EKS&H
AUDIT | TAX | CONSULTING

7979 E. Tufts Avenue, Suite 400
Denver, Colorado 80237-2521
P: 303-740-9400
F: 303-740-9009
www.EKSH.com

April 23, 2015

Avoiding SEC Comment Letters: Tips for Manufacturers

SEC comment letters issued in response to financial disclosures relate to a wide variety of topics, but they all have one thing in common: They have the potential to disrupt normal business operations. In best-case scenarios, a comment letter only requires a response. In moderate scenarios, they may require lengthy back-and-forth exchanges between the manufacturer and the SEC or extensive legwork on the part of company personnel to gather additional information. In worst-case scenarios, issues may require restatements, which can lead to loss of faith within the investment community or even lawsuits.

For these reasons, the fewer comments a company gets in response to each review, the better. The best way to prevent them is to include all disclosure information that the SEC wants. Below are the most common types of comment letters issued to manufacturers by the SEC and how companies can provide the appropriate information to avoid receiving them.

RESULTS OF OPERATIONS, OR MANAGEMENT DISCUSSION AND ANALYSIS (MD&A)

In all sections of the disclosure, including this one, manufacturers should be as detailed, specific, and transparent as possible. Companies should describe why changes to financial results occurred. For example, a statement that gross margins went down by 3% should be followed by a discussion of contributing factors. The SEC expects these discussions to focus at the product line level as opposed to the company or segment level. If multiple factors were involved, companies should document how much each was involved, using percentages or dollar figures, followed by a detailed explanation of that fluctuation. The same is true for assertions about broad economic or industry trends.

TAX EXPENSE/BENEFIT/OTHER FAS 109 ISSUES

Comment letters in this area often cover valuation allowances, specifically the timing of booking and releasing valuation allowances. This includes when booking and releasing should have happened and when a triggering event required the change. The SEC is looking for forewarning language in previous filings that would provide users indications of potential changes and triggering events.

To head off this type of comment, manufacturers should take care to disclose the specific reasons and events that triggered the release or recording of a valuation allowance. The reasons for the change should be very clear in the Form 10K or 10Q. Further, companies should document their analysis and decision-making (especially the timing of these determinations) and provide this information to the SEC.

FAIR VALUE MEASUREMENT, ESTIMATES, AND USE (INCLUDING VSOE)

The SEC may ask registrants about the sufficiency of disclosures for fair value measurements that rely on unobservable inputs. In addition, questions can arise on third-party pricing services and registrants may be asked about procedures used to validate those values; if and why those values were adjusted; and, if multiple quotes were obtained, how the registrants selected the values used. Registrants should carefully evaluate third party pricing services and other valuation sources to assess whether adjustment to inputs used is appropriate given the company’s specific situation. Companies can avoid some of these flags by providing ample descriptions related to value determination and selection.

FINANCIAL STATEMENT SEGMENT REPORTING (FAS131 SUBCATEGORY) ISSUES

Manufacturers must be careful about how they present business segments. Often the SEC will review MD&A, earnings releases, and press releases to determine how the chief operating decision maker (“CODM”) analyzes business performance and will compare that information to reported segments. It is important to note, that the CODM may not be the chief executive officer, but may be at a different level. As such, careful analysis of who are the CODM’s is important when assessing segments. A comment letter on segment reporting could involve considerable work to resolve. An issuer should not be surprised if the SEC requests to see all internal organizational charts and structure documents, management reports and board documents to validate reported segments.

Companies can address this area by performing continuous analyses of the segments they've disclosed in their financials and making sure those segments line up with the information management is using in internal management reports and external communications. This includes analyzing aggregated segments to determine such aggregation remains appropriate. Periods subsequent to an acquisition are particularly sensitive as the SEC is interested in knowing whether management determines it is going to review the results of the new business individually or as a part of an existing segment.

REVENUE RECOGNITION

Comments on revenue recognition are the most critical because they lead to restatements moreso than other types of comments. Issues come up when a manufacturer has different sales channels. Certain rates of return applicable to distributors may lead to improper or delayed revenue recognition. Additional issues include multiple deliverable contracts; inability to estimate returns and allowances; inadequate disclosures around the deliverables; in substance consignment sales; and classification of customer incentives, including slotting fees or coupons, which have to be recorded as a reduction of revenue rather than as an expense.

To avoid a comment in this area, manufacturers should carefully disclose key factors in revenue recognition, including a focus on identifying the triggering event that results in revenue being recognized. Further, companies should familiarize themselves with the new revenue recognition rules, set to go into effect in 2017 (pending delay by the FASB), and understand how they impact current policies and revenue streams.

In addition to the top five issues described above, the following two areas are increasingly becoming SEC comment letter topics for manufacturing companies:

Acquisitions, mergers, and business combinations - A rise in the number of business acquisitions may explain why more comment letters have recently been issued in this area. Typical comment letters pertain to fair value, what assets are being recorded, and how is fair value determined.

Non-GAAP measures (including EBIT and EBITDA issues) - This issue involves reconciling non-GAAP measures to the nearest GAAP measure. If non-GAAP measures are included in financial statements, they must not be given higher prominence that the related GAAP measures and should provide reasonable and valuable information to readers.

CONCLUSION

Facing global competition and tight budgets, manufacturing companies need to ensure that key personnel are available to perform core tasks. Responding to SEC comment letters requires that staff take time away from these tasks, so they should be avoided whenever possible. The best strategy for avoiding comment letters is to include adequate information in financial disclosures. Companies can reduce the number of comment letters they receive by anticipating what the SEC is looking for and proactively addressing these concerns in periodic filings. In addition, when SEC comment letters are received, manufacturing executives should be prepared to respond in a timely manner with well-documented analyses and memos.

This article was originally published online byCompanyWeek and will be included in the June 2015 issue of MFG, CompanyWeek's quarterly print publication.

EKS&H's manufacturing practice serves more than 300 client groups that conducting business in all 50 states, as well as many countries around the world. Of the top 50 CPA firms in the U.S., we are the 16th largest in terms of number of SEC registrant clients. To learn more about how EKS&H can help your manufacturing company avoid comment letters, please contact Audit Partner Bob Bond at 303-448-7000 or bbond@eksh.com or manufacturing niche leader and Audit Partner Kreg Brown at 303-740-9400 or kbrown@eksh.com.