November 22, 2016

Division of Corporation Finance
U.S. Securities and Exchange Commission
100 F Street, NE
Washington DC 20549-1090

Re: *FAST Act – SEC Required Study on Modernization and Simplification of Regulation S-K and*

Release No. 33-10198; File No. S7-18-16
*Request for Comment on Subpart 400 of Regulation S-K*

Ladies and Gentlemen:

As members of the Investor as Owner Subcommittee[1] of the Securities and Exchange Commission's Investor Advisory Committee (IAC), we appreciate the opportunity to share with you the Subcommittee's thoughts on: (1) the FAST Act's requirement for the SEC to conduct a study as to how the Commission might modernize and simplify the disclosure requirements under Regulation S-K, and (2) required disclosures under Subpart 400 of Regulation S-K.

In the FAST Act, Congress directs the Commission to consult with the IAC in conducting the above-mentioned study.[2] The IAC has previously engaged with the Commission on the issue of disclosure effectiveness, and we incorporate by reference all of the issues and concerns raised in our June 15, 2016 letter to the Division of Corporation Finance. Our objectives in this letter are to provide additional input on our views around disclosure "modernization and simplification", as well as provide our thoughts on disclosures required by Subpart 400.[3]

## Overview

We support the SEC's efforts to modernize and simplify the existing disclosure regime, as long as these efforts at simplification provide investors with the information needed for decision making and stewardship purposes. Although we support the SEC's efforts, we are unaware of any broad-based call on the part of investors for reduced disclosure. In addition, as we explain later in our letter, we believe there is inadequate disclosure in numerous areas. Nevertheless, we recognize that disclosures impose costs, both on issuers to prepare the information and on users

[1] This *comment letter* (our emphasis) is being submitted by the members of the Investor as Owner subcommittee of the SEC's Investor Advisory Committee (IAC). A super majority of the Subcommittee supports the issuance of this letter. This letter is not a recommendation made by the full IAC, nor is it a direct report to the Commission or to any federal officer or employee.

[2] *See* Section 72003(b) of the Fast Act, https://www.congress.gov/114/bills/hr22/BILLS-114hr22enr.pdf

[3] One member of the Subcommittee was unable to support the letter. This Subcommittee member questioned whether the benefits of our recommended proposals related to data and technology exceeded their costs. He or she felt that our proposals related to new disclosures went beyond what was material to investors, were covered by existing requirements, or were even counterproductive because the disclosure would reveal a proprietary corporate strategy. In addition to benefits not exceeding costs, this member also felt that our proposals may create unintended consequences, result in longer reports that were not necessarily more useful, and make our capital markets less attractive.

to process the information. Moreover, simply expanding required disclosures, without considering the relevance of provided disclosures for investment and/or stewardship purposes, can serve to obscure information that is truly important. Therefore, the Subcommittee advocates for more useful disclosures, delivered in a more cost effective manner. In particular, investors need more and better forward-looking information. Such forward-looking information may be more predictive and value relevant for decision making. The SEC should encourage the FASB to require such forward-looking information or the Commission should act on its own accord.

We believe that it is possible to achieve both better disclosure and reduced costs. As we discuss below, we believe there are multiple opportunities to more effectively utilize technology in preparing, auditing, and delivering financial reports. As a result, we believe that investors and users can receive better, more-detailed, and more-timely financial reports, that these reports can be made more accessible to a wider spectrum of users, and that issuers can provide these reports at a reduced cost. These objectives are bi-partisan and are worth pursuing, and we elaborate on technology's potential to achieve these benefits below.

## Opportunities to Use Technology to Improve Corporate Reporting

We encourage the Commission to more fully explore the role of technology in improving the corporate reporting process. Such expanded use of technology offers the promise of better and more timely information, and at a reduced cost. In our view, enhanced use of technology offers the most viable path to achieving the FAST Act's objective of reducing "…the costs and burdens on issuers while still providing all material information." In particular, and consistent with the IAC's June 2016 letter, we believe that four actions would achieve substantial benefits: (1) require that filings to the Commission be in a structured machine-readable, interactive format, (2) mandate the use of Inline XBRL,[4] (3) explore the use of layered disclosures by issuers, and (4) explore providing certain relatively-static information in a company profile, with changes to the information in the company profile included in periodic filings as they occur.

### Require filings to be in a structured machine-readable interactive format.

In our view, the most promising means of reducing costs and burdens is for issuers to tag data in a machine-readable format at its source (CFA Institute 2016a, 22).[5] Although there would be a cost of developing systems and controls to tag data at its source, once such processes were developed the cost savings associated with preparing required filings with the Commission could drop as much as 20-30 percent (CFA Institute 2016a, 11, 12). For example, issuers could tag data with the applicable XBRL tag at its source. In addition, the AICPA has developed data standards (tags) that would permit tagging at an even more granular level, essentially at the general ledger level.[6] Tagging at the general ledger level would offer even greater savings, particularly with respect to savings on financial reporting costs.

---

[4] Inline XBRL is a machine-readable interactive format, so our first two recommendations overlap and complement each other.

[5] In discussing various technology options, we rely primarily on the CFA Institute's recent monograph on using technology to improve the provision of financial information. The Subcommittee's members are not technologically experts, but such experts are available within the Commission and certainly on the outside.

[6] See https://www.aicpa.org/InterestAreas/FRC/AssuranceAdvisoryServices/Pages/AuditDataStandards.aspx for further discussion of the AICPA's Audit Data Standards.

Regardless of whether issuers choose to tag data at its source, the Commission should require filings to be in a structured machine-readable interactive format. Today most issuers maintain their internal accounting records in an ERP-system of some type, and such systems produce structured data. Then, for purposes of filing with the SEC, such structured data is converted to unstructured data (i.e., filings with the Commission as HTML paper documents). But users, particularly institutions, typically obtain their data not from the paper filings at the Commission, but via various data intermediaries who convert the unstructured data filed with the Commission back into structured data.[7] Another benefit to users from filing in a structured machine-readable interactive format is that users can more easily access information. In addition, by providing data in a structured machine-readable interactive format users are able to more easily populate their models (which are all computer-based and depend on digital data), and such a format facilitates comparisons across different investment opportunities. Moreover, by lowering the costs of information search and process, companies that might have been too small to analyze in a more labor-intensive fashion now become viable investment targets, potentially enhancing capital formation in smaller public companies (CFA Institute 2016a, 9). Finally, as Commissioner Stein has stated, improving data quality is likely to also improve secondary market liquidity for smaller and medium size companies (as quoted in CFA Institute 2016a, 33). But for users to benefit from filings in a structured format, interim reports and the financial statement notes would have to be filed in this format as well and, over time, such structured filings should be extended to the MD&A as well as to 8-K filings and proxy statements (CFA Institute 2016a, 5, 50).

**Mandate the use of Inline XBRL.**

A structured machine-readable interactive format that we support is Inline XBRL. Inline XBRL allows registrants to embed XBRL code directly into the HTML documents that are currently filed with the Commission (see www.sec.gov/structureddata/osd-inline-xbrl.html). Currently documents are generally filed with the Commission as HTML documents, and XBRL documents are filed separately. There are a number of problems with the existing regime. First, this dual reporting regime adds costs and complexity without any commensurate benefit. Second, since separate XBRL filings are not audited, unlike the financial statements and notes of an HTML filing, the rate of errors in XBRL filings are unacceptably high (CFA Institute 2016a, 20). Third, many investors, particularly retail investors, are unlikely to even know that XBRL filings exist, thereby reducing the extent of potential investor benefit. We recommend that the Commission require the use of Inline XBRL and, as suggested by Commissioner Stein, also require the auditing of this aspect of a registrants' filing (as quoted in CFA Institute 2016a, 37).

There are a number of benefits of required use of Inline XBRL. First, to the extent that the XBRL tagging is audited, the filing would, in many cases, be subject to the rigorous controls and assurance associated with internal control over financial reporting. Second, investors would have access to many more data elements – data elements that registrants are already incurring the costs to provide. For example, there are over 7,000 data elements available in XBRL, compared to approximately 700 data elements available via the Bloomberg dataset (a commonly used third-party data aggregator and provider) (CFA Institute 2016a, 20).

[7] We are not advocating the elimination of paper-based filings with the Commission at the current time, although in the future a reduction, or elimination, of paper-based filings may afford cost savings.

Finally, two caveats with respect to the required use of Inline XBRL. First, the Commission should limit registrants' use of extensions to those situations where company-specific information clearly is not captured via existing XBRL data tags. But, even in this instance, extensions should only be allowed within a well-defined framework so that the integrity of financial statement relationships is maintained (CFA Institute 2016a, 26). Finally, we are concerned that as the number of items to be tagged becomes large consistency in tagging may deteriorate. We believe that embedding the XBRL tags within the HTML filing, and requiring the external audit to encompass the XBRL tagging process and filing, will result in greater discipline around the use of data extensions, thereby increasing the consistency, reliability, and relevance of XBRL filings. Second, a more robust tagging schema for non-financial information needs to be developed. Although notes to the financial statements are currently block tagged, a taxonomy of textual disclosures needs to be developed to facilitate optimum use of non-financial information. Moreover, over time, all information in filings (10-K, 10-Q, 8-K, proxies, registration statements) needs to be block tagged. Given that much of the information in these filings is textual, the Commission needs to develop a robust taxonomy of textual disclosures. For example, a good beginning would involve tagging ownership information in the proxy statement (both the ownership table and related notes), which we believe is currently difficult for users to process.

**Explore the use of layered disclosures by issuers.**

We encourage the Commission to consider whether a layered approach to financial disclosure could reduce costs and complexity, but also facilitate greater use of corporate filings (particularly by retail investors) while not reducing the extent of information available to more sophisticated users. Registrants could provide summary information to the Commission electronically, with various links that would enable users to drill down further into the details based on each user's personal preferences (CFA Institute 2016a, 38). Many retail investors might be content with summary information, and might actually consume the information rather than not even attempt to read an entire 10-K. Large, sophisticated institutional investors would likely drill down to the most granular level, at least in those areas they deem most critical to their investment or stewardship decisions. But, even for large institutional investors, a layered disclosure regime would likely increase the navigability of corporate filings, thereby providing benefits to both registrants and investors.

In addition to layered disclosures, the Commission should mandate the greater use of hyperlinks to facilitate cross referencing in required filings. For example, we support the Commission's proposed rule to require registrants to include a hyperlink to exhibits (listed in the exhibit index) in filings on Forms 10-F or 20-F, or that are required under Item 601 of Regulation S-K (SEC 2016).

**Explore providing relatively-static information in a company profile.**

We also encourage the Commission to consider whether filings can be simplified by enabling registrants to present relatively-static information in a company file that would be filed with the Commission and updated as changes occur (Karmel 2016, 27 also discusses this idea). For example, Items 1, 1A, 2, 3, 4, 5, 10, 11, and 13 (Business; Risk Factors; Properties; Legal Proceedings; Mine Safety Disclosures; Market for Registrants' Common Equity; Directors,

Officers, and Corporate Governance; Executive Compensation; and Related Party Transactions) may be relatively static, at least over relatively short periods of time. Updates to the company file would be made either in the next 10-Q or, for a particularly material change, by filing a Form 8-K. Since under the current regime, changes in the above items may not be disclosed until the next 10-K is filed, movement to a company file may not only reduce costs and complexity but have the positive effect of providing more timely information to the market when changes occur via either a 10-Q or 8-K filing.

**Inadequate Disclosures Under the Current Regime**

As discussed at the beginning of our letter, we believe that there is inadequate disclosure under the current regime in a number of areas. Our premise is that investors and other financial statement users may have a different view as to financial statement amounts if users were provided the information needed for users to make their own adjustments to management's reported amounts, particularly in those areas that are highly judgmental.[8] The areas discussed below are illustrative of this lack of disclosure but are not necessarily an exhaustive list. At a minimum, we believe that existing disclosures are inadequate with respect to: (1) estimates, assumptions, and judgments, including rollforwards; (2) contingencies; (3) income taxes; (4) internally-developed intangibles; (5) human capital, particularly employee training, (6) auditor and partner changes; and (7) identification of subsidiaries.

*Estimates, Assumptions, and Judgments, Including Rollforwards*

For a number of years and from different sources investors have called for greater specificity and transparency with respect to estimates, assumptions, and judgments (e.g., CFA Institute 2008, 2010; IAG 2011). Although financial statements imply a high degree of precision – with earnings per share carried out to two decimal places – the reality is that financial statements are replete with estimates, assumptions, and judgments. A casual perusal of a balance sheet of a generic company illustrates just how pervasive estimates, assumptions, and judgments are – e.g., estimates of fair value for Level II and III securities,[9] allowance for doubtful accounts, allowance for inventory obsolescence, estimates of useful lives and fair values for fixed assets, estimates of future cash flows and fair value for evaluating impairment of intangible assets, estimates of future claims under warranties, estimates of environmental remediation liabilities, discount rate and asset return estimates for defined benefit pension plans, estimates of the recoverability of deferred tax assets and the support for tax positions taken, among others. Simply put, the quality of an entity's financial reporting is directly related to the quality of that entity's estimates, assumptions, and judgments. But therein lies the problem – GAAP is often deficient as it relates to providing specific and transparent information in this area, or even adequate disclosure as to the process the issuer follows in developing highly judgmental estimates. For example, the reported value for Level III securities is likely to contain significant measurement error and is

[8] We realize that some investors and users may accept reported financial statement amounts as a given (given an unqualified audit opinion), and are content with performing their analyses on the numbers reported. In an increasingly customized, on-demand world, we expect an increasing number of investors and users to want sufficient information for them to customize and modify the general-purpose information provided.

[9] Although measurement error is expected to be less for a Level I security, a rollforward comparing unrealized gains/losses to eventual market realization would be useful for all types of securities, including Level I securities, because although the market is efficient it is not infallible.

susceptible to management bias. Requiring issuers to provide tabular disclosure of fair value ranges for each security is likely to be too voluminous to be useful, but issuers should be required to provide more granular disclosure as to the process used to generate fair value estimates. For example, the issuer could be required to disclose how it assesses the independence of the pricing sources used, the role of non-business-line management in evaluating and assessing the price quotes received (e.g., the role of internal audit), and the issuer's process for involving the audit committee in reviewing the reported fair values.

Some may argue that registrants are already required to report information on estimates, assumptions, and judgments in the "Critical Accounting Policies and Estimates" section of the Management Discussion and Analysis (MD&A) section of the 10-K. To evaluate the granularity and transparency of these disclosures we analyzed this section of a large public company's recent 10-K, Apple Inc.[10] In discussing its "judgments, assumptions, and estimates," Apple states that "actual results may differ from these estimates and such differences may be material" (Apple 2015, 33). Therefore, there should be no doubt as to the importance to investors of information related to estimates, assumptions, and judgments.

Apple indicates that critical accounting policies and estimates relate to revenue recognition, valuation and impairment of marketable securities, inventory valuation, warranty costs, income taxes, and legal and other contingencies. With respect to revenue recognition, Apple indicates that for multi-element arrangements that it "… allocates revenue to all deliverables based on their relative selling prices. In such circumstances, the Company uses a hierarchy to determine the selling price to be used for allocating revenue to deliverables: (1) vendor-specific objective evidence of fair value (VSOE), (2) third-party evidence of selling price (TPE), and (3) best estimate of selling price (ESP)" (Apple 2015, 33). No information is provided as to the percentage of multi-element sales where revenue is determined based on VSOE, TPE, and ESP, even though as one moves down the hierarchy the quality and verifiability of the estimate is likely to diminish. No information is provided as to the sources the company uses for TPE, nor is any information provided on the factors, and their respective weighting, used by the company in determining ESP. Given the importance of revenue recognition to any investor, more transparency and granularity as to these assumptions is needed.

With respect to valuation and impairment of marketable securities, Apple indicates that it regularly reviews its investment portfolio to evaluate whether any securities are other-than-temporarily impaired. A statement that the portfolio is evaluated regularly for impairment serves as a reasonable starting point for additional disclosure, but this disclosure alone is limited since such an evaluation is already required by GAAP. No information is provided as to what factors, and their weighting, the company uses in evaluating whether a security is impaired. And, perhaps more importantly, no information is provided on those securities whose market value is significantly below cost but where the company has concluded that no impairment has occurred and the justification for this position.[11]

[10] We are not suggesting that Apple's disclosure does not comply with SEC requirements or that their disclosures are deficient vis-à-vis other registrants. Rather, we use Apple to illustrate that the existing disclosure requirements are inadequate.

[11] If any of this information is provided in the notes to the financial statements, the MD&A should provide a cross-reference to the applicable note. The Subcommittee of the IAC did not perform an exhaustive analysis of Apple's

With respect to inventory valuation, Apple indicates that it "… performs a detailed review of inventory that considers multiple factors including demand forecasts, product life cycle status, product development plans, current sales levels and component cost trends" (Apple 2015, 34). Although Apple does indicate the factors it considers in evaluating inventory valuation, it does not provide any detail on those factors that are likely known only to those inside the company (e.g., demand forecasts, product life cycle status, product development plans, and component cost trends). We recognize that some of these factors may be proprietary but, at a minimum, a rollforward of the valuation account for "allowance for inventory losses" – showing the beginning balance, additions, writeoffs, and ending balance – should be required for all registrants unless clearly immaterial. And, if this account is clearly immaterial for Apple, than we are left wondering why the estimates surrounding the account would qualify as a Critical Accounting Policy.

With respect to warranty costs, Apple indicates that warranty reserves are based on "… historical and projected warranty claim rates, historical and projected cost-per-claim and knowledge of specific product failures that are outside of the Company's typical experience" (Apple 2015, 35). Apple does indicate the factors it considers in establishing warranty claim reserves, but again it does not provide any detail on those factors that are likely known only to those inside the company. Some of these factors may be proprietary, but a rollforward of the valuation account for warranty liability should be required unless clearly immaterial.

With respect to income taxes, Apple indicates that tax benefits based on uncertain tax positions are only recognized "… if it is more likely than not that the tax position will be sustained on examination by the taxing authority …" (Apple 2015, 35). No information is provided on the nature of these uncertain tax positions, nor is any specificity provided as to how the company evaluates whether the uncertain tax position will be sustained. Again, given the confidential nature of uncertain tax positions, a required rollforward of the valuation account should be required unless clearly immaterial.

Differences in estimates, assumptions, judgments can, and should, reflect different economic fundamentals – but they can also reflect the same economic fundamentals but different accounting choices. Even disclosing estimates, assumptions, and judgments leaves open the issue of whether differences reflect economic reality or accounting choices. Therefore, as already discussed, rollforwards of accounts are needed – beginning of year balance, estimate, realization, end of year balance. Over time, the consonance of estimates with realizations help entangle whether estimates reflect economic reality or are systematically biased, in either direction. Commission rules require rollforwards in certain areas (e.g., allowance for doubtful accounts, allowance for inventory losses – see Schedule II – Valuation and Qualifying Accounts and Reserves), but more is needed.

Two other points are worth mentioning here. First, the language discussing Apple's Critical Accounting Policies, particularly the language quoted and paraphrased above, was almost identical from 2014 to 2015. Since, presumably, there was some change in Apple's business across the two years, the almost identical language discussing Critical Accounting Policies across the two years implies that the current disclosure requirements are too blunt to provide

10-K as our objective is not to pass judgment on Apple's filing but rather to highlight the current state of disclosures related to estimates, assumptions, and judgments in the MD&A.

meaningful information to investors. Second, the need for registrants to provide additional information on estimates, assumptions, and judgments would be reduced if auditors opined on the relative aggressiveness/conservatism of these amounts. However, when the PCAOB considered having auditors provide an Auditor Discussion and Analysis – where company estimates, assumptions, and judgments would have been discussed – the firestorm of opposition from the corporate, legal, and accounting communities was intense (PCAOB 2013, 23).

*Contingencies*

GAAP currently requires a registrant to accrue a loss contingency when it is probable that a loss has been incurred and the amount of the loss can be reasonably estimated (see Accounting Standards Codification, Topic 450). Registrants must disclose, but not establish an accrual, when a loss is reasonably possible, or when the loss is probable but a dollar amount of the loss (or range thereof) cannot be reliably estimated. Contingencies where the likelihood of loss is remote need not be disclosed. This disclosure regime has the effect of providing minimal disclosures to investors until a loss is settled or adjudicated (and, in many cases, the registrant has suffered a cash outflow). The FASB recognized that investors lacked timely and adequate information on contingencies and worked on a project to improve disclosure in this area for approximately five years (2008-12).

The FASB recommended that registrants provide tabular information on loss contingency accruals, which would have enabled investors to discern changes in the loss contingency accrual during the reporting period (essentially a rollforward type presentation) (FASB 2010a). In addition, additional disclosures would have been provided. In the first few years after the identification of a contingency, the disclosures would have largely been factual and based on publicly-available information. As the contingency became closer to settlement or adjudication, the required disclosures would become more extensive (FASB 2010a). Although the project had support from investors[12] and notwithstanding the FASB's attempt to respond to concerns of the business community in its second exposure draft, approximately 92 percent of the preparer community opposed the FASB's project (FASB 2010b). In a striking and damning admission from the corporate community, "numerous respondents indicated that the fundamental issue is ***lack of compliance*** (our emphasis) with Section 450-20-50[13] rather than a need for increased disclosure" (FASB 2010b, 7).[14] Notwithstanding the deficiencies in loss contingency disclosures and the clear investor need for better information, the FASB dropped this project from its agenda in 2012. The SEC and/or FASB needs to reexamine registrant disclosures related to contingencies and undertake a project to improve reporting in this area.

[12] See the comment letter from the FASB's Investors Technical Advisory Committee as indicative of investor support for more robust disclosures related to contingencies, including the type of rollforward recommended by the Subcommittee (ITAC 2010).

[13] ASC 450-20-50 is the relevant section of the Accounting Standards Codification.

[14] Given that this FASB project is now six years old, we have inadequate information to evaluate the current state of loss contingency disclosures. We have reason to believe that the SEC's Division of Corporation Finance has devoted significant attention to the adequacy of these disclosures and, as a result, we would have expected substantial improvement.

*Income Taxes*

Income taxes are among the more complex and inscrutable areas of financial reporting, and disclosures, particularly related to foreign subsidiaries and operations, have often been viewed as deficient (*NYT* 2014; *The Economist* 2016). The FASB has responded to these criticisms, and the Board has issued a proposed amendment to the Accounting Standards Codification that would improve disclosures related to income taxes (FASB 2016a). Among other changes, the proposed amendment would require disclosure of: (1) income (from continuing operations), income tax expense, and income tax paid, separately by domestic and foreign operations, (2) income taxes paid to any country that is significant to total income taxes paid, (3) federal, state, and foreign tax carryforwards by expiration date, and (4) valuation allowance amounts recognized or released during the reporting period (FASB 2016b). Although the Subcommittee supports these changes, we would prefer jurisdictional reporting of income taxes paid (*The Economist* 2016) for those jurisdictions accounting for a significant portion of total company income, and a reconciliation of the effective tax rate to the statutory tax rate in those jurisdictions. In addition, additional disclosure on management's tax planning strategies and how these strategies relate to cash taxes paid is needed. Jurisdictions where the effective cash tax rate is low may result in the issuer attracting public and political attention, and the resultant legal, regulatory, and reputational risk is just as material as pure numeric-based criteria. In addition, it is imperative that the SEC ensures that the FASB follows through on improving income tax disclosures given that preparer opposition to the proposed changes is likely.

*Internally-Generated Intangibles*

Companies now invest more in intangible assets than they do in tangible assets (PwC 2016, 1). Notwithstanding the importance of intangible assets to value creation, there are significant differences in the required accounting treatment depending on whether the intangible assets are internally created or acquired from a third party. Generally, the cost of internally-developed intangible assets are expensed as incurred. Conversely, the cost of acquiring intangible assets from a third party are capitalized, and then charged to expense over time or evaluated for impairment depending on the nature of the intangible asset. Therefore, two companies that are otherwise economically similar – i.e., similar intangible assets such as software, patents, trademarks, brand names, etc. – would report very different balance sheets and income statements if one company developed their intangible assets internally and the other company purchased their intangible assets. This wide diversity in accounting for intangible assets makes it more difficult for investors to compare otherwise similarly-situated companies, and acts as an obstacle to optimum capital allocation. Moreover, unrecognized intangible assets likely explains why many companies trade a two or three times book value (PwC 2016, 2).

The FASB is considering adding a project to its agenda related to recognition of internally-generated intangible assets (PwC 2016, 1). Given the importance of intangible assets to value creation, the Subcommittee encourages the FASB to add this project to its agenda and to make it a high-priority project.

Without pre-judging the desired outcome of an FASB project on internally-generated intangible assets, the Subcommittee believes that providing fair value estimates of identifiable intangible assets is desirable. We also support additional disclosure as to the composition of an issuer's

goodwill balance, including the key variables assessed in evaluating goodwill for impairment. Finally, although not an intangible asset per se, the Subcommittee calls for disclosure of key nonfinancial metrics.[15]

*Human Capital, Particularly Employee Training*

A particular type of intangible asset – although not recorded under current GAAP – is an entity's human capital. An entity's investment in human capital should grow via employee training. Notwithstanding the underlying economic reality, human capital is not recognized under GAAP because of uncertainty as to whether employee training generates an asset, the amount of any resultant asset, and its duration. We recognize the difficulties with recognizing a human capital asset, and we are not suggesting that human capital, or an entity's investment in its employees, should be recognized as an asset. However, current GAAP treats investments in employee training as part of Selling, General, and Administrative Expense (SG&A), with no required note disclosure as to the amount of this training.

SG&A is a conglomeration of many different types of expenses, which can vary widely as to their effect on the future success of the entity. For example, research and development, advertising, and employee training are three expenditures that are charged to SG&A as incurred, but all of which are "economic assets" that should contribute to the entity's future success. Conversely, executive perquisites (e.g., corporate jet, country club memberships, supplemental retirement plans) are also charged to SG&A and are harder to justify as economic assets. Consistent with the recent report issued by the Center for American Progress, we encourage the Commission to require registrants to disclose the amount spent on employee training, essentially mimicking the required GAAP treatment of R&D expenditures (Center for American Progress 2016).

*Auditor and Partner Changes*

The Subcommittee believes that disclosures of audit firm changes (resignation, decline to stand for reelection, dismissal) and of premature audit partner changes[16] are inadequate, notwithstanding the 2008 recommendations of the Advisory Commission on the Auditing Profession (ACAP 2008, VII 11).[17] An ACAP recommendation was: "Urge the SEC to amend Form 8-K disclosure requirements to characterize appropriately and report every public company auditor change and to require auditing firms to notify the PCAOB of any premature engagement partner changes on public company audit clients" (ACAP 2008, VII 11).

---

[15] These recommendations are drawn from a recent CFA Institute letter to the FASB on the Board's future agenda (CFA Institute 2016b).

[16] An audit partner can serve as the engagement (signing) partner for five years on a public company before being required to rotate off that public company engagement. Typically accounting firms strive to enable the engagement partner to complete that five-year period, even if it means extending a partner beyond what the firm may specify as its normal retirement age. Therefore, the removal of a partner before the completion of the five-year period is unusual, and may reflect conflict between the public company and the engagement partner. ACAP recommended that auditing firms be required to notify the PCAOB "… of any premature engagement partner changes on public company audits" (ACAP 2008, VII 11).

[17] ACAP was established by President George W. Bush, and operated under the auspices of U.S. Treasury Secretary Henry Paulson. ACAP was a "blue-ribbon" committee designed to study the auditing profession and to make recommendations to facilitate the "… sustainability of a strong and vibrant profession" (ACAP 2008, II 1).

Although existing disclosure requirements are quite extensive,[18] a significant percentage of auditor changes fail to disclose any reason for the auditor change (ACAP 2008, VII 11). Given that auditor-client pairings often are long-standing, auditor changes can signal problems, either immediate or latent, in a company's financial reporting, internal controls, or governance processes. As such, auditor changes and the reasons therefor are material events requiring greater transparency to the investing public.

Notwithstanding ACAP's recommendation for greater transparency as to auditor changes and as to premature partner changes, it appears that the last time that the SEC amended its disclosures related to auditor changes was in 1989. The Subcommittee believes that the SEC should act expeditiously to amend 17 CFR 229.304 to provide more robust disclosures as to auditor changes and to premature partner changes (i.e., partner changes before completion of the five-year period that a partner is allowed to serve).

*Identification of Subsidiaries*

Consistent with the majority recommendation in our June 15, 2016 letter on Disclosure Effectiveness, we believe that the Commission should require the use of a global identifier such as the Legal Entity Identifier (LEI) in filings. By requiring registrants to include a LEI in their filings, the identification of a registrant's subsidiaries and affiliates is facilitated. Through better identification of subsidiaries and affiliates, investors and regulators are better able to evaluate the registrant's risk, firm interconnectivity, and tax-avoidance strategies (e.g., see the recent speech by Commissioner Stein – Stein 2016).

The required use of a LEI would facilitate identification of subsidiaries and affiliates that are separately registered with the Commission, but would not increase the transparency around wholly-owned subsidiaries that are not registered with the Commission. This lack of disclosure is problematic as recent years have seen an alarming trend toward registrants disclosing fewer subsidiaries in filings with the Commission, particularly offshore subsidiaries and most especially those subsidiaries located in tax havens (Holzer 2013). The SEC does not require disclosure of a subsidiary unless it is deemed "significant" based on a 10 percent test applied to assets, investment, or income (Holzer 2013). The Subcommittee suggests that the Commission require disclosure if the subsidiary is qualitatively material, which would certainly encompass those situations where a foreign subsidiary is used to reduce the registrant's effective tax rate.

**Subpart 400 of Regulation S-K**

In the balance of this letter, we respond to the SEC's *Request for Comment on Subpart 400 of Regulation S-K*. We believe that important disclosures are missing from the proxy statement (typically encompassed under Subpart 400 of Regulation S-K) or, even when present, are in need of improvement. The Subcommittee believes that additional disclosures are needed related to environmental risks, and that existing disclosures related to related-party transaction (RPTs), board nominees, and audit committee financial experts are in need of improvement.

[18] SEC requirements in existence at the time ACAP did its work require disclosure of whether an auditor change is due to a disagreement between the company and the auditor related to accounting principles, disclosures, audit scope or procedure, as well as whether the auditor change was due to deficiencies in internal control, the reliability of management representations, or the need to expand the scope of the audit (17 CFR 229.304).

*Environmental Risks*

The Subcommittee believes that existing SEC-mandated environmental disclosures are inadequate, particularly with respect to climate change.[19] Although existing SEC disclosures require companies to disclose material risks that result from climate change, the extent of such disclosure is sporadic and, even when present, often lacks specificity (Randall 2014). Better disclosures on risks related to climate change are clearly important to many investors, and increasingly is viewed as an issue that affects macroeconomic risk. For example, at the behest of G20 finance ministers and central bank governors, the Financial Stability Board (FSB) has formed a task force to develop climate-related financial disclosures (FSB 2016). Unfortunately, the FSB initiative seeks to develop *voluntary* disclosures (FSB 2016). Voluntary disclosures often translate into no disclosure or, at best, disclosures by "good actors" whereas it is the "bad actors" where disclosure is most needed.

The Subcommittee encourages the Commission to develop, either directly or by recognizing an outside standard setter, mandated and specific disclosures related to environmental risks. We agree with the FSB that better climate-related disclosures will help investors better manage risk and allocate capital.[20]

Moreover, we believe that the Commission needs to recognize the legitimate desire on the part of many investors for more holistic disclosures around sustainability (e.g., environmental risks, which are not only limited to climate change; worker safety and working conditions; diversity; supply chain management; etc.). In particular, the work of the Sustainability Accounting Standards Board (SASB) is notable, and whether or not the Commission chooses to recognize SASB as a standard-setter that board's efforts should be carefully considered in the Commission's own rule making initiatives.

*RPTs*

Although Commission rules already require disclosure related to RPTs, we view this area as in need of improvement. The Subcommittee suggests that the staff consider (a) unifying or at least consider aligning disclosure requirements for related person transactions under Regulation S-K Item 404 and related party transactions under GAAP, as they address overlapping topics, and (b) broaden the unified or aligned requirements to include indirect conflicts arising from director or officer ownership of companies in the same line of business as the issuer.

Broadly speaking, two threats to investors exist when the fiduciaries and controlling shareholders of an issuer also own separate businesses: conflict of interest transactions involving the issuer (i.e., self-dealing), which can harm the issuer directly, and opportunities to engage in a transaction that are diverted away from the issuer, which can harm the issuer indirectly. In an array of situations, corporate law forbids fiduciaries both from engaging in unfair conflict of interest transactions, and also from diverting corporate opportunities for their own benefit. For this body of law to protect public companies, however, adequate disclosures of conflict of

[19] Although the Subcommittee does not necessarily endorse the entire content of the letter, we refer the Commission to the more extensive discussion of the need for more robust ESG disclosures, especially related to the environment, in Professor Jay Brown's comment letter (Brown 2016).
[20] See www.fsb-tcfd.org/about/#

interest transactions and diverted opportunities are necessary. An effective combination of corporate and securities law requirements best protects investors and reduces the cost of capital for all companies, including those with fiduciaries who do not engage in self-dealing or diversion of corporate opportunities. This general topic is all the more important as an increasing number of large public companies are owned or controlled by individuals or corporations that have significant affiliated businesses.[21]

Currently, Regulation S-K Item 404 generally seeks to inform shareholders about ways that directors and officers may have benefited from their position and requires disclosure of any "transaction" over $120,000 in which the issuer participates "in which any **related person** had or will have a direct or indirect material interest." "**Related person**" generally includes directors and executive officers, their immediate family members, and 5+% shareholders. Separately, registrants must include in their financial statement footnotes disclosures under U.S. GAAP -- Accounting Standards Codification Topic 850. That Topic generally seeks to inform investors about the fact that, and how, the financial position and results of operations may have been affected by relationships with "**related parties**." "**Related parties**" generally include corporate affiliates, employee trusts, principal shareholders, management, and other parties that can significantly influence the management or operating policies of a transacting party such that one party might not fully pursue its own interests. In addition to disclosing transactions with related parties, Topic 850 requires disclosure of the fact and nature of "control relationships" if such relationships or their "existence ... could result" in financial results that are "significantly different" from results had the related parties been autonomous.

Item 404 does not require disclosure of the fact that related persons have interests in or relationships with other businesses the existence of which could reasonably affect the issuer, such as through diversion of corporate opportunities. Nor does either Item 404 or Topic 850 currently require **clear** disclosure of actual "corporate opportunities" diverted by officers, directors or control shareholders. In principle, Topic 850 might require disclosure of corporate opportunities, but the tests set out in the guidance remain highly subjective and general in nature, such that relationships that in fact have the potential to affect reported financial results in a material way may not be disclosed. We note that the guidance contained in Topic 850 "remained largely unchanged since the issuance of AU sec. 335, *Related Party Transactions*, in July 1975" (PCAOB 2014, 9).

We suggest that the staff consider aligning the two sets of disclosure requirements, broadening the requirements of Item 404 to include corporate opportunities, and beginning the process by which relevant accounting standard setting bodies may clarify and improve the requirements for disclosure of corporate opportunities in the financial statement notes.

Ideally, the disclosure requirements would align, even if there are reasons for them not to be fully unified. In particular, it would be cost-beneficial for issuers to be able to track and maintain information that would be necessary for both sets of disclosures in a single series of

[21] Without this list in any way suggesting anything improper about these relationships, it worth noting that a list of such companies would include **Alphabet Inc**., the holding company for **Google**, Inc., **Alibaba Group**, which is part of a complex corporate family, and **Facebook Inc.**, on whose board sits Peter Thiel, who is also a managing director of a venture capital fund that invests in technology companies.

records. Issuers and investors alike could benefit if Topic 850 had a greater degree of clarity on the scope of relationships and opportunities required to be disclosed, similar to the bright-line approach for self-dealing transactions under Item 404 currently.

Item 404 would be more comprehensive if it addressed corporate opportunities. As with the self-dealing disclosures under Item 404, any corporate opportunity disclosures would likely benefit from some bright-line rules as part of the disclosure requirements. These could include, for example, how to assess whether affiliated companies are in the same line of business as the issuer, and on the size of transactions that an affiliated company was able to engage in rather than the issuer. The modified requirements could also be written so as not to imply any necessary wrongdoing, as not all corporate opportunities need or should be retained by a given issuer. The point of the disclosures would be to make it possible for shareholders to learn basic information about the risk of diversion of valuable opportunities, and decide whether further investigation was warranted.

*Board Nominee Disclosures*

We are concerned about the lack of diversity on corporate boards and, as such, believe that more robust disclosures on the board's consideration of diversity in filling board positions under Item 407(c) is needed. In particular, we echo the recent call from CalSTRS for disclosure, at the individual nominee level, of gender, racial, and ethnic background as well as nominees' skills, experiences, and attributes, preferably presented in the form of a chart or matrix (CalSTRS 2016). More broadly, throughout all of Item 401, we prefer to see use of gender neutral language.

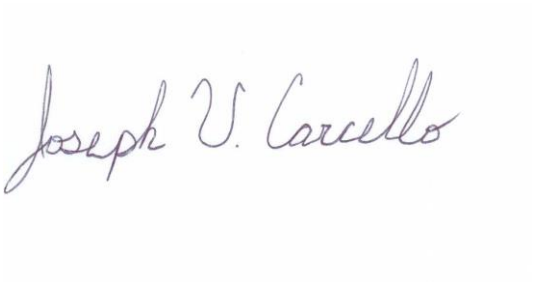
*Audit Committee Financial Expert*

Also consistent with the CalSTRS letter cited, we believe that the current definition of an audit committee financial expert (see 407(d)(5)(i)) is excessively broad and individuals designated as an audit committee financial expert should have substantive experience in accounting or auditing (CalSTRS 2016).

* * * *

We look forward to sharing our perspectives with you in person and we are pleased to answer any questions you may have.

Sincerely,



Joseph V. Carcello
Chair, Investor as Owner Subcommittee
on behalf of the Subcommittee Members
of the SEC's Investor Advisory Committee

## REFERENCES

ACAP (Advisory Committee on the Auditing Profession). 2008. *Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury*.

Apple, Inc. 2015. Form 10-K.

Brown, J. 2016. Comment letter on the SEC's *Concept Release on Disclosure Effectiveness*. October 3.

CalSTRS. 2016. Comment letter on the SEC's *Request for Comment: Subpart 400 of Regulation S-K Disclosure Requirements Relating to Management, Certain Security Holders and Corporate Governance Matters*. October 31.

Center for American Progress. 2016. *Workers or Waste? How Companies Disclose – or Do Not Disclose – Human Capital Investments and What to Do About It*. June.

CFA Institute. 2008. February Monthly Question Results. Cite in *Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury*. VII: 16.

CFA Institute. 2010. *Independent Auditor's Report Survey Results*.

CFA Institute. 2016a. *Data and Technology: Transforming the Financial Information Landscape*.

CFA Institute. 2016b. Comment letter on the FASB's *Agenda Consultation*. November 1.

FASB. 2010a. *In Focus -- Proposed Accounting Standard Update: Disclosures of Certain Loss Contingencies*. August.

FASB. 2010b. *Disclosure of Certain Loss Contingencies: Comment Letter Summary*. October.

FASB. 2016a. *Proposed Accounting Standards Update: Income Taxes*. July.

FASB. 2016b. *In Focus – Income Taxes (Topic 740): Disclosure Framework – Changes to the Disclosure Requirements for Income Taxes*.

FSB. 2016. *Press Release – FSB Announces Membership of Task Force on Climate-Related Financial Disclosures*. January 21.

Holzer, J. 2013. From Google to FedEx: The incredible vanishing subsidiary. *The New York Times*. May 22.

Investor Advisory Group (IAG). 2011. Comment Letter on PCAOB Release No. 2011-003 – *Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards*. Rulemaking Docket No. 34. September 29.

Investors Technical Advisory Committee (ITAC). 2010. Comment Letter on FASB Exposure Draft: *Disclosure of Certain Loss Contingencies*. August 26.

Karmel, R. S. 2016. Disclosure reform – The SEC is riding off in two directions at once. *Business Lawyer*. Summer: 1-50.

PCAOB. 2013. *Proposed Auditing Standard – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*. Release No. 2013-005; Rulemaking Docket Matter No. 034.

PCAOB. 2014. *Auditing Standard No. 18 – Related Parties*. Release No. 2014-002; Rulemaking Docket Matter No. 038.

PwC. 2016. *Point of View: Revisiting Accounting for Software Development Costs*. October.

*The Economist*. 2016. Deltour in the dock. April 30th.

*The New York Times*. 2014. When taxes and profits are oceans apart. July 8.

Randall, T. 2014. Is climate a material risk? Here's what companies are really reporting. *Bloomberg*. June 30.

Securities and Exchange Commission (SEC). 2016. Proposed Rule: *Exhibit Hyperlinks and HTML Format*. Release Nos. 33-10201; 34-78737. File No. S7-19-16.

Stein, K. 2016. *Keynote Address to Big Data in Finance Conference – A Vision for Data at the SEC*. October 28.