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THE NEWSLETTER FROM BDO'S NATIONAL ASSURANCE PRACTICE

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THE 2015 AICPA SEC AND PCAOB CONFERENCE

The annual AICPA National Conference on Current SEC and PCAOB Developments was held on December 9-11, 2015 in Washington, DC, where representatives of the Securities and Exchange Commission and the Public Company Accounting Oversight Board shared their views on various accounting, reporting, and auditing issues. The remarks made by SEC Chair Mary Jo White and members of the Office of the Chief Accountant are available on the SEC's website, www.sec.gov, under News/Speeches.

OVERVIEW

In Chair White's opening remarks, she noted that the United States capital markets require "reliable and relevant financial information that investors can use to make informed investment decisions." The shared responsibility of preparers, auditors, audit committees, standard setters and regulators to ensure high-quality financial reporting was a theme that resonated throughout the conference. To achieve the goal of reliable and relevant financial information for investors, several topics from previous years received expanded focus.

The SEC's disclosure effectiveness project gathered momentum during 2015. The comprehensive review of Regulation S-K and S-X requirements, as well as other registrant and audit committee disclosure requirements, remains a significant priority of the SEC,

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and the staff continued to emphasize actions registrants can take now to improve their disclosures. Conversations about IFRS reporting alternatives for U.S. registrants continued. Additionally, the importance of the design and operation of effective internal control over financial reporting (ICFR), as well as the auditing of ICFR by audit firms, was a pervasive topic of discussion.

The discussion around the new revenue recognition standard, ASC 606, continued its shift toward implementation and transition issues. Regulators have expressed growing concern over the state of many registrants' readiness for adoption of this standard. Efforts to gain an understanding of the accounting impact of the standard and to identify necessary changes or additions to internal controls may require a significant allocation of resources – both human and financial.

The following comments provide additional insight into the SEC and PCAOB staff positions on these and other accounting, reporting, and auditing practice issues. Our companion publication, *SEC Year in Review – Significant 2015 Developments*, discusses SEC and PCAOB rulemaking, standards setting and related staff activities during 2015.

DISCLOSURE EFFECTIVENESS

Disclosure "overload" resulting from many duplicative and irrelevant disclosure requirements remains a focus of the SEC staff. During 2015, the staff continued the momentum of their disclosure effectiveness project. This undertaking includes a comprehensive review of the existing disclosure requirements within Regulations S-K and S-X. The goal of the project is to streamline disclosures where possible, identify new disclosures that may provide enhanced transparency, and provide investors with the information that is most useful. The staff solicited comments on certain Regulation S-X requirements during 2015 and continues to accept feedback.

The staff has started its review of Regulation S-K requirements. The staff acknowledged that certain requirements may be outdated and, therefore, their efforts are focused on developing an appropriate balance between prescriptive (e.g., number of employees) and principles-based disclosure requirements. Redundant disclosures, scaled disclosure requirements for EGCs, and relocating industry disclosure requirements from the industry guides to Regulation S-K are additional areas that will receive the staff's attention.

The Regulation S-X request for comment and the disclosure effectiveness project are discussed in our SEC Year in Review newsletter.

While the staff continues its work, it encourages registrants to re-evaluate existing disclosures, considering them from the perspective of a reasonable investor. Many disclosures, including those previously added as part of the SEC comment letter process, may no longer be applicable or may be immaterial to a registrant's current situation. Reducing the complexity of disclosures as well as eliminating unnecessary, immaterial and duplicative disclosures will result in more focused and effective disclosures. Similarly, certain areas, such as foreign tax disclosures, may require expanded disclosures to be clear and understandable. Enhancing these disclosures may require a discussion beyond the basic reporting requirements in order to provide investors with an understanding of material financial information.

INTERNAL CONTROL OVER FINANCIAL REPORTING

ICFR was a recurring topic throughout the conference, with a number of SEC representatives devoting portions of their prepared remarks to ICFR. Chair White set the tone early in her keynote address stating, "it is hard to think of an area more important than ICFR to our shared mission of providing high-quality financial information that investors can rely on." The SEC believes the ICFR requirements under the Sarbanes-Oxley Act have resulted in improved controls and financial reporting, both of which protect and benefit investors. Representatives of the SEC and the PCAOB also acknowledged the ongoing challenges faced by auditors and registrants with respect to the level of work and documentation required to support the assertion that controls (particularly management review controls) are operating effectively and adequately tested. They do not believe that PCAOB Auditing Standard No. 5 requires a greater level of documentation than called for by the SEC's guidance for management. They believe the requirements are aligned. They also emphasized the need for sufficient management documentation to comply with the books and records provisions of the Securities Exchange Act of 1934 as well as to facilitate auditing of ICFR.

Deficiencies in auditing ICFR continue to be one of the most frequent findings in PCAOB inspections. SEC Chief Accountant James Schnurr indicated that inspection findings should concern both auditors and registrants as evidenced by his statement that "ICFR issues identified by the PCAOB may not be just a problem of audit execution. Rather, they may, at least in part, be indicative of deficiencies in management's controls and assessments."

The SEC staff reminded registrants and auditors of the importance of properly identifying and evaluating the severity of control deficiencies, including understanding the complete population of transactions the control is intended to cover. A deficiency in ICFR that results in a reasonable possibility (likelihood) of a material misstatement (magnitude) is considered a material weakness. As such, a careful analysis of deficiencies must consider known errors as well as reasonably possible misstatements (the "could factor"). Significant judgment is required when evaluating the magnitude of a control deficiency and consideration of the "could factor" should not be an afterthought.

Signs of improvement have been noted. For example, the staff pointed out that the identification and reporting of material weaknesses that were not accompanied by a material misstatement have increased for the second straight year.

An ongoing consideration of internal controls is required, especially when implementing new accounting standards and policies, such as the new revenue recognition standard. Existing controls may no longer be appropriate and new or re-designed internal controls may need to be implemented. A registrant's control environment should not be stagnant and should be responsive to changes in operations and risks. The staff also provided a reminder that the quarterly obligation to disclose material changes in ICFR may require disclosure of changes made as systems are changed in advance of adopting a new standard.

In response to a question on the continued use of the 1992 COSO framework (as opposed to the updated 2013 COSO framework) by a registrant to assess ICFR, the staff indicated that the use of the 1992 framework is not prohibited. However, the staff questioned the use of a framework that is no longer supported by COSO. The staff also stated that if a service provider is using the 1992 COSO framework while the registrant is using the 2013 COSO framework, disclosure would be expected and the registrant should question the reasons why the service provider is using the outdated framework.

REVENUE RECOGNITION

The new revenue recognition standard, ASC 606, was issued in May 2014, representing a significant achievement in the convergence efforts of the FASB and the IASB. Since that time, implementation and transition issues have become a priority. The SEC staff provided insight into the SEC's monitoring of the transition activity related to the new standard. Because the new principles-based revenue standard will replace nearly all existing revenue guidance, including industry-specific guidance, all companies will experience some degree of change (which may include new business processes, systems and controls; additional estimates and judgments; and expanded disclosures). The staff's primary areas of focus are the readiness of registrants and identifying and addressing issues that could cause potential diversity in practice prior to implementation.

The staff observed that successful implementation requires sufficient preparation and resources (both human and capital) and quoted a recent survey that indicated that the overall state of readiness may be lagging (75% of responding companies stated that they had not completed their initial impact assessment, a third of which had not even begun their assessment). As a result, the staff urged registrants to consider the need to step up their efforts. The staff observed that some companies taking a "bottoms-up" approach, which typically involves: 1) identifying individual revenue streams and contracts; 2) reviewing historical accounting policies and practices; and 3) identifying any differences that may result from applying the requirements of the new standard to those arrangements, have achieved good results.

The staff emphasized the importance of a continuing global transition resource group process, collaboration among industry groups (including those formed by the AICPA) and candid discussions among audit committees, management and auditors in order to foster comparability between domestic registrants that file under U.S. GAAP and foreign private issuers that file under IFRS.

Staff Accounting Bulletin Topic 11.M requires registrants to discuss the potential effects of adoption of recently issued accounting standards in registration statements and reports filed with the Commission. The staff expects more detailed disclosures about the expected effect the new standard will have as adoption of the standard gets closer. A registrant should disclose what they know as soon as they know it, including the expected adoption date and method. To the extent information remains unknown, a registrant may consider advising investors when the registrant's assessment is expected to be completed.

In addition to the effect on the financial statements, the adoption of ASC 606 could affect a registrant's filing requirements. For instance, Item 11(b) of Form S-3 requires inclusion or incorporation by reference of restated financial statements in a new or amended registration statement if there has been a change in accounting principles where such change requires a material retroactive restatement of financial statements. Therefore, registrants that adopt ASC 606 using the full retrospective method would be required to recast their financial statements at the time they file a registration statement, rather than later, when they file their first Form 10-K reflecting the adoption.

In this situation, an additional year of financial statements would be revised in the registration statement. The staff emphasized that the requirements in Item 11(b) are clear and changes to those requirements would require rulemaking by the Commission. However, the staff indicated that they will continue to look at this issue and consider thoughts and suggestions.

The staff is focused on easing some of the burden of retrospective adoption, where possible. The staff previously stated publicly that selected financial data would only need to be revised for the periods covered by the financial statements included in a filing. Also, Rule 3-09 of Regulation S-X requires separate annual financial statements of an equity method investee to be provided if certain significance thresholds are met during the fiscal years presented in the registrant's financial statements. Additional staff guidance is expected with respect to the application of Rule 3-09. The guidance is expected to allow a registrant to continue to use its pre-transition significance tests for the years prior to the adoption of the standard.

IFRS FOR U.S. ISSUERS

Further use of IFRS in the United States continues to be a topic of discussion. Foreign private issuers have been permitted to include financial statements prepared in accordance with IFRS, as issued by the IASB, in SEC filings without a reconciliation to U.S. GAAP since 2007. Since that time, the number of registrants filing IFRS financial statements has grown to over 500, causing IFRS to become a significant focus of the SEC.

Chief Accountant Schnurr indicated that an alternative, which would allow domestic registrants to voluntarily provide IFRS-based information as a supplement to their U.S. GAAP financial statements without requiring a reconciliation of that information to U.S. GAAP or requiring that information to be audited, is being considered. Any supplemental IFRS-based information would be considered non-GAAP information, so the SEC's rules would require that it be reconciled to U.S. GAAP. Avoiding the reconciliation requirement as contemplated under this alternative would require rulemaking by the SEC. Chair White stated that the commissioners will discuss this alternative with the staff and consider whether to move forward with a rulemaking proposal.

The staff discussed the benefits of a single set of global accounting standards. Chair White recognized the continued progress that has been made by the FASB and the IASB in the convergence of U.S. GAAP and IFRS, with the new revenue recognition standard being a prime example. The FASB and IASB were urged to maintain their commitment to collaboration and to strive for aligned, high-quality global standards, where practical.

ACCOUNTING ISSUES

The SEC staff shared its views on various accounting issues.

DISCONTINUED OPERATIONS

Prior to the revised guidance in ASC 205-20, there were concerns about the number of dispositions that resulted in discontinued operations presentation. The SEC staff believes that the revised guidance will result in a more meaningful presentation. Under the revised guidance, a component (or group of components) that is disposed of or classified as held for sale is a discontinued operation if the disposal represents a strategic shift that has (or will have) a major effect on an entity's operations and financial results. The determination of whether a strategic shift has occurred requires judgment and ASC 205-20 provides examples to assist with this evaluation. However, the staff stressed that the quantitative thresholds in these examples do not establish bright lines or safe harbors.

The staff believes that an issuer must perform a thorough evaluation of the totality of quantitative and qualitative evidence, rather than relying on any single financial metric, when assessing whether financial results have a major effect on a company's financial results. Revenues, total assets and net income are prominent financial metrics that should be contemplated. Other metrics that a registrant has used on a consistent basis to communicate its operating and financial results may be relevant from an investor's perspective. The impact of a metric on current, historical and forecasted results should be considered as well. The staff highlighted that no single financial metric is determinative.

Qualitative evidence, such as the prominence and consistency of disclosures related to the disposed entity in periodic filings, should also be weighed. A disposition with lesser significance using quantitative metrics requires more substantial qualitative evidence to support discontinued operations presentation.

SHARE-BASED AWARDS: POST-VESTING RESTRICTIONS

Certain share-based awards have provisions that prohibit the sale of the underlying shares for a period of time subsequent to vesting. ASC 718-10-30-10 indicates that these post-vesting restrictions should be considered when estimating the grant date fair value of a share-based award. The SEC staff noted that assumptions used in the valuation of a share-based payment arrangement, including any discount resulting from the post-vesting restriction of shares, should be based on market participant attributes as opposed to attributes of the individual holding the award.

Although post-vesting restrictions must be considered, the staff does not expect any resulting discount in the grant date fair value to be significant. This line of thought is consistent with ASC 718-10-55-5, which states that "…if shares are traded in an active market, post-vesting restrictions may have little, if any, effect on the amount at which shares being valued would be exchanged."

DEFINED BENEFIT PLAN CONSIDERATIONS

The SEC staff discussed the following acceptable approaches for developing discount rates used to calculate interest costs for single-employer defined benefit plans:

- Single weighted average approach – Under this approach, the plan sponsor determines the pension benefit obligation (PBO) at the measurement date by discounting the projected future benefit payments at the individual duration-specific rates forecast for the time of the projected payments. The single weighted average discount rate calculated by the plan sponsor represents the rate that discounts the projected benefits payments to a present value amount that equals the PBO. Plan sponsors commonly use this weighted-average discount rate to determine the annual interest costs for defined benefit plan reporting under ASC 715.

- The "spot rate" or yield curve approach – The plan sponsor determines the PBO in the same manner as in the single weighted average approach. However, the plan sponsor uses the individual, duration-specific ("spot") rates from the yield curve to calculate annual interest costs.

Both approaches result in the same PBO based on the use of an identical yield curve, but the interest costs differ. The staff did not object to a sponsor changing from the use of the single weighted average approach to the spot rate approach in a recent consultation. In that consultation, the staff also did not object to the registrant accounting for the change as either a change in estimate or as a change in estimate inseparable from a change in accounting principle.

Some plan sponsors have determined their PBO and discount rates by developing a hypothetical portfolio of actual bonds with cash flows that match the projected future benefit plan payments. The staff shared some observations for registrants who are assessing whether it is permissible for a sponsor to change from a hypothetical bond matching approach to a yield curve approach to measure the benefit obligation.

The staff recognized that the measurement of the benefit obligation and the determination of interest costs are integrated concepts. However, the measurement of the pension obligation is the relevant starting point in applying the pension accounting model. The pension accounting guidance requires the use of the best rate for which the PBO could be effectively settled. As such, the staff noted that changes in methodology should only occur if, and to the extent that, the alternative market information results in better information for measuring the benefit obligation. The staff further advised that a change in the approach to developing discount rates for interest cost would not seem persuasive enough for a sponsor to change to a different source of market information for measuring the PBO. Registrants should consider prior arguments for changing from a yield curve to a bond matching approach to value the PBO before returning to a yield curve approach.

The staff has also observed the presentation of pension-related adjustments within non-GAAP disclosures. The staff emphasized that a registrant should provide clear labels and descriptions for these adjustments (i.e., actuarial gain or loss, cash contributions) rather than simply labeling the amount as a "pension adjustment." Additionally, sponsors generally settle pension obligations in cash and consequently, registrants should not describe pension-related adjustments within a non-GAAP measure as "non-cash."

REVENUE RECOGNITION: CUSTOMER INCENTIVES

ASC 605-50 provides that all payments to customers should be considered, including other parties in the vendor's distribution chain (e.g. customers of customers), in determining the proper classification of payments in the statement of income. Due to certain business models that have proliferated since ASC 605 was written, questions have arisen in practice regarding how the customer incentive guidance should be applied when evaluating whether payments made by a vendor outside the distribution chain should netted against revenue. The staff noted that reasonable judgment is required when evaluating whether net revenue accounting is appropriate while acknowledging that in certain fact patterns, companies may view those payments as an expense not subject to ASC 605 (i.e., "gross"). Careful consideration should be given as to whether: 1) the vendor was in substance granting a broad pricing concession to its customers; 2) there was a contractual requirement to pass along consideration to a direct customer's customer; and 3) whether the vendor was acting as an agent of its customer in passing through consideration to a direct customer's customer. Regardless of whether a registrant reports vendor payments on a gross or a net basis, clear disclosure of a registrant's presentation policy, assumptions and alternatives remains critical to the decision usefulness of the financial reporting.

CONSOLIDATION AND VARIABLE INTERESTS: FEES PAID TO DECISION-MAKERS

In early 2015, the consolidation guidance in ASC 810 was amended in response to concerns about the consolidation of certain legal entities. The changes primarily affect the consolidation of limited partnerships and their equivalents. The amendments also apply to the evaluation of fees paid to decision-makers as well as the effect of fee arrangements and related parties on the primary beneficiary determination.

The SEC staff provided insight into the application of the revised guidance for fees paid to a decision maker. A registrant is required to determine whether it has a variable interest in an entity that is being evaluated for consolidation. There are many types of variable interests, including certain fees paid to a decision maker (or a service provider). The revised guidance eliminated three of the six criteria that existed for evaluating whether these fees represent a variable interest. Under the amended consolidation guidance, fees paid to a decision maker would represent a variable interest unless all of the following three conditions are satisfied and there is no principal risk of loss:

- The fees are compensation for services provided and are commensurate with the level of effort required to provide those services.
- The decision maker or service provider does not hold other interests in the VIE that individually, or in the aggregate, would absorb more than an insignificant amount of the VIE's expected losses or receive more than an insignificant amount of the VIE's expected residual returns.
- The service arrangement includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length.

The evaluation of whether fees paid to a decision maker are customary and commensurate requires careful consideration and reasonable judgment. Benchmarking of the key characteristics of an arrangement against other arrangements negotiated at arm's length by the decision maker or market participants may be one method used to evaluate the terms, conditions and amounts included in arrangement. The staff stated that a decision maker should also carefully consider whether any terms, conditions or amounts would substantively affect the decision maker's role as an agent or service provider to the other variable interest holders in an entity.

Related party interests, including whether those related parties are under common control with the decision maker, also impact the consolidation analysis. The staff observed that a decision maker fee, which is not otherwise deemed to be a variable interest (i.e., the conditions above have been satisfied), should not be considered a variable interest solely because an investor under common control with the decision maker has a variable interest that would absorb more than an insignificant amount of variability. Additionally, the staff advised that the separation of power from the economics within an entity designed by a controlling party in a common control group for the purpose of avoiding consolidation would be viewed as a non-substantive separation.

Our flash report located here further discusses the three criteria for evaluating fees paid to a decision-maker and the notion of a principal risk of loss.

ALLOWANCE FOR LOAN LOSSES

The allowance for loan losses is one of the most significant estimates in the financial statements of a financial institution. This allowance should represent management's best estimate of probable incurred credit losses as of the reporting date. For auditors, this allowance often represents a significant risk of material misstatement due to the judgments and complexity involved in the determining the estimate. The continued number of PCAOB inspection findings related to the allowance for loan losses caused the SEC staff to direct registrants and their auditors to the requirements outlined in Staff Accounting Bulletin No. 102 – Selected Loan Loss Allowance Methodology and Documentation Issues (SAB 102). SAB 102 establishes expectations for management related to the development, documentation and application of a systematic methodology over the allowance for loan loss estimate.

Management review controls over the estimation process are critical. However, transactional or activity level controls would typically also be needed in order to satisfy the requirements of SAB 102. For instance, the relevance, reliability and sufficiency of source data, a critical component in estimating the allowance, must be considered and subjected to effective internal controls. The level of precision required to ensure that a material misstatement is identified would typically not be sufficient at the management review level.

Allowance adjustments require an adequate understanding of the data, and the methods and judgments applied to that data, currently being used in a registrant's loss estimation model. Factors that are not captured in the historical loss component of the allowance model are considered when making an allowance adjustment. These factors can include changes in underwriting standards, lending policies, economic trends and concentrations. SAB 102, specifically question 9, establishes the expectation that these factors be considered by management, and documentation should indicate which factors are used in the analysis and how the loss measurement was impacted as a result. Registrants should maintain documentation of the sufficient, objective evidence used to support the amount of an adjustment and to explain why the adjustment was necessary.

FAIR VALUE MEASUREMENTS

Fair value measurements and the related disclosures require significant judgment and remain a focus of the SEC staff. The principal or most advantageous market must be considered when measuring the fair value of an asset or liability. ASC 820 states that a fair value measurement assumes that the transaction to sell an asset or transfer a liability will take place in the principal market, or if there is no principal market, the most advantageous market. The principal market has the greatest volume and level of activity for the asset or liability. The most advantageous market is defined as the market that maximizes the amount that would be received to sell the asset or minimizes the amount that would be paid to transfer the liability, after considering transaction and transportation costs. Further, a registrant must have access to the principal or most advantageous market at the measurement date in order to use it in determining fair value.

The staff identified certain common characteristics to consider when relying on observable pricing inputs as part of the fair value measurement of an asset or liability. While a registrant may not be prevented from using observable prices as one input in a fair value measurement, adjustments may be required. For instance, a registrant may not be able to access a particular market price if the registrant needs to transform the asset or liability in some way to match the asset or liability in the observable market. Other factors to consider include any restrictions unique to the registrant that are not contained in the observable market asset or liability as well as any marketability or liquidity differences in the observable market relative to the registrant's asset or liability. When determining the principal or most advantageous market, the staff advised registrants to consider the initial transaction and whether the market for that transaction was different than the principal or most advantageous market.

The use of a transaction price as fair value was discussed by the staff, who noted that they have observed registrants use this initial cost basis for a period of time following the transaction when valuing illiquid assets or liabilities. Fair value is an exit price concept (based upon an orderly transaction between market participants to sell or transfer an asset or liability at the measurement date under current market conditions). Therefore, the transaction price generally does not represent fair value subsequent to the acquisition date as it is unlikely that market conditions are identical at the subsequent measurement date. Changes in current market conditions (i.e., interest rates, make up of market participants, change in expected cash flows) from those at the time the asset was acquired or liability was assumed impact the fair value. In addition to changes in market conditions, the fair value may be different as a result of changes in time value from the initial transaction to the measurement date or inclusion of transaction costs in the original value. A registrant should also consider incorporating observable market prices or observable prices of a comparable asset or liability, to the extent they exist. Quantitative and qualitative evidence supporting a fair value measurement may be applied directly or indirectly to a valuation model.

The staff also discussed fair value disclosures. Disclosures should be appropriately disaggregated by class. The staff has observed improper aggregation of investment types, pointing out that investments with different risks and characteristics should not be aggregated into the same class (e.g., U.S. treasury securities and collateralized debt obligations should not be aggregated). The staff also stressed the importance of detailed disclosures of the actual valuation techniques used during the periods presented for specific assets and liabilities as well as the inputs used within those fair value models. Boilerplate language such as "valued by a third party specialist" or "valued using the income approach" would not provide sufficient detail.

The staff stressed management's responsibility for internal controls over financial reporting covering all fair value measurements, including illiquid assets and liabilities, whether they be estimated internally by management or by using a third party service provider.

OTHER ACCOUNTING ISSUES

Additionally, consistent with prior years, a panel of technical partners from the national offices of the large accounting firms discussed a number of current practice issues. Some of the current "hot topics" discussed were:

- Statement of Cash Flows – Consistent with statements made by the SEC staff, classification and presentation issues on the statement of cash flows are one of the most common causes of restatements. The panel noted that many presentation issues result from problems with a registrant's systems and processes as well as deficiencies in the associated controls surrounding this financial statement.

- Liability vs. Equity Classification – The complexity of contracts and other agreements often contribute to practice issues in this area. Financial instruments must be evaluated in the context of ASC 480 and ASC 815 to assess whether the instrument should be considered a liability or equity. One recent example noted by the panel related to warrants sold as part of a registered offering. Generally, the underlying shares must also be registered when the warrant is exercised. As the events or actions necessary to deliver registered shares are not considered to be under a registrant's control, ASC 815 presumes that the registrant would be required to net-cash settle the contract, resulting in liability treatment for these instruments. However, there have been recent instances of warrants issued in a registered offering that require a cashless exercise in the event that the underlying shares are not registered at the exercise date. In this instance, a registrant may not be required to settle in cash, which could result in equity classification. Each evaluation requires careful consideration of the specific facts and circumstances, including relevant laws and legal views, as well as consultation with the staff, where necessary.

- Debt Modification vs. Extinguishment – Debt may be renegotiated for a variety of reasons, resulting in amendments to the loan agreement. The guidance requires a registrant to assess whether these amendments result in a modification or an extinguishment for accounting purposes. Under ASC 470, a comparison of the present value of the remaining cash flows and the present value of the cash flows under the new loan agreement is required, with a difference in excess of 10% resulting in an extinguishment. Historically, there have been two acceptable approaches used in this calculation, the net method and the gross method. The cash flow comparison under the net method uses the lowest principal balance common to the old and new debt (e.g., if the old debt balance was $10 million and the amended loan agreement provides an additional $2million – $12 million in total – then the cash flows related to $10 million would be used in the comparison). The gross method would compare the cash flows of the entire amount of borrowings before and after the amendment (e.g., compare the cash flows related to the $10 million old debt to cash flows related to the $12 million amended debt in the previous example). The panel noted that practice has evolved such that only the gross method should be used.

- Contingent Consideration in a Business Combination – Contingent payments to employees or selling shareholders may constitute contingent consideration for a business combination or compensation. This analysis requires an assessment of various factors and a detailed understanding of the transaction documents. The panel highlighted one practice issue related to contingent payments to an employee. When two events must occur in order for an employee to receive the payment it is referred to as a "double trigger." For example, under an employment agreement, an employee of a target may be entitled to a payment of $100,000 if 1) the target is acquired and 2) the employee is terminated by the acquirer within six months of the acquisition. Since both events must occur for an employee to receive a payment and the termination is an event triggered by the acquirer, this contingent payment would typically be recorded as compensation expense rather than contingent consideration.

- Consolidation and Push-Down Accounting Matters – The panel discussed the impact of non-cash contributions of assets. If a registrant contributes non-cash assets meeting the definition of a business in exchange for non-controlling equity interests in the receiving entity, ASC 810 would require deconsolidation of the business by the registrant and the equity investment would be recorded at fair value, often resulting in a gain or loss. Alternatively, a registrant must consider if other guidance applies (such as ASC 970 for real estate or ASC 845 for other nonmonetary transactions), when the non-cash assets are not a business. Additionally, a non-cash contribution of assets or

businesses between entities under common control would require the receiving entity to record the transaction at the parent's basis. The 2014 amendment to ASC 805, which made pushdown accounting optional for registrants, did not change this requirement. However, if a newco is involved and is deemed to be the acquirer, that entity would be required to apply the accounting for business combinations.

DISCLOSURE MATTERS

NON-GAAP MEASURES

Registrants often choose to use non-GAAP measures in order to provide further insight to investors. Non-GAAP measures were highlighted as an area of concern and focus for Chair White and the SEC staff given the extensive use of such measures and the potential for confusion. Chair White urged registrants to think critically about these disclosures, including a consideration of why the non-GAAP information is presented, how it provides useful information to investors (not to management), whether information is described accurately and completely, and whether appropriate internal controls over the calculation of non-GAAP measures are in place.

The staff monitors filings to ensure that non-GAAP disclosures comply with the requirements of Regulation G and, if applicable, Regulation S-K, Item 10(e). Non-GAAP disclosures should be presented consistently and be given no greater prominence than GAAP measures. Also, non-GAAP measures and related adjustments require clear labeling to ensure the information is not misleading. A registrant should exercise caution when describing non-GAAP measures to ensure that accounting terms are not used when the appropriate accounting definitions are not met.

SEGMENTS

Segment disclosures have been, and continue to be, a point of emphasis for the SEC staff as well as the PCAOB. The views presented by the staff built on the statements communicated last year. The staff relayed several observations from their consultations with registrants and filing reviews.

Some registrants have argued that segment disclosures may be "competitively harmful' or "misleading" during consultations with the staff. The staff commented that these statements are "troubling" and not persuasive. Rather, registrants should identify which information is useful to investors, why it is important, and how to appropriately report that information.

Certain principles and objectives within the segment reporting guidance were highlighted as reminders to consider during an analysis of segment disclosures.

- Chief operating decision maker (CODM) – The CODM is the individual who makes key operating decisions and may be someone closer to the day-to-day operations (e.g., it may not be a CEO, whose focus is on strategic decisions). A registrant should not default to the individual with ultimate decision-making authority as the CODM.

- Operating segments – A registrant should periodically reassess the identification of operating segments, specifically when there are changes in an organizational structure, key personnel, or significant acquisitions and dispositions.

  A periodic reporting package provided to the CODM and a registrant's organizational structure often provide insight into how the entity has been organized for purposes of making decisions and assessing performance. The staff cautioned that neither is determinative on its own. Consideration should also be given to factors such as the basis on which budgets and forecasts are prepared and the basis on which executive compensation is determined.

  On occasion, the application of the accounting standard may result in a single operating segment. The staff believes a registrant should disclose that resources are allocated and financial performance is assessed on a consolidated basis in addition to explaining the basis for such a management approach. Similarly, a description of the business as being diversified across businesses or products would not be consistent with an aggregated management approach.

  The staff also stated that discrete financial information does not have to include the allocation of all costs, such as general and administrative costs. For instance, if an analysis of gross profit is provided to the CODM, that is sufficient discrete financial information.

- Aggregation of operating segments – Aggregation is only appropriate if all of the following criteria are met: (a) aggregation is consistent with the underlying principle in the standard, (b) operating segments have similar economic characteristics, and (c) operating segments are similar in each of five specific areas.

  When considering aggregation of two or more operating segments, a registrant should consider whether a reasonable investor would find these segments similar. The importance of the first criterion, that aggregation must be consistent with the principles in ASC 280, is often overlooked by registrants. The staff also stated that economic similarity (e.g., similar margins) does not matter if operating segments are qualitatively different. Further, an expectation of similar economic characteristics in the future does not outweigh a lack of similarity in current and past economic performance.

The staff stressed that an effective design and operation of internal controls is necessary to support the inherent judgments needed in segment reporting.

In the event that the staff disagrees with a registrant's segment disclosures, the staff indicated that they will generally not object to a prospective presentation of the amended segment disclosures (i.e., in future filings). However, if the change to segment reporting would materially impact goodwill impairment in the historical period, a restatement would be required.

INCOME TAXES

The complexity of income taxes, especially when foreign jurisdictions are involved, often requires a registrant to provide expanded disclosures in order to paint a clear and transparent picture to investors. The SEC staff called attention to the need for continued improvement in income tax disclosures in the footnotes to the financial statements and in MD&A, specifically mentioning disclosures related to indefinitely reinvested foreign earnings and the income tax rate reconciliation.

When a registrant has asserted that foreign earnings are indefinitely reinvested and the registrant also maintains significant cash balances in foreign jurisdictions which would create a tax liability if repatriated, the staff has requested those registrants to disclose the amount of cash held overseas in the liquidity section of MD&A. The disclosure of foreign cash balances would highlight the amount of cash that is not available for U.S. operations.

The staff has historically observed that additional disclosures with respect to foreign earnings, such as taxes and tax rates by jurisdiction, may help investors understand a registrant's consolidated tax position. Consistent with these past observations by the staff, the FASB reached tentative disclosure decisions during 2015, which would require additional disaggregated disclosures by jurisdiction. The FASB continues to evaluate these tentative decisions for inclusion in future proposed accounting standards.

The staff also suggested that linking the income tax rate reconciliation to the qualitative discussion may help reduce confusion. A registrant should consider each component of the reconciliation and explain one-time or other significant events and their current and future impact on the effective tax rate in the results of operations section of MD&A. To the extent that a component is impacted by multiple factors, such as a "foreign tax rate differential," a disaggregated reconciliation may be a more meaningful presentation in the footnotes to the financial statements.

PREDECESSOR FINANCIAL STATEMENTS

When a registrant succeeds to substantially all of the business of another entity and the registrant's own operations before the succession appear insignificant relative to the operations assumed or acquired, an acquired business would be considered a predecessor. Certain transactions, such as carve-outs, put-together transactions, and spin-offs, may require the presentation of predecessor financial statements and other financial information, such as MD&A and selected financial data. Predecessor financial statements must be full financial statements audited in accordance with PCAOB standards in accordance with Rules 3-01 and 3-02 of Regulation S-X. These requirements for a predecessor are more comprehensive than the financial statement requirements of an acquiree under Rules 3-05 and 3-14 of Regulation S-X.

The SEC staff stated that it would be rare not to have a predecessor, even when a newly formed company is considered substantive and deemed to be the accounting acquirer. The identification of more than one predecessor is also possible. The staff also offered the following non-exclusive list of factors to consider when determining a predecessor:

- Order in which entities are acquired
- Size of the entities
- Fair value of the entities
- Ongoing management structure

RESTATEMENTS

The three most commonly identified topics in restatements are liability/equity accounting, statement of cash flows classifications, and income tax accounting. The SEC staff noted that the restatements were generally a result of misapplication of the standards as opposed to misinterpretations of the standards. A continuous assessment of a registrant's resources, competence and availability of training programs to support high quality financial reporting was suggested by the staff.

AUDIT COMMITTEES

Chair White and the SEC staff discussed the critical role that audit committees play in the financial reporting process. There are growing concerns about the amount of work placed on some audit committees. Audit committee workloads continue to expand beyond the duties required by the SEC and the listing exchanges, which include the selection and oversight of independent auditors, oversight of management's design and implementation of internal controls, establishment of an appropriate system for complaints about accounting, and reporting to shareholders. It is common for audit committees to assume additional roles for entity risks such as cybersecurity. Additionally, Chair White questioned the effectiveness of directors that serve on multiple boards and multiple audit committees. Audit committees should take care to ensure members have the requisite time and experience.

Auditor independence – in both fact and appearance – is critical to safeguarding an auditor's objectivity and providing credibility to the financial statements. The staff believes that auditors, management, and audit committee members all share responsibility for auditor independence. Consistent with prior years, the staff encouraged management and audit committee members to consider whether appropriate policies and procedures are in place (and consistently executed) to thoroughly evaluate threats to auditor independence from any potential non-audit services. Any proposed non-audit service should be evaluated against the four principles in Rule 2-01(c) and ongoing monitoring policies should be in place to ensure that expansions or changes in services ("scope creep") do not result in impermissible services that would impair auditor independence.

The staff also noted that in connection with the implementation of the new revenue recognition standard, or any other standard, an auditor may provide guidance about the proper application of accounting principles, including important factors to be considered in making judgments that may become critical in the accounting process, without violating the Commission's independence rules. However, registrants must take responsibility for accounting decisions and policies as well as internal controls. An auditor must avoid auditing his/her own work and acting as management, such as having direct involvement in the development of specific revenue recognition policies under the new standard.

INTERNATIONAL ISSUES

VENEZUELA

Venezuela's highly-inflationary economy continues to be in a state of flux. The further decline in oil prices and oil production in 2015 compounded the country's economic struggles. Governmental currency controls have resulted in multiple exchange rates and companies continue to have difficulty accessing U.S. dollars. The SEC staff has previously indicated that, when multiple exchange rates exist, registrants should use the rate that is appropriate to the unique facts and circumstance of the registrant and its transactions for remeasurement purposes. This may result in the use of multiple rates and disclosure of the rates used and basis for selecting such rates should be disclosed.

Additionally, ASC 810 indicates that a majority-owned subsidiary shall not be consolidated if control does not rest with the majority owner – for instance, if the subsidiary operates under foreign exchange restrictions, controls, or other governmentally imposed uncertainties so severe that they cast significant doubt on the parent's ability to control the subsidiary. In accordance with this guidance, some registrants have concluded that they no longer have a controlling financial interest in certain subsidiaries domiciled in Venezuela, resulting in deconsolidation of those subsidiaries. In these instances, careful consideration should be given to whether a deconsolidated subsidiary is a variable interest entity because power may no longer reside with the holders of equity at risk. The staff reminded registrants that they should provide appropriate disclosures about the judgments around, and the financial reporting impacts of, deconsolidation as well as the required disclosures for variable interest entities that are not consolidated.

Further, the staff expects consistency in judgment to be applied in the event that exchangeability improves or governmental restrictions lessen, such that registrants may need to consolidate these subsidiaries again. Internal controls must be in place to allow for continuous reassessment of exchange restrictions and government controls.

CROSS-BORDER TRANSACTIONS

The SEC staff participated in a discussion about considerations in cross-border transactions. In these transactions, the status of a registrant and its target (e.g., U.S. domestic filer, foreign private issuer, or foreign business) are critical to determining the age and basis of financial statements to be provided upon acquisition (Rule 3-05) or as required for an equity method investment (Rule 3-09). A foreign business is defined in Rule 1-02 of Regulation S-X as an entity that is 1) majority-owned (greater than 50%) by persons who are not residents or citizens of the U.S., 2) not organized under the laws of the U.S., and 3) either more than 50% of its assets are located outside the U.S. or the majority of executive officers and directors are not U.S. residents or citizens. If financial statements of an entity that does not qualify as a foreign business are required under Rule 3-05 or Rule 3-09, those financial statements must be prepared under U.S. GAAP or reconciled to U.S. GAAP. Alternatively, financial statements of a foreign business may also be prepared under IFRS, as issued by the IASB, with no reconciliation requirements. In all cases, financial statements of an acquired company cannot be audited under local jurisdictional rules.

The staff noted that they have observed instances where a joint venture was owned 50% by a U.S. investor and 50% by a non-U.S. investor. In this case, the joint venture would not qualify as a foreign business since foreign ownership was not a majority, even if all other criteria were met.

Further, unlike the rules governing foreign private issuers, SEC rules do not specify the date on which the foreign business assessment must be made. Instead, the staff stated that a registrant should use the "date that makes the most sense" (e.g., registration filing date, date of an Item 2.01 Form 8-K, date immediately prior to the acquisition, date of the prior year end, etc.).

For acquisitions, the pro forma financial information is based on the comprehensive body of accounting used by the registrant (e.g., U.S. GAAP, IFRS as issued by the IASB) and the age of financial statements requirements applicable to the registrant. In certain circumstances, pro forma information of a foreign target may be necessary for a period more current than the required historical financial statements. The staff reminded domestic registrants that Regulation S-X permits the use of a combination of periods that involve overlaps or gaps in the information of the target company by up to 93 days as long as the periods are the same length as required by the registrant. For example, assume that upon acquisition of a foreign target in early 2016, a domestic registrant is required to present pro forma information for fiscal year 2014 and the nine months ended September 30, 2015. If the September 30, 2015 interim financial statements of the foreign target are not available because they were not yet required, the registrant could use the combined information for the six months ended June 30, 2015 and the three months ended December 31, 2014 for use in the September 30, 2015 pro forma financial statements (resulting in nine months of information, but excluding information for the three months ended September 30, 2015).

FOREIGN PRIVATE ISSUERS

Foreign private issuers are required to assess their status at the end of the second quarter of their fiscal year. The SEC staff noted that a foreign private issuer will continue to be subject to the foreign private issuer requirements after losing foreign private issuer status until the first day of the subsequent fiscal year. In that subsequent fiscal year, all requirements of a domestic filer would be required (Rule 3-09 financial statements, three years for audits using U.S. GAAP, etc.).

The SEC has not yet approved a XBRL taxonomy for IFRS filers.

AUDITING ISSUES

GOING CONCERN EVALUATIONS

The FASB has adopted a requirement for management to make a going concern evaluation, which is defined differently than in the existing PCAOB standards. The PCAOB staff reminded auditors to continue to follow AU 341, even if the entity being audited adopts the FASB going concern standard early. There has been significant outreach and research into the effectiveness of existing going concern reporting and whether it is giving investors the information they need on a timely basis as well as reconciling the difference in the definition of "substantial doubt" in the auditing and accounting standards.

INSPECTIONS

The PCAOB staff noted that in many respects, the state of audit quality has improved over the last 13 years. The staff also noted the five key areas where improvements were seen: tone at the top, training (including targeted training on complex audit areas), new practice aids and checklists, coaching and support to audit teams and monitoring the quality of work performed. The audit areas that continue to require improvement include internal controls, fair value, revenue recognition, effective remedial action, root cause analysis, consistent execution of a global audit methodology and monitoring of independence.

The staff also indicated that 2016 inspections will likely focus on the implementation of the new Auditing Standard No. 18, recurring audit deficiencies (such as ICFR), segment disclosures, mergers and acquisitions, income taxes, going concern, technology risks (such as cybersecurity), and economic and environmental risks, among other areas.

The staff has historically been barred from performing inspections in certain foreign jurisdictions. PCAOB Chair James Doty cited that progress has been made with respect to these global inspection issues, citing several additional countries that now have bilateral agreements to allow inspection access. The global inspection process continues to be a challenge, particularly in China. The PCAOB continues to negotiate to expand their inspection reach.

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