

Auditor Evaluation Report

Peer Benchmarking,
Auditor Profile and
Risk Indicators for
the Audit Committee

COMPLIANCE WEEK

Data Research Division, powered by **AUDIT ANALYTICS**®

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Introduction

There are two truths about corporate compliance: No universal solution exists for all businesses, and everyone wants to know what everyone else is doing. As part of Compliance Week's effort to better serve the compliance community, we now have a way to address both those points of pressure.



Compliance Week is delighted to offer a new Data Research Division—where we listen to your company's specific needs for data about audit, compliance, and risk; and then compile a detailed benchmarking report to help you (and your CFO, and your CEO, and your audit committee) make better decisions about the compliance obligations you face.

For example, let's say you are scheduled to brief your audit committee next month about whether your company is getting its money's worth from your current external audit firm, or should select a new one. You'll need to answer several questions for yourself before you even walk into the boardroom:

- » How much market share does each audit firm have in your industry?
- » Which firms serve what types of companies (large accelerated filers; pre-IPO; small market capitalization; and so forth)—and above all, serve companies like you?
- » What's the average tenure for various audit firms and clients in your industry?
- » What are the average audit fees that a firm charges? And what are the average fees that a company in your industry typically pays?

Those are just the preliminary questions. Your audit committee might also want to know how well various audit firms have weathered inspections from the Public Company Accounting Oversight Board, and whether failing grades with the PCAOB led to higher audit fees later. You might want to consider asking shareholders to ratify the committee's choice for audit firm.

You might want to string the answers to all these questions together, to present a complete picture to the audit committee and help it do what it desperately needs to do: make better, smarter, more informed decisions.

That sort of analysis is what our Data Research Division can provide.

The process works like this: You tell our Data Research Division staff about the questions you're trying to answer, and the data you need to answer them. We go to our databases of financial, audit, and compliance disclosures; compile an analysis; and send it to you. It's that simple, and that customized to your specific needs.

Where do we get all this data? Compliance Week has formed a joint venture with Audit Analytics, the premier research firm in this field, which has tracked all manner of public company disclosures for more than a decade. Audit Analytics has emerged as the standard for academics, audit firms, and regulators trying to conduct research or set policy in compliance and audit today. If you want the most comprehensive data, Audit Analytics has it, and Compliance Week is thrilled that we can now bring it to you, tailored to your company's specific needs.

Clearly the aforementioned example of reviewing your audit firm appeals more to chief accounting officers or heads of Sarbanes-Oxley Act compliance than it does to, say, legal counsel or corporate compliance officers. Rest assured that the range of data we can provide includes plenty of risk areas relevant to those groups, too. For example, you may want to know which disclosure issues keep turning up these days in comment letters from the Securities and Exchange Commission—or did turn up in SEC comment letters from a few years ago, and whether companies on the receiving end of those letters subsequently suffered financial restatements or shareholder litigation. Or whether any of those headaches later resulted in what we'll politely call a "change in named officers" that left the CFO or CEO's office suddenly vacant.

The Compliance Week Data Research Division can conduct that level of analysis too.

Most exciting about the Data Research Division isn't merely the depth of data that can now be studied; it is the ability to tie multiple circumstances together, to provide precise answers to very specific questions—with comprehensive data from living, breathing businesses just like yours, underlying all of it. Any compliance or audit professional knows modern Corporate America is awash in too much information; the trick is in finding the right information buried in those piles of data to provide the context you need to make better decisions and guide your company to better outcomes.

For more information about the Data Research Division, or if you have a specific question or idea on how to put all this information to good use, feel free to e-mail us at info@complianceweek.com.



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Each year, audit committees should evaluate the external auditor in fulfilling their duty to make an informed recommendation to the Board whether to retain the auditor."

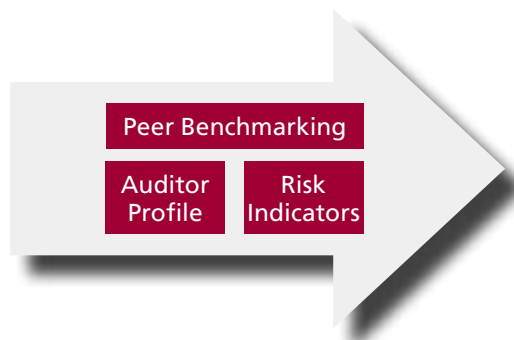
Audit Committee Essentials.
(The Audit Committee Collaboration 2013)

Auditor Evaluation Report

Peer Benchmarking, Auditor Profile and Risk Indicators for the Audit Committee

The Auditor Evaluation Report can be separated into two distinct sections, each with a different focus.

In the first section—the main part of this white paper—we present a detailed analysis of a sample company’s independent auditor. Our discussion of the auditor includes a market share breakdown, audit fee benchmarking, and an analysis of Public Company Accounting Oversight Board inspection reports.



In the second section, we turn our attention to the company and its peers, analyzing qualitative risk indicators and disclosure trends.

Topics include a trending analysis of financial restatements, benchmarking SEC comment letters, and other reporting events that might be considered high risk. The information available in the second section will help the audit committee stay on top of current and emerging issues in the company’s industry and among its peers.

Taken together, these insights can help the chief financial officer, the chief accounting or audit executive, and the audit committee to assess the big picture of the company’s reporting and disclosure environment. Backed by market-leading data and intelligence, the audit committee can better evaluate the auditor as well as the company’s own reporting.

Choosing Our Sample Company

To show you the kind of data analytics we can provide, we are presenting a real-life example. Let’s say you are John or Jane Doe, chief accounting officer at Midsized Pharma Corp., and next month you need to brief the audit committee on what to expect with your audit firm in the next audit cycle. In your report, you would like to benchmark your company’s audit fees against a group of peers, comparing revenue, total assets, and other factors. In addition, you would like to present an analysis of auditor changes and auditor tenure: how does your company’s auditor compare to your peers and industry? You might also like to highlight reporting trends in your industry, such as specific accounting or control issues that are beginning to pop up among the company’s peers, either through restatements, adjustments, SEC comment letters, or other similar disclosures. This can help the audit committee decide what areas pose more risks and require closer inspection.

Taking that as a starting point, we came up with two benchmarks that we use throughout this paper: (1) an Industry Peer group, and (2) an Immediate Peer group. The Industry Peer group provides a wide-angle view of the market, whereas the Immediate Peer group is focused on companies that are most similar to our sample company.

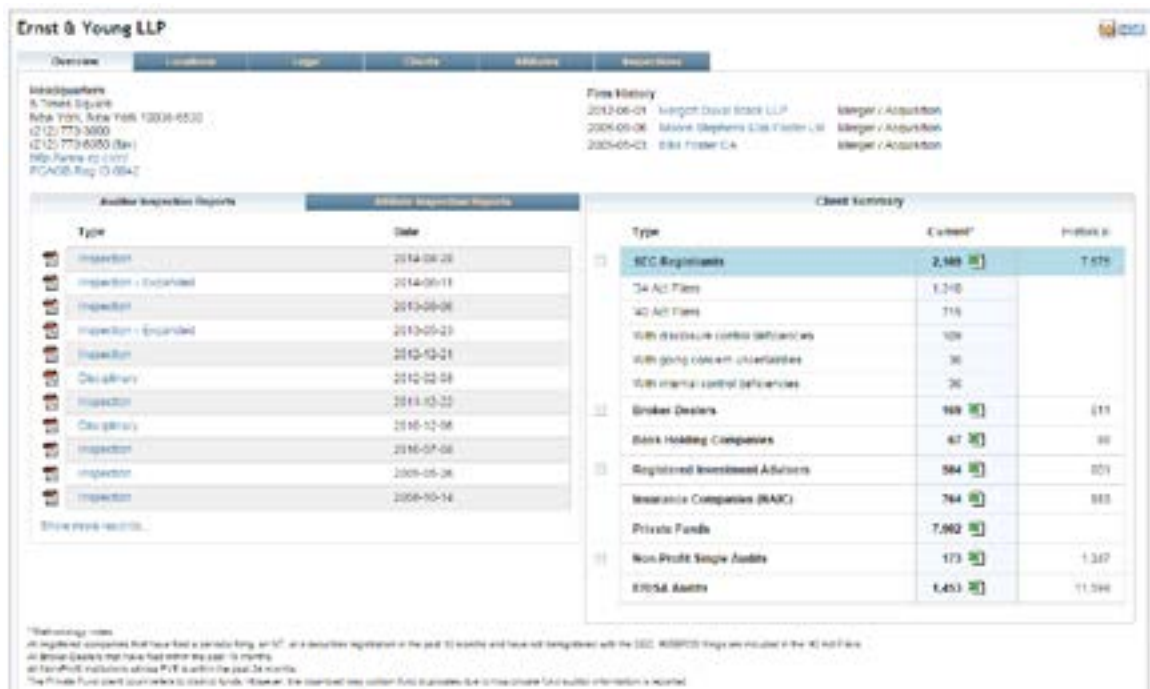
Industry Group	
NAICS Code:	3254*
Filer Status:	(Large) Accelerated Filers
Auditor Filter:	Big 4
Total Industry Peers:	155

Immediate Peers	
NAICS Code:	325412
Filer Status:	(Large) Accelerated Filers
Auditor Filter:	Big 4
Market Cap:	\$1 billion - \$20 billion
Total Immediate Peers:	31

Part I: The Independent Auditor

The audit committee's primary responsibility relates to the selection and monitoring of the company's independent public accountant. In this section, we will look at a handful of benchmarks and metrics that would be of interest to the committee. By looking at factors such as industry presence, audit fees, and the actions of various stakeholders, we aim to provide the audit committee with the data required to make rational and informed decisions about their audit services.

FIGURE 1: THE AUDITOR PROFILE PAGE OF ERNST & YOUNG, AVAILABLE AT WWW.AUDITANALYTICS.COM.



Industry Market Share, Tenure, and Auditor Changes

First, let's look at the auditor market share for the companies in our Industry Group. The first table shows the number of clients each of the Big 4 firms provide audit services to, broken down by Industry Group and Peer Group.

Auditor Market Share

As of 8/25/2014

Independent Auditor	Industry Group	%	Peer Group	%
Ernst & Young	73	47%	13	42%
PricewaterhouseCoopers	45	29%	7	23%
KPMG	24	15%	7	23%
Deloitte & Touche	13	8%	4	13%
Total	155		31	

Ernst & Young has a commanding position in this industry, providing audit services to 47 percent of the companies we identified in our industry peer group. The total number of clients, however, is only one way to look at the auditor's expertise and market share. Another way is to look at the size and stature of the companies each firm audits, which we can measure roughly by using market capitalization. There we see that companies audited by EY represent about 23 percent of the total market cap of these companies, second to PwC's 55 percent. Further, while EY audits the most companies in this group, the companies audited by this firm have the lowest average market cap, at \$8.1 billion.

The following table presents a breakdown of each audit firm's share of the total market cap of the Industry Group.

Independent Auditor: Market Cap of Companies Audited

As of 8/25/2014

Auditor	% Total Market Cap	Average Market Cap (\$millions)
PricewaterhouseCoopers	55%	\$ 32,103
Ernst & Young	23%	\$ 8,161
KPMG	15%	\$ 17,008
Deloitte & Touche	7%	\$ 14,441

Next we turn to a consideration of auditor tenure, which continues to be a controversial topic. Some parties seek to place a limit on the length of time one firm can provide audit services to a given company, while others argue that there are checks and balances to ensure independence on the one hand, and that experience with a client increases audit quality on the other. Either way, auditor tenure can be a sensitive issue for the audit committee, and access to tenure data from the company's industry can help the audit committee make an informed decision.

Average Auditor Tenure

As of 8/25/2014

Auditor Tenure	Industry Group	Peer Group
Ernst & Young	13	12
PricewaterhouseCoopers	16	12
KPMG	13	8
Deloitte & Touche	17	24
Total	13	12

(I.e., the average tenure of EY across the industry group is 13 years)

Audit Fee Benchmarking

Another common request we receive is an audit fee benchmark report. Audit fees, of course, are one of the main responsibilities of the audit committee. Because of fiduciary duty, independence, and other reasons, the audit committee might be wary of fees that are significantly higher than average. On the other hand, concerns about audit quality should prompt the committee to question fees that are too low. As part of our External Audit Report, we can benchmark a company's audit fees against its industry group and its selected immediate peers.

Audit Fees Analysis: Immediate Peer Group

Sorted by Total Assets (\$ thousands)

Company	Auditor	Auditor Since	Total Assets	Revenue	Audit & Audit-Related Fees	Total Fees		Audit Fees / Total Assets	Audit Fees / Revenue
MYLAN INC.	DT	1975	\$15,236,341	\$6,909,143	\$5,600	\$6,200	2	0.04%	0.09%
Grifols SA	KPMG	1990	\$8,048,719	\$3,777,999	\$4,363	\$4,775	3	0.06%	0.13%
Endo International plc	DT	2014	\$6,571,856	\$2,616,907	\$5,480	\$6,594	1	0.10%	0.25%
HOSPIRA INC	DT	2004	\$6,178,900	\$4,002,800	\$4,089	\$4,150	6	0.07%	0.10%
PERRIGO CO	EY	2008	\$5,350,800	\$3,539,800	\$3,142	\$4,608	4	0.09%	0.13%
CUBIST PHARMACEUTICALS INC	PwC	1992	\$3,145,821	\$1,054,442	\$1,861	\$2,374	9	0.08%	0.23%
Catalent, Inc.	EY	2014	\$3,090,200	\$1,827,700	\$3,501	\$4,260	5	0.14%	0.23%
SALIX PHARMACEUTICALS LTD	EY	2011	\$2,941,394	\$933,838	\$1,125	\$1,141	19	0.04%	0.12%
DR REDDYS LABORATORIES LTD	KPMG	2003	\$2,850,000	\$2,213,000	\$1,338	\$1,383	16	0.05%	0.06%
BIOMARIN PHARMACEUTICAL INC	KPMG	2002	\$2,249,217	\$548,485	\$1,301	\$1,303	17	0.06%	0.24%

A number of factors can affect the audit fee, ranging from size and complexity to special events and risk identification. Ultimately, it is the role of the audit committee to make a determination as to the appropriateness of the audit fee. Whether you are looking to make sure you have hired the right auditor for your company or simply want to gain a better understanding of your industry, gathering good market intelligence is the first place to start.

Stakeholders Considerations

Now let's turn our attention to the role of stakeholders and how they relate to a company's independent auditor. In particular, we will look at the shareholder voting results of auditor ratification and the regulatory findings of PCAOB inspection reports. After considering these two areas, the audit committee should be able to quickly assess potential areas of further inquiry.

Auditor Ratification

Of the 155 companies in the sample company's industry peer group, 137 (88 percent) asked their shareholders to ratify the independent auditor in at least one of the years under consideration in this analysis. The 137 companies that submitted the ratification to a shareholder vote include most of the leading companies in this industry, including Johnson & Johnson (JNJ), Pfizer (PFE), Merck (MRK), and Bristol Myers Squibb (BMY). Further, over 90 percent of the Russell 3000 request their shareholders to vote on the ratification of the auditors. It clearly appears to be a best practice in both the industry and across the U.S. reporting landscape.

In only 14 cases over the period under review did the auditor receive less than 90 percent of the vote, and in only six cases did at least 10 percent of shareholders vote against ratification. As the nearby chart demonstrates, auditors are typically ratified with a substantial majority of the vote. In about half of all votes, the auditor was ratified with 99 percent of the votes cast in favor, and 92 percent of the time the auditor received at least 95% of the vote. Looking at these results, the audit committee might consider whether their company's auditor should be submitted to the shareholders for ratification. If the company's shareholders do vote to ratify the auditor, then the audit committee might want to benchmark the voting results against this peer group. For example, imagine that the shareholders ratify the company's auditor

DID YOU KNOW? Research models suggest that extended periods of reduced fees can lead to a decline in audit quality. (Brant Christensen, et al. 2013)

DID YOU KNOW? Recent studies in the accounting literature have found that companies that put their auditor up for shareholder ratification are less likely to have restatements. (Dao, Raghunandan, and Rama 2012)

with 90 percent approval. This may seem like an overwhelming result in favor of the auditor, but 10 percent voting against ratification is actually extremely rare—in this peer group, it has happened only about 2 percent of the time of the past three and a half years.

In the next table, we present the auditor ratification voting results from the past year for a selection of companies from the immediate peer group of our sample company.

Auditor Shareholder Ratification Voting Results

Immediate Peers 2013

Company	DT	EY	KPMG	PwC	Votes Against % 2013
MYLAN INC.	✓				1.41%
MANNKIND CORP	✓				0.68%
HOSPIRA INC	✓				0.47%
UNITED THERAPEUTICS Corp		✓			2.83%
SALIX PHARMACEUTICALS LTD		✓			1.18%
IMMUNOGEN INC		✓			0.40%
THERAVANCE INC		✓			0.34%
INTERMUNE INC		✓			0.34%
MYRIAD GENETICS INC		✓			0.29%
IRONWOOD PHARMACEUTICALS INC		✓			0.17%
IMPAX LABORATORIES INC			✓		2.20%
INTERCEPT PHARMACEUTICALS INC			✓		0.05%
China Biologic Products, Inc.			✓		0.00%
CUBIST PHARMACEUTICALS INC				✓	3.16%
ACADIA PHARMACEUTICALS INC				✓	3.04%
Alkermes plc.				✓	0.07%
MEDIVATION, INC.				✓	0.05%
	4	11	5	6	
Average % Votes Against	1.21%	0.67%	0.51%	1.17%	

PCAOB Inspection Reports

Another critical resource to consider when hiring and overseeing the work of an independent public accountant is the PCAOB inspection report for the relevant firm.

Going back to our J. Doe, chief audit executive at Midsized Pharma Corp., what might the audit committee be interested in with respect to the PCAOB's inspections of the company's auditor?

The audit committee, in this case, might want to consider the following questions:

- » Has the PCAOB noted audit deficiencies in an area sensitive to our industry?
- » Have any deficiencies led to a restatement in an area sensitive to our industry?
- » Are there recurring issues that we should be sure to address with the engagement partner?
- » Are we properly addressing and considering our internal controls over financial reporting, especially with respect to the weaknesses found by the PCAOB?

The public response to the PCAOB inspection reports has been varied, but most seem to express surprise at the high num-

ber of deficiencies the PCAOB finds in the inspected audits. In reports issued by the PCAOB between 2011 and 2013, the PCAOB inspected about 680 separate audits performed by the Big Four and identified deficiencies in about 35 percent of those audits.

(Note: It is important to note that the PCAOB purposefully selects high-risk audits, such as those with a history of issue or which are known to have complex accounting. The rate of deficiencies, therefore, should not be taken to be representative of the overall quality of audits across the firm. It is also worth noting that the PCAOB does not distinguish between different levels of severity of deficiency. Any finding whatsoever is labeled as a deficiency. It is, therefore, difficult to make some comparative statements regarding audit quality.)

In the first figure, we present an overview of each of the Big 4 firms' inspection report that were filed in 2013 for the 2012 inspection year. The PCAOB inspected about fifty audits for each firm during this timeframe, and on average found deficiencies in about 37 percent of those audits.

PCAOB Inspection Reports

Big 4: 2013 Inspections

Auditor	Issuance Date	Audits Inspected	Deficient Audits	Deficiencies	Deficient Audits/ Audits Inspected
Deloitte & Touche	5/7/2013	52	13	24	25%
Ernst & Young	6/28/2013	52	25	58	48%
KPMG	7/30/2013	50	17	48	34%
PricewaterhouseCoopers	8/20/2013	54	21	51	39%

In the second figure, we look at the specific issues noted by the PCAOB in their inspections of one of the Big 4 firms. It shows the top five most-commonly cited issues found by the PCAOB in their 2012 inspection. Then, it also shows how these issues ranked in the prior two years.

For example, deficiencies related to internal controls were the most common issue in all three years.

Sample Firm PCAOB Inspection Reports

Breakdown by Issuer

2010-2012 Inspections

Nature of Deficiency	Rank of Issue by Year		
	2012	2011	2010
ICFR - Internal control-related issues	1	1	1
Acc - Revenue recognition	2	6	4
Acc - Inventory, vendor, and cost of sales (SGA)	3	2	12
Acc - Business combinations	4	14	14
Information systems	5	4	6

The audit committee might notice the increase in questions on revenue recognition—always a sensitive area—and the recent focus on inventory. These accounting areas can pose difficulties for companies in the pharmaceutical industry.

In this section, we provided a look at some of the auditor intelligence that Compliance Week and Audit Analytics provide to its corporate clients. We covered audit fees, auditor tenure and market share, and some stakeholder considerations, such as shareholder auditor ratification votes and PCAOB inspection reports. This is a good overview of the research we provide, but there are many other reports available, such as audit firm litigation and involvement in SEC comment letters. In the next section, we will present a brief overview of some of our qualitative risk indicators as well as examples of disclosure trends and peer benchmarking.

Part II: Risk Indicators and Peer Benchmarking

In addition to providing comprehensive auditor intelligence, qualitative disclosure intelligence is also available. Our red flags and qualitative research are used by a variety of clients, including investment firms, securities lawyers, and – importantly – the regulators themselves. We believe that the audit committee would benefit from having access to much of the same information. In this section, we present a sample of the reports that are possible through the Audit Analytics databases.

We group our red flags and qualitative disclosures into five broad areas: (1) Financial Reporting, (2) Controls, (3) Insiders, (4) Stakeholders, and (5) Auditors.

Financial Reporting

- Restatements
- Changes in Accounting Estimates
- Out-of-Period Adjustments

Stakeholders

- Shareholder Activism
- Litigation
- SEC Comment Letters

Controls

- Internal Controls (SOX 404)
- Disclosure Controls (SOX 302)
- Late Filings

Auditors

- Significant Changes in Audit Fees
- Going Concerns

Insiders

- Director and Officer Changes

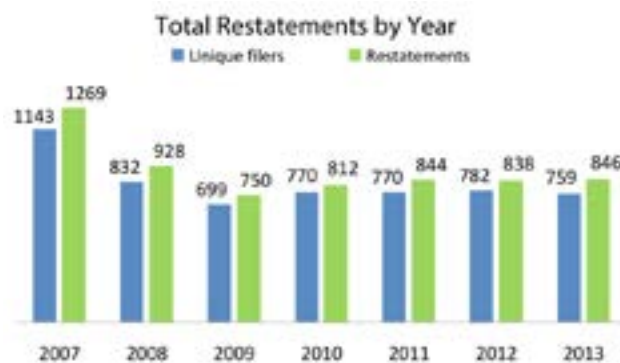
With these databases, it is possible to be alerted to risk indicators in a company’s peer group and industry; to benchmark disclosure reporting trends in sensitive areas; and to make inquiries about these potential issues to management and the internal and external auditors.

What kind of intelligence can we provide J. Doe of Midsized Pharma Corp., who in turn will provide to the audit committee?

Financial Restatements and Out-of-Period Adjustments

Take, for instance, our restatements database. It is a quick and easy process to answer questions along the following lines: How many of our peers have had a restatement in the past five years? What are the most common restatement issues? Is any particular issue becoming riskier in our industry? Restatements can exhibit a kind of “snowballing” effect. One big restatement by a major company in the peer group or industry can often lead to more restatements related to the same issue, as every company, auditor, and regulator starts investigating whether the issue is systemic.

Compliance Week and Audit Analytics are at the forefront of reporting and disclosure trends. One issue that we are paying close attention to relates to so-called “out of period” adjustments, which are errors deemed by management to require correction, but not material enough to warrant restating previously reported financial results. These errors are reported on a prospective basis, and, while they typically are immaterial, they may become material in the aggregate or as a sign of control weaknesses.



Out of Period Adjustments

Out of Period Adjustments: Industry Peer Group 2011-2013

Accounting Area	# of Companies
Tax expense/benefit/deferral/other (FAS 109) issues	8
Revenue recognition issues	6
Liabilities, payables, reserves and accrual estimate failures	3
Acquisitions, mergers, disposals, re-org acct issues	2
Acquisitions, mergers, only (subcategory) acct issues	2
PPE intangible or fixed asset (value/diminution) issues	2
PPE issues - Intangible assets, goodwill only (subcategory)	2
Capitalization of expenditures issues	1
Consolidation issues incl Fin 46 variable interest & off-B/S	1
Debt, quasi-debt, warrants & equity (BCF) security issues	1
Expense (payroll, SGA, other) recording issues	1
Lease, SFAS 5, legal, contingency and commitment issues	1

Disclosure Controls and Procedures

For a more detailed example, let's turn to management's assessment of the company's disclosure controls and procedures mandated by Section 302 of the Sarbanes Oxley Act. Each quarter, management must review their disclosure controls, that is the processes and procedures that provide reasonable assurance that the company makes all required public disclosures in a timely and complete manner. Unlike the company's internal controls over financial reporting, mandated by Section 404, the disclosure controls are not audited or reviewed by the company's auditor. They are the sole responsibility of management. As such, the audit committee would do well to review the trends

In the following table, we present an analysis of accounting-related material weaknesses disclosed by our company's industry peer group. For the last five years, it shows a selection of five of the most common issues faced by these companies.

Disclosure Controls and Procedures (SOX 302)

Number of Accounting-related Material Weaknesses by Year: Industry Group

	2013	2012	2011
Acc - Revenue recognition issues	9	1	-
Acc - Expense recording (payroll, SG&A) issues	6	1	3
Acc - PPE , intangible or fixed asset (value/diminution) issues	3	6	4
Acc - Acquisition, merger, disposal or reorganization issues	4	4	3
Acc - Tax expense/benefit/deferral/other (FAS 109) issues	3	3	7

In terms of control-related weaknesses, separation of duties was by far the most common issue, followed by weaknesses in the company's IT controls and the recording of numerous audit adjustments. With this trending analysis, the audit committee might consider additional procedures to assess the proper working of controls related to these areas.

SEC Comment Letters

We also read every SEC comment letter and analyze each of them according to a standardized taxonomy. This information is valuable for at least two reasons. First, the audit committee could perform a trending analysis to determine whether the SEC is focusing on a specific issue that could affect the company's entire industry. With that knowledge, the audit committee could proactively make sure that the company's policies are in line with the SEC's comments. Second, if the company were to receive a comment letter, management and the audit committee could quickly find examples of similar comments, helping them to better understand the context of the question and craft more concise answers.

This is just a brief overview of our many risk indicators and other benchmarking tools. The list above provides a more comprehensive view, including some of our most popular red flags such as changes in accounting estimates, going concerns, late filings, and out-of-period adjustments. We work closely with our subscribers and are continually adding new databases and risk indicators.

Conclusion

In this white paper, we wanted to share with you some of the best practices we have observed in our long history of serving the research needs of corporate reporting and finance professionals. As a leading provider of audit, accounting, and risk intelligence, our insight is also informed by our experience with accounting firms, regulators, universities, and investment institutions. We believe that the research and examples provided in this white paper present a unique and valuable tool for audit committees and internal audit groups.

If you are interested in learning more about our services, please contact us for more information. We would be happy to provide additional information, to offer a customized product demonstration, and to answer any questions you might have.

SEC Comment Letters: Common Issues

Industry Peer Group
1/1/11 to 6/30/214

Issue	Conversations
Revenue Recognition	66
Research and Development	60
Tax Expense/Liability/Asset	46
Fair Value/Estimates	44
Contingencies/Commitments	32
Foreign Affiliates	29
Intangible Assets/Goodwill	24
Tax Rate Disclosure	21
Inventory/Cost of Sales	21
Liabilities/Accruals	21

Must-Haves for the Audit Committee: As part of the annual presentations, does your audit committee have access to the following reports?

- ✓ Audit Fee benchmarking
- ✓ Auditor market share, tenure, and rotation analysis
- ✓ Auditor ratification benchmarking
- ✓ PCAOB inspection reports benchmarking
- ✓ Restatement and non-recurring adjustments analysis
- ✓ Internal control (SOX 404) analysis
- ✓ Disclosure controls (SOX 302) analysis
- ✓ SEC comment letters analysis