



# Preparing for 10-K and Proxy Season

Securities Law Breakfast Series



Heyward Armstrong and Alex Bowling  
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# Agenda

- 2016 & 2017 Recap
- Form 10-K: SEC Comment Letter Trends
- Revenue Recognition
- Pay Ratio Disclosure
- New Auditor Reporting Standard
- Shareholder Issues and ISS Update
- FAST Act Modernization and Simplification of Regulation S-K Proposal

# 2016 & 2017 Recap

# Form 10-K Summary

- On June 1, 2016, the SEC released an interim rule that allows registrants, at their option, to include a summary of the information in their Form 10-K in a new Item 16
- Each item on the summary page must include a cross-reference (by electronic link or otherwise) to the material contained in the Form 10-K to which that item relates
- Most companies include “None” or “Not applicable”
- Companies utilizing summaries: [GE](#), [Pfizer](#) and [3M](#)

# Form 10-K Cover Page

- Effective April 12, 2017, the cover page of Form 10-K was revised to include a “check the box” item to indicate whether the company is an “emerging growth company” and, if so, an additional box if the company has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Securities Act
- Cover page additions are also applicable for Forms 10-Q and 8-K

# Say-on-Frequency Vote

- In 2017, most companies held their second say-on-frequency votes (due no later than the meeting held in the sixth calendar year after the immediately preceding vote)
- This year, 88% of boards recommended annual frequency, up from only 53% in 2011
- SRCs were exempt from holding a say-on-pay or say-on-frequency vote until the first annual or other meeting of shareholders occurring on or after January 21, 2013, and therefore these companies would not be required to hold a frequency vote until the sixth anniversary of the first vote (2019)
- EGCs are exempt from these requirements

Source: Georgeson, 2017 Proxy Season Roundtable and Outlook for 2018 Proxy Season

# Exhibit Hyperlinks

- Effective September 1, 2017, the exhibit index must include hyperlinks to the underlying exhibits (whether attached or incorporated by reference)
- Based on amendments to Item 601 of Reg. S-K, most registrants are now including only one exhibit table/index, which precedes the signature page to the report
- This is a good year to clean up the company's exhibit index given this new requirement

# Form 10-K: SEC Comment Letter Trends



# Comment Letters - Volume

- Number of comment letters on Forms 10-K and 10-Q declined by 65% from 2010 (13,968 letters) to 2016 (4,838 letters)
  - Staff focusing attention on more frequent reviews of larger filers
- While the number of comment letters is trending downward, the percentage of public companies subject to a filing review has increased, from 52% in 2013 to 56% in 2016

• Source - Audit Analytics, SEC Summary of Performance and Financial Information Fiscal Year 2016

# Non-GAAP

- C&DIs updated in May 2016 and increased comments since that time, although volume lessened in 2017
- Areas of focus:
  - Undue prominence of non-GAAP measures
  - Enhancing disclosure of purpose and use
  - Clear labeling
  - Liquidity v. performance measures
  - Reconciliation
  - Potentially misleading nature of certain adjustments
  - Tax impact of non-GAAP adjustments

# MD&A

- Generally at or near top of list of sources of SEC comments every year
- Areas of focus:
  - Uncertainties affecting results of operations
  - Critical accounting estimates
  - Key metrics monitored by management
  - Income taxes
- *Leidos, Inc. v. Indiana Public Retirement System*
  - Is failure to disclose known uncertainties a per se 10b-5 violation?

# Segment Reporting

- Continued focus on segment disclosures and application of ASC 280
- Companies should regularly assess their segment reporting conclusions and evaluate whether internal controls are designed to ensure that the Chief Operating Decision Maker (CODM), operating segments and reportable segments are correctly identified
  - Comments focused on the process that the company uses to identify segments and have required that a company provide detailed information on the CODM's direct reports, how often the CODM met with those direct reports, who is accountable for the financial results of each segment, etc.
- Consider any inconsistencies between segment disclosures and organizational structure, other public information, changes in the business environment and the CODM's evaluation of performance and allocation of resources

# Emerging Areas of Focus

- State sponsors of terrorism
  - Areas of focus:
    - Nature and extent of contacts
    - Quantitative and qualitative factors about activities
  - Iran, North Korea, Sudan and Syria
- Cybersecurity
  - 2011 CF Disclosure Guidance: Topic No. 2
- New accounting standards
  - Revenue recognition

# Revenue Recognition

# Revenue Recognition—Effective January 1, 2018

- Effective for annual reporting periods beginning after December 15, 2017
- Two methods of adoption
  - Full retrospective method—all periods presented using the new standard
  - Modified retrospective method—year of adoption applies the new standard with a catch-up adjustment and disclosures

# Revenue Recognition—SAB 74 Requirements

- Comparison of the current accounting policies to the new accounting policies under the new standard
- Status of implementation, including significant matters not yet addressed
- Consideration of the effect of new footnote requirements in addition to the effect on the balance sheet and income statement
- Disclosure of the quantitative impact of the new accounting standard if it can be reasonably estimated
- Disclosure if the expected financial statement impact cannot be reasonably estimated
- Qualitative disclosures if the expected financial statement impact is not yet known



# Revenue Recognition—SAB 74 Practice Pointers

- Disclosures should continue to become more detailed
- Subject to internal control over financial reporting—audit committee should continue to be involved
- Revisit any previous disclosures stating that adoption will have an immaterial effect

# Revenue Recognition—Registration Statements

- If using full retrospective method, once the 1Q18 Form 10-Q has been filed, new Form S-3 registration statements may trigger early disclosure of retrospectively revised 2017, 2016 and 2015 financial statements
- Accordingly, a registrant with a Form S-3 that will expire before the 2018 Form 10-K is filed in 2019 should consider filing (and having declared effective) a new Form S-3 before it files its 1Q18 Form 10-Q
- Do not have the same issue for shelf takedowns off effective registration statements so long as the adoption of the new revenue recognition standard does not result in a “fundamental change”

# Revenue Recognition—Other Disclosure Considerations

- Impact on financial guidance and other investor communications
- Revisions to MD&A, including critical accounting policies and estimates
- Updates to risk factors
- Changes in internal controls/disclosure controls and procedures
- XBRL
- Ensure Investor Relations understands the impact

# Revenue Recognition—Other Areas of Impact

- Debt covenants
- Earnouts, milestones and similar provisions
- Incentive compensation plans and targets
- Licensing arrangements based on net sales
- Standard contract terms

# Pay Ratio Disclosure

# Overview

- Required pay ratio disclosure:
  - Median of the annual total compensation of all employees other than the CEO
  - The annual total compensation of the CEO
  - The ratio of these amounts
- Pay ratio may be described numerically or narratively

# Applicability

- Pay ratio required in registration statements, annual reports and proxy statements in which Item 402 executive compensation disclosure is included
- Not required for EGCs, SRCs, foreign private issuers or US-Canadian multijurisdictional disclosure system filers

# Definition of Employee

- Encompasses full-time, part-time, seasonal and temporary employees for the registrant and its consolidated subsidiaries
- Defined as an individual employed on any date of the registrant's choosing within the last 3 months of the last completed fiscal year
- Independent contractors are not employees under the rule
  - Allowed to rely on existing characterization as long as based on “widely recognized test under another area of law that the registrant otherwise uses to determine whether its workers are employees”



# Exemptions

- Data Privacy Exemption
  - Can exclude workers in foreign jurisdictions in which the company is unable to obtain compensation data without violating data privacy laws
  - Requires reasonable efforts and additional disclosure obligations, including filing a legal opinion from local counsel
  - Counts against the de minimis exemption
- De Minimis Exemption
  - May exclude non-U.S. employees up to 5% of total employees
  - Must exclude all employees located in a particular jurisdiction
  - Requires additional disclosure

# Frequency

- Only required to identify median employee once every 3 years
- Must update if there has been a change in the employee population or compensation arrangements creating reasonable belief that there would be a significant change to pay ratio disclosure

# Flexibility

- Company has flexibility in choosing the method of identifying its median employee based on its own facts and circumstances
  - Disclosure—method chosen, including material assumptions, adjustments or estimates
- Use of reasonable estimates, assumptions and methodologies and statistical sampling permitted
  - Allowed to use reasonable estimates in identifying the median employee, including using statistical sampling and a consistently applied compensation measure
  - Companies may specifically describe their pay ratios as an estimate in their disclosures
- Companies may use internal records to identify the median employee, even if every element of compensation is not included in those records

# Action Items

- Consider how/where to disclose pay ratio
- Explicitly state that it is a reasonable estimate
- Efficiently provide specific information required by rule
- Carefully document pay ratio methodologies for disclosure and application in future years
- Continue to focus on how the company has designed executive compensation program to drive company performance and shareholder returns
- Assess how employee base will react to disclosure and be proactive in discussions with employees

# Transition Periods

- Acquired Businesses—permitted to omit from calculation any employees obtained in a business combination or acquisition for the fiscal year in which the transaction becomes effective
  - Required to identify the acquired business and disclose the approximate number of employees being omitted
- New Registrants—the first pay ratio disclosure must follow a new registrant’s first full fiscal year beginning after the company (i) has been subject to the reporting requirements of the Exchange Act for at least 12 calendar months beginning on or after January 1, 2017 and (ii) has filed at least one annual report under the Exchange Act that does not contain the pay ratio disclosures
- Former SRC or EGC—a company that ceases to be a smaller reporting company or an emerging growth company will not be required to provide pay ratio disclosure until after the first full fiscal year after exiting such status and not for any fiscal year commencing before January 1, 2017

# New Auditor Reporting Standard

# New Auditor Reporting Standard— Effective Dates

- Generally effective for audits for fiscal years ending on or after December 15, 2017
- With respect to critical audit matters (CAMs)
  - Large accelerated filers—audits for fiscal years ending on or after June 30, 2019
  - All other filers—audits for fiscal years ending on or after December 15, 2020
- CAMs requirement does not apply to EGCs

# New Auditor Reporting Standard— New Requirements

- Auditor tenure—statement disclosing the year in which the auditor began serving consecutively as the company’s auditor
- Independence—statement that the auditor is required to be independent
- Enhancements to basic elements—revisions to certain standardized language
- Standardized form of the auditor’s report—opinion will appear in the first section of the auditor’s report and section titles have been added
- Critical audit matters (CAMs)



# New Auditor Reporting Standard— CAMs

- Definition:
  - Matter that was communicated or required to be communicated to the audit committee
  - Relates to material accounts or disclosures
  - Involved especially challenging, subjective or complex auditor judgment

# New Auditor Reporting Standard— CAMs

- Determining whether a matter involved especially challenging, subjective or complex auditor judgment:
  - Auditor's assessment of the risks of material misstatement
  - Degree of auditor judgment
  - Nature and timing of significant unusual transactions and the extent of audit effort and judgment related to these transactions
  - Degree of auditor subjectivity in applying audit procedures
  - Nature and extent of audit effort required
  - Nature of audit evidence obtained regarding the matter

# New Auditor Reporting Standard— CAMs

- Communication of each critical audit matter includes:
  - Identifying the CAM
  - Describing the principal considerations that led the auditor to determine the matter is a CAM
  - Describing how the CAM was addressed in the audit
  - Referring to the relevant financial statement accounts or disclosures

# New Auditor Reporting Standard— Practical Guidance for Issuers

- Communication with auditors—Discuss with auditor how it intends to apply the standard and what matters may be CAMs
- Notification procedures—Establish procedures for the auditor to notify the company when the auditor intends to disclose a CAM and the disclosure the auditor intends to make
- Ensure consistency—Ensure that company disclosures are consistent with auditor disclosures
- Timetables—Establish timetables for the auditor to provide draft and final CAM disclosures to the company
- Proxy disclosure—Consider additional proxy statement disclosure regarding long-tenured auditors

# Shareholder Issues and ISS Update

# Shareholder Issues - Key Topics

- Spread of proxy access bylaws at major public companies
- Shareholder activists targeting larger companies, effecting CEO ousters
- Proxy advisory firms continue to hold clout, attract criticism

# Shareholder Issues - Proxy Access

- More than 60% of S&P 500 now have proxy access bylaws/charter provisions
- Proxy access bylaw provisions have standardized
  - Ownership requirement of at least 3% of a company's shares for at least three years
  - An ability to nominate candidates for up to 20% of board seats, with a minimum of two nominees
  - A 20 shareholder limit on the ability of shareholders to aggregate to meet the 3% ownership requirement

Source: Harvard Law School Forum on Corporate Governance and Financial Regulation

# Shareholder Issues - Proxy Statement Action Items

- Review proxy disclosure holistically as a shareholder-communication tool rather than focusing on individual disclosure items:
  - Are the disclosed qualifications and expertise of the director nominees aligned to the company's business and strategy?
  - Is it clear how the company's executive and director compensation is designed to incentive the realization of the company's business objectives?
  - Is the format and language approachable to diverse audiences?



# Shareholder Issues - Engagement

- Corporate engagement with proxy advisory firms and investors increasing
  - Companies that have regular communication with institutional investors up 16% this year
- 92% of companies support legislation that would require advisory firms to register with SEC

Source: Nasdaq and the Center for Capital Markets Competitiveness, Corporate Governance Update: 2017 Proxy Season, Fall 2017

# ISS Update

- Institutional Shareholder Services (ISS) issued its updated guidelines on November 16, 2017
- The 2018 guidelines include updates on the following issues:
  - Shareholder Rights Plan
    - ISS recommends voting against all directors of companies with a shareholder rights plan (or “poison pill”) that has been in place more than one year and that has not been approved by shareholders
  - “Excessive” Non-Employee Director Compensation
    - ISS will recommend voting against directors who make comp decisions if there is a pattern (i.e., over two consecutive years) of “excessive” compensation for non-employee directors
    - “Excessive” has not been defined by ISS
    - The first such recommendations will be made in 2019

Source: <https://www.issgovernance.com/file/policy/2018-Americas-Policy-Updates.pdf>

# ISS Update (cont'd)

- The 2018 guidelines include updates on the following issues:
  - Gender Pay Gap Proposals & Board Diversity—ISS will:
    - Highlight companies with no gender diversity on their boards
    - Evaluate on a case-by-case-basis shareholder proposals related to the gender pay gap, considering whether the company is the subject of recent controversy on pay gap issues or if the company is lagging behind its peers on reporting regarding gender pay gap policies
  - Pledging of Company Stock—ISS recommends not voting for director where:
    - The level of pledged company stock held by executives/directors raises concerns
    - There are not sufficient mitigating factors, such as disclosure on the issue and efforts to reduce the amount of pledged stock
  - Pay-for-Performance Analysis
    - ISS will consider, among other things, the rankings of CEO total pay and company financial performance within a peer group measured over a three-year period in connection with its pay-for-performance analysis

# FAST Act Modernization and Simplification of Regulation S-K Proposal

# MD&A

- Discussion of the earliest year of three-year period covered by financial statements can be omitted from MD&A if
  - that discussion is not material to an understanding of the company's financial condition, changes in financial condition and results of operations and
  - the company has filed its prior year Form 10-K containing MD&A of that earliest year
- Instructions would be updated to clarify that a company may use any presentation that, in the company's judgment, would enhance a reader's understanding
  - For example, in certain circumstances, a narrative discussion about specific periods on a stand-alone basis may be more meaningful than period-to-period comparisons

# Compliance with Section 16(a) of the Exchange Act

- Companies would be allowed to rely on Section 16 reports filed on EDGAR when assessing whether there are any Section 16 delinquencies that must be disclosed under Item 405 of Reg. S-K
- Eliminates the requirement for insiders to furnish Section 16 reports to the company on paper
- Eliminates the need to include the caption “Section 16(a) Beneficial Ownership Reporting Compliance” when the company does not have Section 16(a) delinquencies to report and changes heading to “Delinquent Section 16(a) Reports”
- Eliminates the checkbox on the cover page of Form 10-K relating to Item 405 disclosures and the related instruction in Item 10 of Form 10-K

# Confidential Treatment

- Companies would be allowed to redact confidential information from material contracts filed under Reg. S-K Item 601(b)(10) where such information is both (i) not material and (ii) competitively harmful if publicly disclosed, without simultaneously submitting a confidential treatment request to the SEC
- If the Staff requests, the company must promptly provide an unredacted paper copy of the exhibit and its materiality and competitive harm analyses
- Companies would be permitted (consistent with current guidance) to redact any personally identifiable information from filed exhibits without filing a confidential treatment request

# Exhibits

- Expands existing Reg. S-K Item 601(b)(2) accommodation that permits companies to omit immaterial schedules and attachments to acquisition agreements to include all exhibits filed under Item 601
- Companies would still be required to provide with each filed exhibit a list that briefly identifies the contents of all omitted schedules and attachments and, upon Staff request, must furnish a copy of any omitted schedules or attachments



# Risk Factors

- Relocates Item 503(c) to subpart 100 of Reg. S-K to reflect the application of risk factor disclosure requirements to Exchange Act reports and registration statements
- Eliminates the risk factor examples that are currently enumerated in Item 503(c)
  - Goal is to encourage companies to revisit their risk assessment and to disclose the risks that are most significant to them

# Incorporation by Reference

- Consolidates rules regarding incorporation by reference and eliminates the five-year limitation under Reg. S-K Item 10(d)
- Includes requirements for the use of hyperlinks to documents incorporated by reference to other SEC filings
- Cross-referencing from elsewhere within a filing, including from the financial statements to other locations in a Form 10-K, would generally be permitted but would not be required
  - However, the proposed rule would specifically prohibit financial statements from cross-referencing or incorporating information from outside the financial statements, unless specifically permitted by SEC rules, to prevent confusion about whether such information is or has been subject to audit or review by the registrant's external auditor

# Status of Other Pending Proposed Rules

- Form 10-K
  - Inline XBRL
- Proxy
  - Universal Proxy Card
  - Clawback Listing Standards
  - Pay-for-Performance Disclosure
  - Hedging Disclosure

# Additional Questions and Discussion

# Thank You

Heyward Armstrong  
[harmstrong@smithlaw.com](mailto:harmstrong@smithlaw.com)  
919.821.6619

Alex Bowling  
[abowling@smithlaw.com](mailto:abowling@smithlaw.com)  
919.821.6687