC 326, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. The staff recently communicated that registrants generally should not adjust a non-GAAP performance measure to remove the impact of ASC 326. Registrants may contact the staff in CF-OCA to discuss how to best present the impact of the adoption of ASC 326.