

**Recommendation from the Investor-as-Owner Subcommittee (IAO) of the  
SEC Investor Advisory Committee (IAC)  
Relating to Accounting and Financial Disclosure**

**(As of April 27, 2020)**

This recommendation addresses four elements of accounting and financial disclosure: (1) an SEC proposal to permit the omission of fourth quarter financial results from annual reports; (2) increased use of “reverse factoring” and its effects on investors’ ability to evaluate issuers’ financial positions and known financial risks; (3) continued reliance by companies on non-GAAP financial and other metrics in investor communications; and (4) an SEC proposal to permit the omission of tabular information regarding contractual obligations. The reason for bringing these specific topics forward is they were flagged as important and timely for the IAC and the IAO subcommittee by investors and market participants at an IAC meeting on February 27, 2020.<sup>1</sup> They also are based on a follow-up call with SEC accounting and corporate finance staff,<sup>2</sup> and research conducted at the direction of the IAO subcommittee. We briefly present findings and recommendations for each of these four elements.

**1. Proposal to Omit Fourth Quarter Results in Annual Reports**

In January 2020, the SEC proposed a large number of changes to disclosures by public companies.<sup>3</sup> Among them was a proposal to permit companies to omit fourth quarter results in annual reports.<sup>4</sup> The reasoning for the proposal is straightforward: usually fourth quarter results are simple to derive from annual results by subtracting the results from the first through third quarters. Permitting omission of the fourth quarter data would reduce costs for companies.

However, for a significant number of companies, fourth quarter results cannot be derived from annual results. This is because companies may change what and how they report results within a year. For example, companies can discontinue operations in the fourth quarter. This can cause significant differences between results from the first three quarters of the year and the full-year results, and render actual fourth quarter results significantly different from those implied by annual results and results from the first three quarters. An example of this is AeroVironment, Inc., which divested operations in Q4 2018.<sup>5</sup> Other events and changes can have similar effects, making fourth quarter results impossible to derive from annual results.

We asked researchers at Harvard Business School to assess the impact of the proposal using past data, from years 2010 through 2019.<sup>6</sup> They extracted from Compustat/CRSP net income reported by all companies with available net income data. They calculated “derived Q4 net income” by deducting Q1-Q3 net income from annual net income. They compared derived Q4 net income with reported Q4 net income, and calculated (a) the number of companies with any difference, (b) the size of differences, scaled by reported Q4 net income, and (c) the number of companies with scaled differences greater than 1% of reported net income. They found that between twenty and 300 companies (out of between 3000 and 4500) had differences between reported and derived Q4 results. Roughly two-thirds of companies with differences had differences of greater than one percent of net income. For companies with differences, more than ten percent of the differences exceed 10% in a typical year. These differences relate to just one line-item – net income -- which while important is not the only item of importance to investors.

In sum, actual fourth quarter results can be routinely and importantly different from what could be inferred from the annual data and other reported results. We note that several commenters on the SEC’s Disclosure Concept Release also supported retaining fourth quarter reporting in annual reports.<sup>7</sup>

**Recommendation.** Based on the foregoing, we believe the SEC and staff should **reconsider** whether to permit all companies to omit fourth quarter information from annual reports. The cost savings from doing so would appear to be minimal, since companies must have fourth quarter data to be able to report full year data. The benefits to investors of preserving that data in annual filings would appear to outweigh those modest benefits. At a minimum, the SEC and staff should **consider a reasonable alternative** to the proposal to permit companies to omit fourth quarter results: permit companies to omit Q4 results if and only if they are not different from what could be easily derived from other reported results.

## 2. Use and Risks of Reverse Factoring

Since the financial crisis of 2008, public companies have reportedly been increasingly relying on a once-arcanic method of financing: reverse factoring (sometimes called “supply chain financing”). In brief, reverse factoring typically involves a downstream company arranging for a bank or other intermediary to pay the company’s suppliers on its behalf, and subsequently the company pays the bank or intermediary back (often with a fee). The economics of an arrangement may be equivalent to debt with a third-party that should be reflected as such both on a balance sheet and in the statement of cash flows, but current accounting guidance permits companies to judgmentally choose how to account for the arrangements, and some companies may not be reporting the arrangements as debt or reflecting the associated cash flows in a consistent way.<sup>8</sup> As noted by a panelist in February, the issues involved have become sufficiently concerning that “the Big Four have recently requested that FASB provide guidance on the appropriate accounting for these arrangements.”<sup>9</sup>

The effects of increased use of reverse factoring include that investors may be increasingly unable to understand fairly a company’s financial position, believing that what are effectively long-term debt facilities are in fact current liabilities. Reverse factoring can “impact key performance ratios and influence [investors’] understanding of the [company’s] financial position, debt and cash flows.”<sup>10</sup> In addition, companies may face increased financial risks from reliance on this financing technique. Particularly now, amid the coronavirus, as global trade flows fall, multinational companies with lengthy and significant supply chains may experience disruptions in both their financing and their supply relationships, making investor understanding of supply chain finance all the more important.<sup>11</sup> Credit rating agencies have also been sounding the alarm.<sup>12</sup>

Currently, disclosure of reverse factoring arrangements appears to be less than adequate. The SEC’s Investor Advocate included significant discussion of this topic in his 2019 report, drawing on investor and analyst reports documenting the increase.<sup>13</sup> That report noted among other things that in 2019, UBS reported that 34 out of 1,354 companies in its coverage universe disclosed the use of reverse factoring. Yet roughly 40% of those companies had exhibited significantly higher levels of “days payable”<sup>14</sup> in their financial statements, consistently increasing them over many years, a shift that UBS did not believe was consistent with other explanations (such as improved relationships with suppliers or improved credit), and from which UBS inferred significantly underreported use of reverse factoring. GAAP is of course set primarily by the Financial Accounting Standards Board, but disclosures that are designed to illuminate risks associated with different kinds of financing arrangements are within the scope of the SEC’s requirements for disclosure in Item 303 of Regulation S-K (management’s discussion and analysis or MD&A), which requires disclosure of known material trends or risks.

**Recommendation:** The SEC should **closely monitor** accounting developments relating to reverse factoring. The Office of Chief Accountant and the Division of Corporate Finance should carefully **review** MD&A disclosures relating to the use of reverse factoring or supply chain finance, should **inquire** of companies whether those without disclosures of risks or trends in their use of reverse factoring should include such disclosures, and should **consider** whether specific questions or line items relating to reverse factoring should be included in any revision of Item 303 that it adopts.

### 3. Use and Risks of non-GAAP Metrics

Companies have increasingly relied on non-GAAP metrics (both financial and non-financial) over the last twenty-five years as a way to give investors' insight into their operations. Analysts have come to use such metrics to assess and compare companies and track companies over time. Generally speaking, such metrics can be a good addition to GAAP reporting. Nonetheless, GAAP reporting remains the core of financial accounting, and non-GAAP metrics can sometimes overshadow or create confusion about more traditional financial metrics. The SEC has taken up non-GAAP measures and provided guidance on the topic, and brought at least one enforcement case involving non-GAAP disclosures, which we applaud.<sup>15</sup> Continued and increased use of such metrics by companies outside of formal SEC reports, such as in press releases and presentations to investors, however, suggests that continued monitoring and consideration of SEC disclosure requirements may be important in reducing the risk that companies may manipulate or deceive investors with non-GAAP metrics, either relative to GAAP or by changing metrics over time.

**Recommendation:** We recommend that the SEC and its staff **continue to monitor** the use of non-GAAP measures by reporting companies. In particular, we recommend consideration of a **study**, which could be modest in scope initially, to examine whether companies are using non-GAAP metrics prominently in communications to investors that are not part of formal SEC reports, and if so, whether they are changing their non-GAAP metrics' definition or calculation, or otherwise using them in ways that may be materially deceptive to investors. Based on such a study, and from canvassing the use of non-GAAP metrics more generally, the SEC should also consider whether any of the commonly used non-GAAP metrics may be better presented within MD&A or other non-GAAP elements of formal reporting documents, where full SEC oversight and monitoring can be brought to bear.

### 4. Proposal to Omit Tabular Information on Contractual Obligations

In its January disclosure release, the SEC also proposed to modify Item 303 to permit the omission of tabular presentation of contractual obligations.<sup>16</sup> The SEC correctly noted that much of the information in the currently required table can be found elsewhere in a Form 10-K, such as in financial statement footnotes. The SEC also questioned whether the information required would be, on its own, meaningful.

Investors and analysts, however, have informed the subcommittee that the information in the current tabular format is useful and material. While much of the information can be derived from other places in a Form 10-K, it is more complete and substantially less costly and less time-consuming for analysts to gather and analyze, and for investors to use, in its current presentation. It is not apparent to us that the cost savings from the company side from the proposed change would be greater than the increased costs that dispersed analysts and investors would have to bear from having to gather the information themselves.

Its potential materiality can be illustrated with a recent analyst report on the cruise line industry, which has been hit particularly hard by the coronavirus.<sup>17</sup> The report relied on the tabular presentation of contract obligations to compare and contrast cruise lines' exposures to a mismatch between revenue shortfalls and their near-term obligations. While a similar analysis could have been done by relying on information in financial footnotes, the substitute analysis would have been less complete and taken longer to execute. In the current environment, less timely disclosure of this analysis would have been less useful to investors.

**Recommendation:** We recommend that the SEC and staff **reconsider** whether to permit omission of the tabular contractual obligations information in annual reports. To the extent the SEC believes such information is duplicative, we suggest that companies could provide internal links in the table to information elsewhere, allowing investors and analyst to rapidly locate and analyze the information. To the extent the SEC believes the information in the table is materially incomplete as regards a particular use for the information, we suggest considering whether to augment the table, rather than to delete it.

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<sup>1</sup> We thank the panelists for their helpful presentations and discussions: Zach Gast (President, CFRA Research); Keith Higgins (Ropes & Gray LLP); James Kroeker (Vice chairman, FASB); Jeff Mahoney (General Counsel, CII); Andrew McMaster (Former Chair, FASC and retired Deputy CEO, Deloitte & Touche LLP); and Professor Katherine Schipper (Thomas F. Keller Professor of Business Administration, Duke University). The archived webcast is [here](#).

<sup>2</sup> We thank the staff for their helpful responses, particularly as the call occurred amid during under coronavirus stay-at-home orders: Sagar Teotia, Chief Accountant, SEC's Office of the Chief Accountant; Marc Panucci, Deputy Chief Accountant, Professional Practice, SEC's Office of the Chief Accountant; Lindsay McCord, Acting Chief Accountant, CF's Office of the Chief Accountant; Patrick Gilmore, Deputy Chief Accountant, CF's Office of the Chief Accountant; Ryan Milne, Associate Chief Accountant, CF's Office of the Chief Accountant; Betsy Murphy, Associate Director, Legal and Regulatory Policy, CF Luna Bloom, Chief, CF's Office of Rulemaking; and Angie Kim, Special Counsel, CF's Office of Rulemaking.

<sup>3</sup> SEC Rel. 33-10750, [Management's Discussion and Analysis, Selected Financial Data, and Supplementary Financial Information](#) (Jan. 30, 2020).

<sup>4</sup> Id. at 22-29 (proposing to modify Item 302(a)).

<sup>5</sup> See AeroVironment, Inc. Form 10-K for the year ended April 30, 2019, at 3 (reporting discontinued operations) and 102 (reporting Q4 results for continuing operations).

<sup>6</sup> We thank Professor Suraj Srinivasan and researcher Botir Kobilov for their assistance and research.

<sup>7</sup> See, e.g., [BDO USA, LLP](#) (July 20, 2016); [Bloomberg LP](#) (July 21, 2016) (noting that “any numbers derived by this method [i.e., subtracting Q1-Q3 numbers from annual numbers] are at best approximate”); and [CFA Institute](#) (Oct. 6, 2016).

<sup>8</sup> Deloitte, [Clarity in financial reporting: Implications of supplier finance arrangements on trade payables](#) (July 2018), at 1 (“appropriate presentation of supplier finance arrangements in the financial statements will require significant judgement based on the facts and circumstances for each arrangement”).

<sup>9</sup> Zach Gast, CFRA Statement to IAC at 3; See [Letter from Big Four Accounting Firms](#) to Shayne Kuhnack, Acting Technical Director, FASB (Oct. 2, 2019).

<sup>10</sup> Deloitte, *supra*, at 1.

<sup>11</sup> Jean Eaglesham, [Supply-Chain Finance is New Risk in Crisis](#), Wall St. J. (Apr. 4, 2020).

<sup>12</sup> Moody's Investor Service, [Reverse factoring's rising popularity comes with high, but hidden risks](#), Sep. 19, 2019; Jenny Wiggins, [S&P toughens reverse factoring scrutiny](#), Australian Financial Review (Mar. 11, 2010).

<sup>13</sup> SEC Investor Advocate, [Report on Activities Fiscal Year 2019](#), at 19-20.

<sup>14</sup> “Days payable” are typically defined as Accounts Payable x 365 / Cost of Goods Sold, and are a measure of the average time a company takes to pay its suppliers.

<sup>15</sup> See <https://www.sec.gov/divisions/corpfin/guidance/nongapinterp.htm>; <https://www.sec.gov/rules/interp/2020/33-10751.pdf>; <https://www.sec.gov/Archives/edgar/data/1419536/000162828018011582/filename1.htm>; and <https://www.sec.gov/litigation/admin/2018/34-84956.pdf>.

<sup>16</sup> SEC Rel. 33-10750 at 33.

<sup>17</sup> See CFRA Industry Report, *Risks Ahoy! Key Metrics at Cruise Lines* (Mar. 11, 2020).