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Alert

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Just Before Filing: A Last Minute Checklist for the 2019 Form 10-K

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The SEC has been a beehive of activity throughout 2019 and into 2020, whether on the rulemaking, interpretive or enforcement fronts that affect the annual report on Form 10-K of many, if not most, calendar-year filers. To help companies now in the final stages of preparing their Form 10-K ensure that they have covered all the line-item bases, we have prepared the attached checklist. This checklist includes a summary of the most recent SEC interpretive guidance relating to disclosure of MD&A/Key Performance Indicators issued on January 30, 2020, which is available here. For ease of reference, the checklist items appear in the order of the Form 10-K line-item disclosure requirements.

10-K Cover Page

- For large accelerated filers, Tag all cover page data in Inline XBRL.
  - June 15, 2020 for accelerated filers and June 15, 2021 for all other filers.
- For each class of exchange-listed securities including exchange-listed debt, add trading symbol to the existing requirements of the title of the class and national exchange or principal U.S. market on which it trades.
- Remove check box regarding disclosure of delinquent Section 16 filers.

Part I, Item IA, Risk Factors

- Review risk factors to ensure that they do not present a risk as hypothetical when it has already occurred.
  - In September 2019, Mylan N.V. settled charges with the SEC for $30 million. The SEC alleged that Mylan, the maker of the EpiPen, failed to accrue on a timely basis for the “probable and reasonably estimable” material loss related to a Department of Justice probe into whether Mylan overcharged Medicaid, and that Mylan’s risk factor disclosure was misleading given that it made the government claim regarding misclassification sound hypothetical when the government claim had already been made.
  - In July 2019, Facebook agreed to pay $100 million to settle charges by the SEC that it misled investors by presenting the risk of misuse of user data as hypothetical when it was known within the company, and that it did not maintain disclosure controls or procedures sufficient to ensure adequate and timely disclosures.

- Consider whether developments and uncertainties "ripped from the headlines" pose material risks to the company:
  - **Brexit:** Disclose the potential adverse effect of the UK's exit from the EU on January 31, 2020, including the impact on regulatory approvals, licensing arrangements, taxes, supply chain, financing or swap arrangements or other global business risks. William Hinman, the Director of the SEC's Division of Corporation Finance, has emphasized that "merely stating that Brexit presents a risk, that the outcome is uncertain and that it could materially and adversely impact the business and its operations won't cut it."
  - **Climate Risk/Sustainability:** In his Open Meeting Statement on the MD&A proposals and interpretive guidance issued on January 30, 2020, available here, Chairman Jay Clayton noted that environmental/climate-related disclosure is an area of evolving risk that the Commission is monitoring. We recommend following the principles-based materiality analysis that Director Hinman articulated in a March 2019 speech, available here.
  - **Coronavirus:** Many companies already have a risk factor covering health crises and epidemics/pandemics, but consider a specific reference to coronavirus if it could have a material impact on the company's business – due, for example, to operations in or sourcing of key supplies from China. We note that nearly 20 non-calendar fiscal year-end companies across different industries updated their risk factors to specifically address coronavirus in their last 10-Q (post the December 2019 outbreak) – which is notable because such updates to risk factors are necessary only if there has been a material change since the last Form 10-K.
  - **Cybersecurity:** At this point, almost all companies have included risk factors on cybersecurity and data privacy, taking into account SEC guidance from February 2018, available here, and the SEC's 21(a) investigative report, available here. As noted above, these existing risk factors should be carefully reviewed to ensure that they do not describe breaches as just hypothetical risks when breaches have already occurred and that they are updated for developments such as the EU's General Data Protection Regulations and the California Consumer Protection Act. Also, in managing cybersecurity risks, see the latest guidance on cybersecurity and operational resiliency from the SEC's Office of Compliance, Inspections and Examinations, available here.
  - **LIBOR Transition:** Consider the July 2019 SEC statement on the transition away from LIBOR by January 1, 2022, focusing particularly on the potential accounting and other financial reporting implications of the transition. Identify LIBOR-based contracts extending beyond 2021, and, if material, disclose associated risks. Consider whether contracts have fallback provisions that are triggered by the unavailability of LIBOR. Note the implications for hedge accounting, discussed below.
  - **Sanctions and Tariffs:** Consider risks related to business activities in areas subject to sanctions, including, if material, reputational damage to the company that could be caused by negative publicity surrounding the conduct of business in sanctioned areas and/or countries with poor human rights records. Also, analyze with a view to disclosure, if material, the risk that an increase in tariffs has had and/or will have on the company's results of operations. Continued volatility in this area in the past year requires careful ongoing re-assessment of the constantly evolving global trade environment.
  - **Technology and Intellectual Property:** Consider the disclosure guidance issued on December 19, 2019 by the Division of Corporation Finance, available here, addressing risks related to the potential theft or compromise of technology, data, and intellectual property of companies with international operations, particularly in jurisdictions that do not have comparable protections to the U.S. If material, disclose risks posed both directly (e.g., breach of computer systems by foreign actors) and indirectly (e.g., reverse engineering by joint venture partners to infringe or steal know-how or trade secrets). Note that the SEC Staff indicated that disclosure may be necessary in MD&A, the business section, legal proceedings, disclosure controls and procedures, and/or the financial statements.

Part I, Item 2, Properties

- Provide disclosure about a physical property only to the extent that it is material to the company.

Part II, Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations Item 303 of Regulation S-K

- **Key Performance Indicators:** Consider the SEC's new guidance on disclosure of key performance indicators and metrics in MD&A, available here. Examples of KPIs/metrics include metrics relating to external or macro-economic or industry-specific matters, metrics combining external and internal information, specialized, company-specific sales metrics (such as same store sales or revenue per subscriber) and environmental metrics, including metrics regarding the observed effect of prior events on a company's operations. The release notes that companies should consider what additional information may be necessary to provide adequate context for an investor to understand the metric, including:
  - A definition of the metric and how it is calculated;
  - A statement indicating the reasons why the metric provides useful information to investors;
  - A statement indicating how management uses the metric in managing or monitoring the performance of the business;
  - Disclosure of any estimates or assumptions underlying the metric or its calculation if necessary for the metric not to be materially misleading;
  - Certain additional information if a company changes the method by which it calculates or presents the metric from one period to another, including the differences in the way the metric is calculated or presented compared to prior periods; the reasons for the changes; the effects of any such changes on the amounts or other information being disclosed and on amounts or other information previously reported; and other differences in methodology and results that would reasonably be expected to be relevant to an understanding of the company's performance or prospects; and
  - Any additional material information that may be necessary in order to make the presentation of the metric not misleading
- See the SEC's related message enforcement action against Constant Contact Inc. and Endurance International Group Holdings, Inc., two companies offering web hosting and online and email marketing products. The SEC alleged that the two companies materially misrepresented subscriber and customer metrics and the growth of these metrics. Constant Contact targeted 10,000 new "unique paying customers" per quarter. In anticipation of the company not meeting that goal, the company instituted a new program pursuant to which customers who were going to cancel their subscription, thus being removed from the "unique paying customers" count, were offered a free month of service. This tactic allegedly inflated the number of unique paying customers. Moreover, Constant Contact continued to describe the count as including "paying customers" in its quarterly and annual reports, notwithstanding the fact that customers in the program called to cancel their service prior to the quarter's end and therefore were not paying customers.
- **Non-GAAP Financial Measures:** Review the use and placement of non-GAAP measures. As discussed in the SEC Chairman and Staff December 30, 2019 Statement, available here, the use of non-GAAP financial measures remains on the SEC's radar screen and SEC Staff have re-emphasized that non-GAAP measures must relate to the way management runs its business and be consistent from period to period. In particular, the SEC continues to vigorously enforce – via comment letter and enforcement action – the requirement that GAAP financial measures be disclosed with "equal or greater prominence."
  - As we discussed here, in December 2018, the SEC settled an enforcement action with ADT Inc. stemming from the company's alleged failure to comply with the "equal or greater prominence" requirements of the

SEC's non-GAAP disclosure rules. Based on the SEC's findings (which ADT did not admit or deny), in the headlines and other locations of its fiscal 2017 and Q1 2018 earnings releases, ADT provided non-GAAP financial measures such as "adjusted EBITDA," "adjusted net income" and "free cash flow before special items" without giving equal or greater prominence to the comparable GAAP financial measures.

- Note that non-GAAP issues have recently become the basis of demand letters to a company's board of directors.

- **Elimination of the "Third Year" from Results of Operations if Immaterial:** Companies are able to exclude discussion of the earliest of three years in MD&A if the company has already included the discussion in a prior filing, and references such filing, so long as the information is not necessary to an understanding of the company's financial condition, changes in financial condition or results of operations. Make sure you have controls and procedures in place to make, and record, this **difficult** materiality judgment. The SEC Staff posted new interpretations on January 24, 2020, available here, including one that clarified that by referencing the prior filings with third year information, a company is not incorporating by reference such filing unless the company affirmatively states it is intending to do so.

Part II, Item 8. Financial Statements

- **Critical Audit Matters:** Auditors of large accelerated filers are required to include disclosure of any CAM relating to that year's audit starting with their audit reports on the 2019 year-end (FYE June 30 and later) financial statements, and to discuss each CAM with the Audit Committee of the particular company. To date, the number of CAMs disclosed in these new reports ranges from 1 to 4 per company. Goodwill and intangible assets, revenue, and income taxes have been the most frequent CAMs observed thus far; other CAMs that we are seeing relate to New GAAP, accruals/allowances, and material weaknesses in internal control over financial reporting (ICFR). A CAM does not represent a "bad report card" but rather describes an area that the company's independent auditor believes involves "especially challenging, subjective, or complex auditor judgment." Note that a CAM need not overlap with a critical accounting estimate; the PCAOB has stated, available here, that the source of CAMs is broader than just critical accounting estimates. Consider whether the company might want to enhance disclosure in the 10-K itself as a result of a CAM and also consider addressing discussion of CAMS in the audit committee report in the proxy statement.

- **Loss Contingencies:** Applying ASC 450, carefully consider whether a material loss is probable and reasonably estimable (requiring accrual), reasonably possible (requiring disclosure) or remote. In the previously mentioned Mylan case, the SEC alleged that Mylan knew or should have known that a material loss relating to the DOJ investigation was *reasonably possible* by the time it filed its Form 10-Q for the third quarter of 2015, due to numerous contacts between the DOJ and the company and the company's knowledge of the DOJ's refusal to halt its investigation.

- **New GAAP:** For many companies, the new credit loss standard under ASC 326, better known as "CECL," will become effective in the first quarter of 2020. The new standard will shift recognition of credit losses away from the current "incurred loss model" to an "expected loss model" that will require loss estimates to be made for financial assets within the scope of the standard over their contractual terms based on "reasonable and supportable forecasts and historical information." See the new CECL Staff Accounting Bulletin, published in November 2019, available here. While financial institutions will be most directly affected, companies in numerous other sectors will be covered by ASC 326 as well. For those companies adopting CECL effective in Q1 of 2020, the 2019 Form 10-K will represent the last chance to provide transition disclosure (under SAB 74) of a company's preparation for adoption of ASC 326. However, note that SEC Staff have cautioned companies adopting ASC 326 this year against using a non-GAAP measure that excludes the effects or impact of the new standard; this would be regarded as the impermissible tailoring of GAAP deemed misleading under Non-GAAP C&DI 100.04, available here.

- Division of Corporation Finance accounting staff also have given fairly extensive guidance based on the staff's review of companies' disclosure on post-adoption application of the new revenue recognition standard, ASC 606, effective for most companies in fiscal 2018. Particular areas of focus for staff review and comment include financial statement footnote disclosures of the identification of performance obligations, principal vs. agent determinations, and the timing of revenue recognition. In this connection, the Staff indicated that companies that had adopted ASC 606 pursuant to the modified retrospective (cumulative adjustment) transition method could no longer make comparisons using former ASC 605 results during the year of transition; in other words, this one-time accommodation for companies opting for modified retrospective transition is no longer available because it is not contemplated by ASC 250.
- ASC 842, the new lease standard, became effective on January 1, 2019 for most calendar-year companies.
- Some New GAAP disclosure questions (both pre- and post-adoption) have been answered via consultation with the Office of Chief Accountant, and were described in various SEC Staff speeches available here (application of revenue recognition to sale-leaseback transactions); here (applying principal versus agent guidance); here (collectability by lessors); and here (assessing the collectability of cash flows in connection with hedge accounting accommodations made by FASB for the demise of LIBOR).

Part II, Item 9A, Controls & Procedures

- **Internal Control Over Financial Reporting:** Possible changes to ICFR to be identified would include changes anticipated (pre-adoption) or implemented (post-adoption) for New GAAP. Note in this regard, the difficulties companies encountered in preparing for the new lease standard under ASC 842, which required bringing many leases onto the balance sheet for the first time. The Division of Corporation Finance accounting staff will be focusing on the new lease disclosures in reviewing/commenting on 2019 Form 10-Ks.

Part III, Item 10, Directors, Executive Officers & Corporate Governance

- **Section 16(a) Compliance:** Whether a company is including disclosure in response to Item 405 of Regulation S-K relating to Section 16(a) compliance in the Form 10-K itself or cross-referencing to the proxy statement, note that the SEC has changed the title from "Section 16(a) Beneficial Ownership Reporting Compliance" to "Delinquent Section 16(a) Reports." Also note, however, that the SEC has encouraged companies to exclude this caption if there are no delinquencies to report.

Part IV, Item 15. Exhibits, Financial Statements Schedules

- Include new Exhibit 4 containing a description of securities for each Section 12 registered class of securities, which should correspond to the securities listed on the cover page discussed above.
- Companies may omit confidential information in material contracts and certain other exhibits without submitting a confidential treatment request to the Commission, so long as they comply with Item 601 of Regulation S-K. See also Division of Corporation Guidance Topic 7, available here.
- Except for new reporting companies, companies are no longer required to file material contracts that were entered within two years of the applicable registration statement or report if the contracts have been completed.
- Companies are no longer required to file schedules or similar attachments to material agreements if the attachments do not contain material information or were not otherwise disclosed.
- Companies are no longer required to file as an exhibit any document or part thereof that is incorporated by reference in a filing, but instead will be required to provide hyperlinks to documents incorporated by reference.

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