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SEC Comments to Indian Foreign Private Issuers

Introduction

The US Securities Exchange Commission (SEC) selectively reviews filings made under the Securities Act of 1933 and the Securities Exchange Act of 1934. As required by the Sarbanes-Oxley Act of 2002, the SEC staff performs some level of review of each reporting company at least once every three years, but additionally also reviews a number of companies more frequently.

In addition, the SEC staff selectively reviews transactional filings — the documents companies file when they engage in public offerings and business combination transactions.

The SEC's filing review process is aimed at monitoring and enhancing compliance with the applicable disclosure and accounting requirements; and primarily focuses on critical disclosures that appear to be materially deficient in explanation or clarity or that appear to conflict with SEC rules or the accounting standards. The SEC staff does not evaluate the merits of any transaction or determine whether an investment is appropriate for any investor.

The SEC staff comments serve to assist compliance with the applicable disclosure requirements and to enhance the overall disclosure in filings by the companies. When the SEC staff identifies instances where it believes a company can improve its disclosure or enhance its compliance with the applicable disclosure requirements, it provides the company with comments along with references to the applicable authoritative literature. The SEC staff's comments are based on a company's disclosures in the financial statemnets as well as other public information including discussions in the registration statement outside the financial statements, and reflect staff's understanding of the facts. The range of possible comments is broad and depends on the issues that arise in a particular filing review.

In its comments, the SEC staff may request that a company provide additional supplemental information so the staff can better understand the company's disclosure, revise disclosure and/or provide additional disclosure in current filings with the SEC, or provide additional or different disclosure in a future filing with the SEC.

A company generally responds to each comment in a letter to the staff and, if appropriate, by amending its filings. The SEC staff may issue additional comments following its review of the company's response to its prior comments. The comment and response process continues until the company resolves all the comments. To increase the transparency of the review process, the SEC, after the completion of the review, also makes its comment letters and company responses public on the SEC's website.

This bulletin lists common financial reporting and accounting issues on which SEC has frequently commented in the past; the list has been compiled primarily from SEC comments issued for the Indian foreign private issuers and includes comments on disclosures commonly missed by the Indian foreign private issuers. We hope that the readers will find this compilation helpful in improving the overall quality of their reporting and disclosures in their SEC filings.

Business Combinations

The SEC staff frequently comments expressing concerns on the adequacy of disclosures for business combination transactions in accordance with the accounting standard requirements. The SEC staff may also seek clarifications on the business combination transactions to better understand the accounting treatment applied. The SEC staff also requires registrants to explain to the staff the reasons for recent acquisitions; and the consideration to describe the effects of the acquisition on business and financial results as well as the challenges that company will face rather than just a factual description of the acquisition.

Accounting policy

The SEC staff often requires registrants to elaborate the accounting policy for business combinations with regard to the material adjustments recognised in the current reporting period that relate to business combinations.

The SEC staff also requires registrants to elaborate the accounting policy for step-acquisitions, and acquisitions of noncontrolling interests.

The SEC staff may require registrants to provide to the staff an analysis of control, or loss of control especially when there is a significant continuing involvement by the registrant in the operations of the investee. In addition, the SEC staff may ask for the details of involvement in investee's operating activities as well as the decision making hierarchy.

In cases of control by less than majority equity interests in investees, the SEC staff often asks registrants to provide to the staff the analysis supporting their conclusion that consolidation is appropriate.

Description of goodwill

The SEC staff often requires registrants to elaborate in the financial statements the qualitative descriptions of the factors that make up the goodwill recognised, such as expected synergies from combining operations of the acquiree and the acquirer, intangible assets that do not qualify for separate recognition or other factors.

Contingent consideration

The SEC staff often requires registrants to disclose in the financial statements a description of the contingent consideration arrangement, the basis for determining the amount of the payment and an estimate of the range of undiscounted outcomes showing the maximum amount that could be payable.

Purchase price allocation

The SEC staff often requires registrants to improve their disclosures on the fair values for each major class of assets and liabilities acquired in a business combination, including fair values of intangible asset recognised separately.

In cases the purchase price allocation is still preliminary and is not finalised, the SEC staff requires registrants to provide the most current information as well as the nature of uncertainties that may result in any material adjustments upon final allocation.

The SEC staff often also requires registrants to provide to the staff the details about the nature of the intangible asset, how fair value is determined; and how it is concluded that the intangibles meet the criteria for separate recognition

Transactions accounted for separately from business combination

The SEC staff often requires registrants to explain to the staff the transactions that are recognised separately from the business combination and the basis to conclude that it is a separate transaction and the amounts recognised for each transaction and the line item in the financial statements in which each amount is recognised.

The SEC staff also requires registrants to improve their disclosures to show separately, the amount of acquisition-related costs recognised as an expense and the line items in the statement of comprehensive income in which those expenses are recognised and may also link the information filed by the counterparty if it is publicly available.

Bargain purchases

The SEC staff, in case of material gain on bargain purchase, often comments seeking more information on the process followed by the registrants for, and to provide the results of, reassessment of the fair values of the assets and liabilities.

Revenue and profit or loss of the acquiree

The SEC staff often requires registrants to improve their disclosures to include the revenue and profit or loss of the combined entity for the current reporting period as though the acquisition date for all business combinations that occurred during the year had been as of the beginning of the annual reporting period.

Revenue

The SEC staff frequently comments on registrants' accounting policy and disclosure of revenue in accordance with the accounting standard requirements. The SEC staff also requires registrants to explain to the staff the significant estimates and judgments in revenue recognition especially in circumstances allowing management discretion in measurement of revenue. Majority of the SEC staff's comments are result of inaccurate or unclear discussion around business model as well as observed or perceived inconsistencies with the disclosure in non-F pages.

Fixed-price contracts

The SEC staff often requires registrants to elaborate in the financial statements the method of revenue recognition from fixed-price contracts, and where proportional performance method is used, the basis for determining the pattern of performance rather than the pattern in which money or effort is expended by the service provider i.e. how progress is measured (e.g., cost to cost, units of delivery, units of work performed), and how is there a direct and consistent relationship in that basis with the pattern in which service is provided to the customer. The SEC staff also requires registrants to disclose in the financial statements the nature of these contracts.

Software products

In case of arrangements to deliver software products, which generally include three elements consisting of the license, implementation and support, the SEC staff often requires registrants to explain to the staff how the fees is allocated and recognised. In addition, the SEC staff may require registrants to explain to the staff any effect on revenue recognition for multiple element arrangements that have elements subject to change order and escalation clause adjustments.

In case of maintenance contract, the SEC staff may require registrants to explain to the staff how maintenance services element is accounted for and valued where such services may be linked together with other deliverables in the revenue arrangement.

Customer sign-off

In case where the customers are required to formally sign off on the work performed, the SEC staff may require registrants to provide to the staff the description of the terms of the formal sign-off and an explanation of whether the registrant has the ability to make reasonably dependable estimates for fixed-price contracts recognised on a percentage of completion basis.

Non-refundable fees

In case of initial non-refundable fee in consideration for establishing a franchisee relationship, the SEC staff often requires registrants to provide to the staff the description of the nature of any additional services being provided and how the related revenue is recognised. The SEC staff often also requires registrants to provide to the staff the details of whether the registrant charges a separate fee to the franchises for rights to use the company's logo, brand and trade names and, if so, how such revenue is recognised. If there are also subsequent services being provided, the SEC staff also may require registrants to provide to the staff the details whether the subsequent services constitute continuing services, and when and over what period the subsequent services are rendered.

Customer concessions

In case of volume discounts, pricing incentives or any other customer concessions to customers, the SEC staff invariably requires registrants to disclose accounting for such discounts and incentives, with reference to the relevant accounting guidance that supports the accounting, and especially for fixed-price contracts recognised on the percentage of completion basis, the SEC staff often also requires registrants to explain to the staff how the registrant had the ability to make reasonably dependable estimates of progress towards completion and contract revenues.

Incentive-based pricing

In case of contracts with incentive-based or value-based or other pricing terms that condition some or all of the fees on registrant's ability to meet defined performance goals or service levels and payment is contingent on meeting contract goals or customer expectations, the SEC staff often requires registrants to explain to the staff the accounting for such contingent revenues, with reference to the relevant accounting guidance that supports the accounting.

Aggregation and separation of contracts

The SEC staff may also require registrants to explain to the staff, how multiple contracts with a single counterparty are treated as separate arrangements, and whether contracts that include fixed price services and application maintenance and support services are considered a combined agreement or separate agreements.

Gross vs net

In case of trading transactions involving gross or net basis of revenue reporting depending on fact-specific evaluation of such transactions, the SEC staff invariably requires registrants to provide to the staff more details about the nature of these transactions, including the details of an arrangement that results in revenue being reported gross and another when revenue is reported net and analysis determining whether the registrant is a principal or an agent in the respective transactions.

Costs of revenue

With respect to the costs, the SEC staff may require registrants to explain to the staff why any cost are excluded from cost of revenues, e.g. depreciation and amortisation expense. The SEC staff may also require registrants to explain to the staff the nature of any salaries and compensation expense that is included in cost of revenues, and if no amounts related to salaries and compensation are included in cost of revenues, an explanation why and the basis for the accounting treatment.

Taxation

Tax holidays

Especially in case of Indian companies which enjoy a host of tax holidays, the SEC staff invariably requires registrants to disclose in the financial statements the details of the nature of tax exemptions and benefits and the disclosure of when such exemptions expire regardless of nearness of expiration. The SEC staff also requires registrants to disclose in the financial statements the aggregate impact of the tax holidays on results of operations, including per share amounts.

Additional tax demands

Regarding additional tax demands received from Indian income tax authorities, the SEC staff invariably requires registrants to disclose in the financial statements an assessment of the likelihood of a material loss with respect to such tax demands. The SEC staff has asserted that a statement that a contingency is not expected to be material does not satisfy the requirements if it is at least a reasonable possibility that a loss exceeding amounts already recognised may have been incurred, and the amount of that additional loss would be material. In such cases, the SEC staff often requires registrants to disclose in the financial statements the estimated additional loss, or range of loss, that is reasonably possible, or state that such an estimate cannot be made; or provide analysis for the conclusion that no accrual is necessary related to the demand for payment of additional taxes.

Deferred taxes

In case of tax losses, the SEC staff invariably requires registrants to explain to the staff why or why not, the deferred tax asset is recognised depending on the recent history of pre-tax losses or income.

Income tax reconciliation

The SEC staff also requires the registrants to provide to the staff details about explanation of the relationship between tax expense (income) and accounting profit, especially the details of any reconciling amounts labeled as ‘others’.

Reconciliation of tax expense and provision

The SEC staff may also require registrants to provide to the staff a reconciliation of the foreign income tax expense to the foreign income tax provision. Additionally, the SEC staff requires registrants to explain to the staff why the domestic income tax expense and the foreign income tax expense may not directly correlate to the geographic revenues in case of a discrepancy.

Segment reporting

The SEC staff invariably emphasises on the segment information disclosed by registrants. In doing so, the SEC staff looks for perceived inconsistency in the segment information and the MD&A and communication on earnings calls. The SEC staff critically questions why the registrant believes it does not have discreet financial information wherever contradicting statements are made in the MD&A or on the earnings calls or on the registrant's website.

Aggregation of operating segments

The SEC staff also invariably critically questions the components within a segment and how the aggregation criteria is met; for example, the SEC staff may require registrants to provide to the staff the analysis demonstrating whether the development, design, manufacture, assembly and sale of product represent operating segments that are being aggregated into within one reporting segment.

The SEC staff may also question that how financing services, if present, are not its own reportable business segment separate from the product segment if it is a separate operating segment that separately meets the quantitative thresholds.

The SEC staff may also require the registrants to explain to the staff the considerations for aggregating the acquired operations which retain distinctive identities and continue to pursue their respective businesses as before the acquisition, and are significantly different, for example, based on geographic area, from registrants' existing segments.

Analysis of results of operations by operating segments

The SEC staff often also requires registrants to improve disclosures to discuss and analyze results of operations by the operating segments disclosed in the financial statements; for example, discussion and analysis of both, revenues and cost of revenues separately for each segment if the chief operating decision maker evaluates segment performance by profits of the segment before operating expenses, or a better insight into the impact of segmental cost of revenues as opposed to segmental selling, general and administrative expenses when analyzing changes in the segmental operating income, particularly if these types of expenses experience differing trends.

Non-allocable costs

The SEC staff often also requires registrants to disclose in the financial statements how centrally incurred costs such as selling, general and administrative expenses are allocated to the reportable segments.

Others

The SEC staff often also requires registrants to disclose in the financial statements the components of income/loss before income tax expense separately for the domestic and foreign components of operations.

Impairment

The SEC staff invariably requires registrants to explain to the staff how their impairment methodology is consistent with the requirements of the accounting standard, and a description of how the registrant performs the impairment testing, including how the cash flows are determined and the fair value of the underlying assets is assessed.

The SEC staff often also requires registrants to provide to staff the details of amount by which the expected future cash flow associated with the asset groups exceed their carrying amount, how the recoverable amount is determined, and whether such amount is based on the higher of value in use or the fair value less cost to sell.

The SEC staff, in case of impairment charge for goodwill and intangibles related to an acquisition, also requires registrants to explain to the staff how the amounts, if any, are determined for any goodwill or other intangible assets associated with that acquisition that are not impaired.

Derivatives and hedging

The SEC staff often requires for each type of hedging relationship entered into during the periods presented, an explanation how the registrant determined that they met the criteria for hedge accounting; specifically requiring the following information for each type of hedging relationship:

- the nature and terms of the hedged item or transaction;
- the nature and terms of the derivative instruments;
- the specific documented risk being hedged;
- the type of hedge (fair value, cash flow, etc.); and
- the quantitative measures used to assess effectiveness of each hedge both at inception and on an ongoing basis.

In case the registrant uses short term forward foreign exchange contracts (roll-over hedging), the SEC staff often requires registrants to explain to the staff how the criteria in determining that the roll-over instruments qualify for hedge accounting has been applied. The SEC staff also requires a description of the material terms of the hedging instruments, including whether roll-overs are at current or historical exchange rates, and a description of accounting for these instruments from inception to final resolution clearly explaining how the portion of the gain or loss on a given forward exchange contract that is deferred and the portion that is recognised in current earnings is determined.

The SEC staff often also requires registrants to provide details to the staff of conversion options in debt instruments and preferred shares including any potential adjustments to the exercise price of such options, and considerations in disclosing the number of shares into which the convertible instruments are potentially convertible. The SEC staff also may ask considerations given to whether there is an embedded conversion feature which should be bifurcated and accounted for as a derivative.

Effect of foreign exchange

The SEC staff often requires registrants to disclose in the financial statements the market risks in view of multiple foreign currency exchange rate risks.

The SEC staff requires registrants to explain to the staff the considerations for reasonableness of presentation of foreign exchange gain/loss in the statement of income. The SEC staff invariably also requires registrants to disclose in the financial statements the nature and reasons for reclassification within the statement of income on a change of presentation of foreign exchange gain/loss in the statement of income, if any, e.g. change in presentation of foreign exchange gain/loss from as a component of operating income/loss to amount below operating income/loss.

Earnings Per Share (EPS)

The SEC staff often requires disclosure for each year in which an income statement is presented, the nature and amount of securities that could potentially dilute basic EPS in the future that were not included in the computation of diluted EPS because to do so would have been antidilutive for the period(s) presented.

Cash flows

The SEC staff invariably requires registrants to provide to the staff the considerations made in classifying cash flows as operating, investing and financing activities in the cash flow statements. The SEC staff often also requires registrants to confirm whether the cash equivalents include only the short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

Accounting policies and estimates

The SEC staff invariably requires registrants to improve disclosures with respect to critical accounting policies if they do not provide investors with an understanding of those estimates and assumptions that are both important to the portrayal of financial condition and results of operations and require most difficult, subjective or complex judgments.

The SEC staff often also requires disclosures of sensitivity analysis or other quantitative information when it is reasonably available addressing the questions that arise once the critical accounting estimate or assumption has been identified by analyzing, to the extent material, such factors as how they arrived at the estimate, how accurate the estimate/assumption has been in the past, how much the estimate/assumption has changed in the past, and whether the estimate/assumption is reasonably likely to change in the future.

Year-end adjustments

The SEC staff may require registrants to provide to the staff the schedule of fiscal year end/ fourth quarter adjustments to close the books if it believes that an estimate of an amount reported in an interim period has changed significantly during the final interim period of the financial year. The SEC staff may also require registrants to disclose the nature and amount of that change in estimate in a note to the annual financial statements for that financial year. The SEC staff may also require registrants to quantify for the staff the effect on pre-tax net income/loss of each adjustment, and the net effect of all adjustments on pre-tax net income/loss, and explain to the staff why the timing of each adjustment is appropriate, and why none of the adjustments relate to prior periods.

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