HIGHLIGHTS OF THE 2014 AICPA NATIONAL CONFERENCE ON CURRENT SEC AND PCOAB DEVELOPMENTS
AICPA Conference

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Overview and theme

1. The 2014 AICPA National Conference on Current SEC and PCAOB Developments (the Conference) was held on December 8, 9, and 10, 2014. Similar to prior years, the Conference hosted representatives from regulatory and standard setting bodies, along with auditors, users, preparers, and industry experts who expressed views on a wide range of important accounting, auditing, and financial reporting topics.

2. Disclosure effectiveness, the importance of financial statement comparability across companies, and the need for simplification were themes highlighted throughout the Conference. Each of these themes supported the overall focus on providing users of financial statements with decision-useful information.

Regulatory update and financial reporting matters

Disclosure effectiveness

3. The SEC staff is in the midst of a broad, ongoing project to evaluate the requirements of Regulation S-K and certain provisions of Regulation S-X for all registrants. This effort evolved out of a JOBS Act requirement for the SEC staff to evaluate ways to modernize and simplify the registration process and reduce the costs and other burdens associated with Regulation S-K requirements for issuers that are emerging growth companies. While the SEC staff was clear that current disclosure requirements are not broken, there appears to be widespread support for identifying targeted recommendations to minimize duplication, eliminating disclosures that are not useful, and reducing the costs and burdens of financial reporting to preparers.

4. The SEC staff will first focus on the portions of Regulation S-X that address financial information of entities other than the registrant (e.g., acquired businesses, equity method investees, guarantors). The application of these rules can be complex and many consider it to be disproportionately burdensome to smaller registrants since they are more likely to trigger the quantitative thresholds in these rules. The project may serve as an opportunity to further scale disclosure requirements for the various classes of registrants. The SEC staff also suggested that enhancements to Regulation S-X Article 11 pro forma financial statement requirements could support a reduction in the requirements for pre-acquisition financial statements.

5. The SEC staff was clear that registrants can still take action to make disclosures more effective in the absence of revisions to existing rules. They can do so by streamlining disclosures, eliminating boilerplate language in areas such as risk factors and legal
proceedings, avoiding duplication (e.g., between critical accounting policy and summary of significant accounting policy disclosures), and making greater use of hyperlinks and cross referencing where applicable and appropriate.

.6 The SEC staff reiterated that disclosure effectiveness is not only about what information is disclosed, but how it is disclosed. Technology has evolved, and the SEC staff is looking at ways to improve the EDGAR system to organize information to be more useful and accessible to investors. Any such advancement, however, would need years to develop.

.7 Although the SEC staff is working to identify ways to streamline disclosures, the ultimate goal is not to reduce the volume of disclosures. While the disclosure effectiveness project may identify and eliminate duplication or overlaps in disclosure requirements, it may also identify gaps in information that investors would find useful, in which case it may lead to additional disclosure requirements.

**SEC staff observations**

**Segment reporting**

.8 The SEC staff is refreshing its approach to reviewing segment disclosures and strongly encouraged registrants to do the same when evaluating segment reporting conclusions. Registrants should not default to the Chief Executive Officer as the function operating in the role of the Chief Operating Decision Maker (“CODM”) simply because that individual has ultimate decision-making authority. Rather, they should evaluate what the key operating decisions are and who is making those decisions for the entity as a whole.

.9 The SEC staff also noted that preparers often place a great deal of reliance on the CODM reporting package when identifying operating segments. The CODM reporting package is one data point to be used in combination with other indicators, such as the basis on which budgets and forecasts are prepared, the basis on which executive compensation is determined, and the overall organizational/management structure.

.10 Despite the segment reporting standard being issued more than 15 years ago, the SEC staff believes there are still basic reporting requirements being overlooked, including entity-wide disclosures. The staff reminded preparers that the entity-wide disclosures are required even if a registrant has only one reportable segment. In addition, the entity-wide disclosure of revenue by product may be different than how revenue is reflected in segments organized by product.

.11 The “type or class of customers” criterion as it relates to the aggregation of operating segments is another provision that merits additional focus. If operating segments have characteristics so similar that they are expected to have essentially the same future prospects, separate reporting of segment information would not add significantly to an investor’s understanding. Therefore, aggregation of two or more operating segments is permitted. However, the SEC staff believes that the aggregation criteria are intended to be a high hurdle, emphasizing that similar long-term performance alone is not sufficient to justify aggregation. Registrants should use reasoned judgment in determining whether all of the aggregation criteria have been met.

**PwC observation:**

In October, we released the inaugural edition of our accounting and financial reporting guide, *Financial statement presentation – 2014 edition*. This guide is designed to assist companies in understanding financial statement presentation and disclosure requirements under U.S. GAAP. Chapter 25 provides information about the assessment and disclosure of segments.
Management’s discussion and analysis

.12 With a view towards simplification and a focus on the needs of investors, the SEC staff discussed areas of frequent comment related to management’s discussion and analysis (MD&A). Registrants were reminded that the discussion of critical accounting estimates is not meant to be a repeat of the summary of significant accounting policies found in the notes to the financial statements. MD&A should highlight the judgments, estimates, and uncertainties embedded in the financial statements that make them uncertain and subject to change. A formal sensitivity analysis may not be required in all cases, but registrants should include qualitative and quantitative information that allows investors to understand the implications if those uncertainties were to be resolved in different ways.

.13 MD&A disclosure of material trends and uncertainties is critical. It is important to properly evaluate which trends and uncertainties should be disclosed to provide information to investors about the quality and potential variability of a company’s earnings and cash flows. Doing so is consistent with the intent of MD&A—to provide information that allows investors to use past performance to assess future performance. To determine if disclosure is required, management must assess if the known trend or uncertainty is reasonably likely to come to fruition. If they conclude it is not, no disclosure is required. Otherwise, management must objectively evaluate the consequences of the known trend and uncertainty on the assumption that it will come to fruition. Disclosure is then required unless management determines that a material effect on the registrant’s financial condition or results of operations is not reasonably likely to occur. Using this 2-step thought process, the determination of disclosure is binary; it is not based on probability weighting.

.14 The SEC staff also highlighted income tax disclosures in MD&A as a key area of focus. While the SEC staff continues to ask questions regarding valuation allowances, the realizability of deferred tax assets, and indefinite reinvestment assertions, it expects to increase its focus in 2015 on income tax expense. Areas of focus are expected to include instances where tax rates appear unusual relative to the expected statutory rate, effective tax rates are volatile, or effective tax rates do not change because material changes in components are offsetting. The SEC staff also expects to see disclosures in MD&A that do not simply repeat the components of the rate reconciliation. Material offsetting components should be described individually. Foreign earnings and associated taxes are also expected to garner additional comment as the staff is aware of investors’ desire for more information in this area. Lastly, the SEC staff may question boilerplate language that refers to taxes being potentially impacted by changes in the mix of foreign earnings. Registrants can enhance disclosures in this area by including specificity about statutory and effective rates in the significant countries in which the company operates.

PwC observation:

In addition to the trends noted above, we have observed other areas of focus in SEC staff comment letters over the past year. In early December, we held industry webcasts to discuss recent comment letter trends, which can be found on CFOdirect at the following link:

SEC comment letter trends webcasts

We have also issued several industry-specific comment letter trend publications available on CFOdirect:

SEC comment letter trends by industry sector
Initial public offerings

.15 The SEC staff highlighted several matters specific to initial public offerings (IPOs). In the absence of a waiver, the SEC staff is generally unwilling to commence a filing review of an initial registration statement when the financial statements for the earliest fiscal year are omitted on the basis that they will be removed in a subsequent filing prior to the effective date of the registration statement.

.16 While the SEC staff may ask companies to explain the reasons for pre-IPO common stock valuations that appear unusual, the comments are often intended to confirm that the registrant has appropriately accounted for share-based compensation. As such, registrants should not assume that additional disclosures in MD&A or elsewhere in a prospectus are necessary. The SEC staff updated the Division of Corporation Finance Financial Reporting Manual (section 9520) earlier this year to clarify the staff’s expectations regarding pre-IPO stock compensation disclosures in IPO prospectuses.

.17 The SEC staff also commented that there has been a growing number of complex business reorganizations occurring concurrent with, or immediately prior to the effectiveness of an IPO, commensurate with the increase in IPO volume. In these situations, registrants should carefully evaluate which entity is considered the registrant, and hence which financial statements are required in the registration statement. Preclearance with the SEC staff may be needed in unusual situations.

Division of enforcement

.18 Andrew Ceresney, Director, and Michael Maloney, Chief Accountant, of the SEC’s Division of Enforcement provided an overview of enforcement trends, noting that the number and breadth of enforcement actions have significantly increased over the past fiscal year. The increase could be attributed, in part, to the SEC’s focus on enforcement in general and financial reporting specifically, and the creation of the Financial Reporting and Auditing Task Force. The Task Force was charged with developing state-of-the-art tools to better identify financial fraud and incubate cases to be investigated by other groups. The Task Force monitors high-risk areas, analyzes industry performance trends, reviews restatements, revisions, and class action filings, as well as academic research. The Task Force continues to leverage internal analytical tools and external resources to assist in the identification of anomalies that may require further investigation.

.19 The enforcement division has completed its first full year since announcing that, in certain enforcement cases, the SEC staff would pursue an admission of wrong doing rather than permit a company to “neither admit nor deny” responsibility in certain situations. During this time, there were fourteen instances of admission, representing cases where heightened accountability or acceptance of responsibility through the defendant’s admission of misconduct was deemed appropriate.

Standard setting update

.20 Russell Golden, FASB Chairman, focused his remarks on the effort the FASB is making to improve U.S. GAAP by reducing complexity. Golden grouped these efforts into three categories: (1) the FASB’s “Foundational Projects,” such as the conceptual framework and disclosure framework projects, which define long-term standard setting goals focused on critical issues, (2) the FASB’s simplification initiative, which addresses complexity in U.S. GAAP on narrow-scope agenda projects identified by stakeholders, and (3) recent cost-benefit assessments performed for proposed standards, to ensure the benefits of information produced by these standards justify the cost to prepare it.

.21 Golden referred to the recently formed joint FASB/IASB Revenue Recognition Transition Resource Group (“TRG”) as a “prototype” for future standards in addressing application issues and the need for clarification for major standards. Golden reaffirmed that working towards a more converged global accounting standard with both the IASB
and other standard setters is important to reducing complexity. However, Golden was clear that the FASB’s first priority is to improve U.S. GAAP for its users in the U.S. and abroad.

.22 Ian Mackintosh, IASB Vice-Chairman, discussed the need for continued collaboration between the FASB and IASB, and their joint responsibility to minimize differences in the future. He noted that the use of IFRS in many jurisdictions across the world has led to an improved ability to compare results across national borders that have, in the past, been obscured by differences in national GAAPs. Mackintosh emphasized his belief that the similarities between U.S. GAAP and IFRS are greater than the differences. He touted the leases project as an example that, while not fully converged, will achieve agreement on the fundamental issue of leases being recognized on the balance sheet.

.23 Hugh Shields, IASB Executive Technical Director, and Sue Cosper, FASB Technical Director and EITF Chair, provided updates on IASB and FASB accounting standard setting activities. Shields discussed the IASB’s recently issued IFRS 9, Financial Instruments, and IFRS 15, Revenue from Contracts with Customers. He also discussed the IASB’s improved standard setting process, which includes an initial research program to better understand issues before initiating a standard setting project. This is expected to shorten the time needed to develop standards. Shields provided updates on the IASB’s major standard-level projects, including leases, insurance contracts, macro hedging, rate regulated activities, disclosure initiative, and IFRS for SMEs. The status of each project was consistent with existing public information.

**PwC observation:**
Refer to our In depth US2014-05, IFRS 9 — Classification and measurement, and In depth US2014-06, IFRS 9 – Expected credit losses, for more information regarding the recently issued standard.

.24 Cosper provided an update on the FASB’s simplification initiative and the status of current FASB projects. The leases project is expected to be completed in 2015, with neither the FASB nor IASB staff willing to estimate its effective date. In response to a question from the audience, Shields and Cosper noted that, at this time, it is highly unlikely that the lease standard would be subject to additional exposure.

.25 The FASB’s financial instrument classification and measurement project is also expected to be completed in 2015, following redetermination of impairment of equity method investments and the transition and effective date. Other projects the FASB recently added to its technical agenda include hedging, the definition of a business, goodwill, and the separation of identifiable intangible assets. The status of each project was consistent with existing public information.

**Revenue recognition**

.26 Not surprisingly, there were many references to the new revenue recognition standard by a variety of presenters. The focus was on the new standard’s intent to develop a principles-based model that would result in consistency across companies and industries with similar facts and circumstances. It was generally assumed that application of the new standard would require increased judgment and expanded disclosure.

.27 It was noted that some of the implementation issues being raised are concerns under current guidance as well, and are not necessarily a result of the new standard. The TRG has met several times and will meet again in January. The Boards may issue clarifying or additional guidance on two of the issues discussed by the TRG—the principles applicable to “distinct in the context of the contract” and licenses of intellectual property. These are
critical areas for the FASB and IASB to address to meet the stated effective date. Cosper noted that the FASB will discuss possible effective date deferral in early 2015.

.28 In a separate revenue recognition panel consisting of preparers and auditors, participants further explored the judgment required to apply the new model. Panelists were concerned that taking similar facts and circumstances through the principles-based model can result in different accounting outcomes. The panelists noted that it will be important to document the relevant judgments throughout the implementation process. They cautioned that the criteria and indicators provided in the standard are not the same as a policy choice. All factors should be carefully considered to determine the appropriate accounting conclusion.

.29 There was broad agreement that preparers should not wait for answers (from the various working groups, standard setters, or peer companies) or hope for a deferral before they start implementing the standard. Companies will need cooperation from departments across their organization to ensure a successful implementation and the process may be lengthy.

.30 Application of the new standard and the increased use of estimates and management judgments may result in the need for new processes and controls. Brian Croteau, SEC Deputy Chief Accountant in the Professional Practice Group of the Office of the Chief Accountant (OCA), noted that as companies work to implement the new revenue standard, management should be cognizant of its obligation to disclose material changes to internal control over financial reporting on a quarterly basis. This is particularly relevant when newly designed or redesigned controls are implemented in advance of adoption, yet impact current period financial reporting.

**IFRS**

.31 The SEC staff praised the efforts of the FASB and IASB on their work toward converged standards, highlighting the newly issued revenue recognition standard as a significant milestone and the leases project as the next important indicator of successful convergence. Many presenters emphasized the importance of IFRS due to the significant amount of foreign debt and equity securities held by U.S. investors. Mackintosh stated that more than half of the world’s largest companies report under IFRS. As a result, a significant number of U.S. companies are regularly compared to peers that use IFRS, which has raised investors’ knowledge and comfort with IFRS.

.32 While there was no definitive announcement on the use of IFRS by domestic registrants, James Schnurr, SEC Chief Accountant, suggested that one possible alternative would be to allow domestic issuers to submit supplemental IFRS-based financial information on a voluntary basis. Discussions around this alternative are preliminary and Schnurr is encouraging stakeholder input on the form of the supplemental information (e.g., key metrics, reconciliation from U.S. GAAP, or full financial statements) as well as whether the information should be subject to some level of auditor assurance. Schnurr was clear that this idea is preliminary and that he continues to be open to input on this or any other alternatives and has not predetermined the path he will recommend to the SEC.

**Committee of Sponsoring Organizations of the Treadway Commission**

.33 In May 2013, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) released an updated Internal Control – Integrated Framework. The core definition of internal control and the overall structure of the framework remain the same as under the 1992 framework. One of the more prominent changes relates to 17 principles that underpin the five components of the COSO framework. While detailed in the 1992 framework, the 2013 framework now requires them to be evident to support the
effectiveness of internal control. In addition, 77 points of focus provide additional clarification of the framework’s components. Chuck Landes, Vice President of the AICPA’s Professional Standards and Service Group and COSO Board Member, noted that the points of focus are not a requirement of the 2013 COSO framework. Rather, they are for management to consider in determining whether each of the five components and the 17 principles are present and functioning in a system of internal control over financial reporting (ICFR).

34 On December 15, 2014, COSO will discontinue its support of the 1992 framework. The SEC staff indicated that either the 1992 or 2013 COSO frameworks would be accepted for 2014. However, the staff and investors may question why a registrant continues to use the superseded framework going forward. As recommended last year, the SEC staff believes that management should continue to clearly identify which framework was used. Landes expressed his view that companies that expect to use the 1992 COSO framework subsequent to December 15, 2014 should document a sound, valid business reason for that decision.

**PwC observation:**

We recommend that management use the 2013 COSO framework to evaluate the effectiveness of ICFR. However, PCAOB Auditing Standard No. 5 requires that the auditor use the same recognized, suitable framework as management. As such, if management chooses to use the 1992 COSO framework, the auditor must also use the 1992 COSO framework in conducting the integrated audit.

If management decides to continue to use the 1992 COSO framework, they should consider discussing such decision with the company’s audit committee, including how the framework continues to meet the four suitability and recognition criteria articulated by the SEC rules.

35 Landes also indicated that if management concludes that its system of ICFR is not compliant with the 2013 COSO Framework, it would call into question whether it was or would be compliant with the 1992 COSO Framework.

**PwC observation:**

The 2013 COSO framework requires that each of the 17 principles within the five components of internal control be present and functioning in the company’s system of ICFR, whereas the 1992 COSO Framework required less specificity in the assessment of the five components of internal control. Therefore, by applying the more granular evaluative criteria in the 2013 framework, management may identify additional control deficiencies.

**Internal control over financial reporting**

36 Croteau reiterated his concern from last year that not all material weaknesses are being properly identified, evaluated, and disclosed. He continues to question the low number of material weaknesses in the absence of a restatement or other known material error, implying that the “could factor” or the potential exposure is not being correctly evaluated. He noted that the SEC’s efforts pertaining to ICFR requirements (e.g., consultations, disclosure review, and enforcement actions), specifically as they relate to management’s conclusions on the effectiveness of internal control, are “ongoing, coordinated, and increasingly integrated.”
The SEC staff continues to believe that the top-down, risk-based approach described in its interpretive guidance to management on implementing Section 404 of Sarbanes-Oxley is typically most effective for determining whether any material weaknesses exist. SEC Senior Associate Chief Accountant Kevin Stout emphasized the importance of understanding the cause of each control deficiency. He noted that while it is possible that some transaction-level control failures are isolated within the Control Activities COSO component, the cause may often stem from a broader breakdown in other internal control components, for example, the Risk Assessment and Monitoring Activities components. Stout also discussed identifying financial reporting risks, and noted that it is critical for management to consider the nature and extent of any changes in the risks to reliable financial reporting.

Stout also addressed the importance of an accurate definition and disclosure of control deficiencies. He emphasized that describing the accounting error is not the same as describing the control deficiency. Stout reminded registrants that in order to understand, describe, and appropriately remediate a deficiency, management should consider the nature of the control deficiency, its impact, cause, and how it was identified. Echoing Croteau’s comments, Stout noted that the actual error is only the starting point for evaluating the severity of a deficiency, and that the potential impact—the “could factor”—must be considered as well.

Other financial reporting topics

Audit committee disclosures

The SEC staff commented that they are reconsidering the current audit committee disclosure requirements. While the Sarbanes-Oxley Act had a dramatic impact on the role of audit committees, the SEC's disclosure requirements in this area have not changed since 1999. The SEC staff acknowledged that some audit committees have taken the initiative to enhance their disclosures beyond the current audit committee report requirements. Audit committee report disclosures are considered an element of good governance, and were addressed in a report released late last year by the Center for Audit Quality (CAQ) entitled Enhancing the Audit Committee Report – a Call to Action.

Integrated reporting

Paul Druckman, CEO of the International Integrated Reporting Council (“IIRC”), discussed the importance of integrated reporting (IR) and its ability to provide strategic insights, as contrasted with financial reporting that merely reflects historical data. He further noted that IR is not just a Form 10-K plus a sustainability report, or an executive summary. Rather, it is a synthesis of how a company wants to tell a story about its business, risks and opportunities, strategy, and value creation. He discussed the six capitals (i.e., resources that create value in companies) introduced by the IR framework—financial, manufactured, intellectual, human, social and relationship, and natural—and illustrated how these capitals are addressed in a sample of published public company IR reports.

Amy Pawlicki, Director of Business Reporting, Assurance and Advisory Services of the AICPA, discussed the assurance implications of IR, noting that credibility is paramount. It is unlikely that traditional financial reporting assurance would be sufficient to instill the required confidence. Pawlicki described two papers released by IIRC earlier this year—Assurance on IR: an introduction to the discussion, and Assurance on IR: an exploration of issues—which will serve as the basis of planned IIRC discussions with constituents. IIRC expects to issue a summary of its findings in early 2015.
PwC observation:
Investors have been showing increased interest in the correlation between financial performance and sustainability factors like resource scarcity, environmental performance, and corporate governance when assessing a company’s future risk and growth opportunities. Having better insight into these issues also benefits companies, by integrating their thinking to develop a better understanding of what impacts their businesses, allowing them to tell a more holistic value creation story.

Our 10Minutes on integrated reporting provides additional insights and perspectives on the integrated reporting model.

Conflict minerals
.42 In the first year of conflict minerals reporting, approximately 1,300 Form SDs (Specialized Disclosure) were filed, signed primarily by the CFO. The majority of the filers were in the consumer and industrial products industries.

.43 A legal challenge to portions of the conflict minerals rule are still pending. In April 2014, the U.S. Court of Appeals for the District of Columbia ruled that one of the provisions of the rule violated the First Amendment. However, the same court granted a request by the SEC to re-hear the case in light of a recent ruling in another case that may have interpreted related First Amendment case history in a different manner.

.44 Conflict mineral panel participants discussed the requirements for the conflict mineral report (CMR) to be audited if the issuer declares its products to be DRC conflict free. There are two objectives of the audit: for the auditor to report on whether a company’s due diligence measures relative to its conflict minerals are in conformity with the criteria set forth in the chosen framework, and whether the due diligence measures described in the CMR were performed as described. With regard to the latter objective, it is important for issuers to ensure that the description of the company’s due diligence measures in the CMR is written with sufficient specificity so as to be auditable.

Technical accounting topics
.45 The following technical topics were discussed by the OCA Professional Accounting Fellows. Many of the scenarios discussed in the speeches depend on individual facts and circumstances, and should therefore not be considered precedent in other situations. Dan Murdock, Deputy Chief Accountant in OCA, opened his remarks with specific comments about how SEC staff speeches have a general “shelf life” and current thinking can be influenced by changing business models, unintended consequences, and new information and accounting literature. As a result, speeches cannot be a substitute for thoughtful, researched analysis.

Statement of cash flows
.46 The statement of cash flows is an area where restatements continue to increase. The majority of the restatements relate to applications of GAAP that are relatively less complex, such as failure to appropriately reflect the cash flows for capital expenditures purchased on credit. To avoid cash flow statement errors, a registrant should consider whether it has the appropriate processes and controls to ensure that the preparers of the cash flow statement receive all applicable information, have sufficient training and knowledge, and allow adequate time for its preparation and review.
Defined benefit plans

The Society of Actuaries published its updated mortality tables and improvement scale, which reflected improved longevity. The tables represent the most recent information available and are therefore effective upon issuance. The SEC staff commented that it would not be appropriate for a registrant that relies on such tables to disregard the new data in determining the best estimate of mortality. Registrants are also reminded that ASC 715-20 requires disclosure of the impact of mortality to the extent it results in a significant change in the benefit obligation. Consideration of the new mortality table and improvement scale is likely to increase the recorded benefit obligation for the current year.

Changes to equity-classified preferred stock

There can be diversity in whether an amendment or exchange of certain equity-classified preferred stock is considered an extinguishment or a modification. Amendments of equity-classified preferred stock can be evaluated in several ways, including:

- a qualitative approach, which considers the significance of contractual term changes, their business purposes, and how the changes may influence the economic decisions of the investor;
- a fair value or cash flow approach, which considers changes in fair value or contractual cash flows before and after the amendment; and
- a legal form approach.

With respect to the legal form approach, registrants should be cautious. The form in which the transaction was executed (modification vs. exchange) is merely one data point to consider and should not be viewed as determinative with respect to this issue.

In accounting for modifications, it is appropriate to analogize to the modification guidance in ASC 718-20 for modifications to equity-classified share-based payment awards and measure any incremental fair value resulting from the modification. With respect to recognition, the SEC staff has not objected to recording the additional fair value in retained earnings as a deemed dividend from the entity to the preferred stockholders. In certain circumstances, it may be appropriate to reflect the debit as a charge to earnings as a form of compensation for agreeing to restructure.

In determining if a liability-classified preferred stock has been modified or extinguished, companies should follow existing guidance related to debt modification and extinguishment.

Financial instruments

Derivative novation

The SEC staff reaffirmed a position stated in a 2012 letter to the Accounting Policy Committee of the International Swaps and Derivatives Association regarding the impact on hedge accounting of replacing one party of a derivative contract with a new party (i.e., a novation). In specific circumstances, the SEC staff would not object to the continuation of the existing hedging relationship for accounting purposes, provided that the other terms of the contract had not been changed. In other words, a novation does not necessarily result in the effective termination of the derivative contract and replacement with a new one. Provided no other terms of a derivative instrument have been changed, the SEC staff has accepted that an entity may continue to apply hedge accounting upon a novation only when:
1. the registrant’s derivative counterparty merges with and into a surviving entity that assumes the same rights and obligations that existed under a pre-existing derivative instrument of the merged entities;

2. the registrant’s derivative counterparty novates a derivative instrument to an entity under common control with the derivative counterparty; or

3. at the inception of the hedging relationship, the registrant knows and contemporaneously documents that all or part of the derivative will be novated to a new counterparty during the hedging relationship.

**Allocating proceeds to a bifurcated derivative liability**

.53 In certain circumstances, when allocating the proceeds of a financing, the fair value of a bifurcated derivative liability (which is required to be recorded at fair value) may exceed the net proceeds received for the hybrid instrument. Potential scenarios whereby an entity would enter into this type of transaction include circumstances in which alignment with a particular investor is viewed as beneficial to the registrant or because a registrant is in financial distress and requires financing.

.54 In such instances, registrants should first verify that the fair values of the financial liabilities required to be measured at fair value are appropriate under ASC 820. If appropriate, then the registrant should evaluate whether the transaction was conducted on an arm’s length basis, including an assessment as to whether the parties involved are related parties under ASC 850. If the transaction was conducted at arm’s length between unrelated parties, a registrant should evaluate all elements of the transaction to determine if there are any other rights or privileges received that meet the definition of an asset under other applicable guidance.

.55 Assuming the transaction is on an arm’s length basis between unrelated parties, and no other rights or privileges are received that meet the definition of an asset under other guidance, the SEC staff believes it is appropriate to measure the financial liability at fair value, with the excess over the net proceeds of the hybrid instrument recognized as a loss in earnings. In addition, adequate disclosure is required regarding the nature, purpose, and benefits received in the transaction. Consultation with OCA is encouraged in circumstances where the transaction was not executed at arm’s length or was entered into with a related party.

**Gross versus net**

.56 The gross vs. net presentation examples under the existing revenue recognition guidance do not specifically address many emerging business models, such as those involving content and services delivered through the internet and mobile devices. The existing principles of ASC 605-45 are equally applicable to these emerging business models, but more judgment may apply. The existing indicators and their relative strength should be carefully considered. Whether the company is the primary obligor is often the focus of SEC staff consideration and the subject of SEC staff questions. The SEC staff also reminded registrants that general inventory risk is an indicator that could still be applicable with respect to intangible goods or services. The staff also noted that it is important to consider economic constraints when assessing whether the company has latitude in establishing prices.
Reverse spinoffs

.57 Current guidance contains a rebuttable presumption that a spinoff should be accounted for based on its legal form (rather than as a reverse spinoff). Therefore, when indicators are mixed, significant judgment is required to determine whether the presumption has been overcome. Although mentioned in an SEC staff speech at the 2000 AICPA conference, tax planning considerations are not one of the explicit indicators provided in ASC 505-60.

.58 A reverse spinoff conclusion does not necessarily mean the financial statements of the existing registrant (i.e., the legal spinnor) can be used to satisfy the financial statement requirements of the entity that will be spun off (i.e., the accounting spinnor/legal spinnee). This is an assessment that needs to be based on the unique facts and circumstances of each transaction. There may be situations in which separate carve-out financial statements of the legal spinnee are required. Separating a registrant into one or more entities can trigger multiple reporting questions in registration statements and Exchange Act reports. Consultation with SEC staff is encouraged.

Change in annual goodwill impairment testing date

.59 Some registrants may conclude that a change in the annual goodwill impairment testing date does not represent a material change in the method of applying an accounting principle, even if goodwill is material to the financial statements. In these situations, the SEC staff will no longer request that a preferability letter be filed, provided that such change is prominently disclosed in the registrant’s financial statements.

PwC observation:

ASC 350 requires that goodwill be tested at the same date each year. Therefore, a change in the annual goodwill impairment testing date is a change in the method of applying an accounting principle. Although a preferability letter is not required if management concludes that the change is not material, the change must still be preferable.

Presentation of certain expenses related to pushdown accounting

.60 Financial statements spanning a period during which there has been a change in basis often reflect a black line to visually separate information on the old and new basis and to highlight that certain periods may lack comparability due to the change in basis. When certain expenses contingent upon a change-in-control event are recorded, the SEC staff has not objected to an “on the line” presentation (i.e., the expenses are not reflected in either the old or new basis periods), provided that transparent and disaggregated disclosure of the nature and amount of such expenses was made. Registrants should determine whether each expense relating to the change-in-control event is most appropriately reflected in the predecessor period, successor period, or “on the line.” The amounts recorded in each period and the basis for determining the amounts included in each category should be disclosed.

Variable interest entities

.61 Under the variable interest entity (VIE) model, power is shared when all decisions related to the significant activities of the VIE require the consent of each party. When some significant activities are shared, but other significant activities are unilaterally directed by one party, the SEC staff does not believe that shared power, as described in ASC 810, exists. In these situations, the party with more power (relative to others) over the significant activities of the VIE should consolidate the VIE. Non-significant activities should not be considered in determining the primary beneficiary.
When a decision maker is acting in an agency capacity, it may be necessary in certain cases to continue the consolidation analysis even when it is determined that a fee paid to a decision maker is not a variable interest. In situations where a decision maker is acting as an agent and one variable interest holder is absorbing all or essentially all of the variability that the VIE is designed to create and pass along, the stated power may not be substantive. In this case, it may be appropriate to attribute the stated power of the decision maker acting as an agent to the variable interest holder absorbing the variability of the VIE.

Common control arrangements require careful consideration when determining if stated power is substantive. The SEC staff does not believe there is a requirement to consider the related party tie-breaker guidance or that this guidance is necessarily determinative unless no party in the common control group individually meets both characteristics of a primary beneficiary.

**Joint ventures**

The SEC staff spoke about the definition of a joint venture, and emphasized that joint control is not the only defining characteristic of a joint venture. Rather, each of the characteristics in the definition of a joint venture in ASC 323 should be met, including that the purpose of the entity is consistent with that of a joint venture. Significant diversity in practice exists given the inherent subjectivity in making this conclusion, coupled with the lack of specific guidance in U.S. GAAP. The SEC staff suggested that it would be appropriate for the FASB to consider providing clarity on the definition of a joint venture in ASC 323, and to provide guidance on the appropriate accounting in the standalone financial statements of a joint venture for assets and businesses contributed to the joint venture.

**PwC observation:**

At this time, a project to clarify the definition of and accounting by a joint venture has not been added to the FASB’s standard setting agenda. We are uncertain if it will be included on their agenda in the future.

**Auditing update**

**PCAOB update**

PCAOB Chairman James Doty highlighted that the PCAOB is focused on helping the profession further public confidence in the audit and is taking steps to align economic considerations with enhancing the relevance and reliability of the audit.

Doty noted that the PCAOB has issued staff guidance on the use of economic analysis in PCAOB standard setting, and undertaken a review of its own standard setting policies and procedures. The PCAOB staff also intends to increase the use of staff consultation papers to solicit stakeholder input prior to initiating formal standard setting. Such actions are intended to improve the timeliness of the PCAOB’s standard setting. The SEC staff recently criticized the length of time necessary to issue final PCAOB standards.

**Standard setting update**

Marty Baumann, PCAOB Chief Auditor and Director of Professional Standards, stated that a reproposal on the auditor’s reporting model, including the disclosure of critical audit matters (CAMs), is expected in the first quarter of 2015. Suggestions from commenters that CAMs be limited to those matters considered material to the financial statements and reported to the Audit Committee will be recommended to the PCAOB for inclusion in the reproposal. Baumann believes this project will help shed light on the
significant aspects of the audit for the benefit of investors, and may cause auditors and company management to increase the level of attention paid to CAMs, thereby increasing audit quality.

Baumann indicated that many audit firms expressed significant concerns about increased liability and consent requirements when naming the engagement partner and other audit firms in the audit report. The PCAOB has undertaken a lengthy proposal process and will be making a supplemental request for comment on a proposal to include the names of the engagement partner and other audit firms in a separate form outside of the audit report.

Additional Staff Consultation Papers are forthcoming and will relate to the use of specialists and going concern. Baumann also indicated that a proposal is being made to the Board to update its supervision standards. The proposal will explicitly discuss the supervision of other auditors—particularly other firms—in multinational audits. This is in response to a number of inspection findings associated with the work of non-U.S. auditors. The proposal is expected to be shared with the public in early 2015.

**Inspections results and findings**

Helen Munter, PCAOB Director of Registrations & Inspections, discussed the nature of findings identified during the most recent inspection cycle. Munter noted that overall results across the inspected firms were mixed. Certain firms made improvements in audit quality, as evidenced by a sequential decrease in the number of findings, while other firms had results consistent with prior inspection cycles, both in quantity and subject matter. Findings continue to be noted related to revenue recognition, inventory, goodwill and intangible assets, business combinations, and ICFR. The most prevalent source of deficiencies continues to be ICFR.

Munter and Claudius Modesti, PCAOB Director of Enforcement & Investigations, discussed the PCAOB’s increased focus on the involvement of non-U.S. firms in the audits of SEC registrants. This includes an increased focus on controls within an audit firm’s global network and a planned increase in enforcement activity involving non-U.S. audit firms. This increased focus was driven, in part, by recent inspection results on work referred to non-U.S. audit firms.

Munter also discussed new areas of focus as the PCAOB plans its 2015 inspection program. While the PCAOB will continue to conduct a risk-based scoping approach that considers the results of past inspections, expected areas of focus include: (1) controls in business processes associated with business combinations, (2) income taxes, particularly as profits in low-tax jurisdictions grow, (3) the valuation of hard-to-value financial instruments, (4) the impact of falling oil prices on financial reporting risks, and (5) whether management and the auditor properly considered how significant transactions are reflected in the statement of cash flows.

**Auditor independence**

As of July 2013, auditors of broker-dealers are now required to perform their audits in accordance with the standards of the PCAOB. This has resulted in some firms needing to register with the PCAOB for the first time. Croteau noted that in the past year, OCA saw an increase in independence consultations related to broker-dealers, even though auditors of broker-dealers have been subject to the SEC’s independence rules since 1975. PCAOB inspections of audits of broker-dealers have found instances where the auditor was heavily involved in maintenance of the books and records of the broker-dealer, including the preparation of financial statements. The PCAOB recently issued staff guidance on audits of broker-dealers, to highlight specific requirements and provide guidance on the application of PCAOB standards to these engagements. Baumann believes that this will be most beneficial to smaller audit firms that primarily audit
smaller broker-dealers and who may not have previously completed audits in accordance with PCAOB standards. Ceresney highlighted the focus of enforcement on the work of auditors, given the importance of their role as gatekeepers. He noted that recent enforcement actions regarding independence violations were concentrated on auditors of broker-dealers.

.74 At last year’s conference, Croteau mentioned that management and audit committees should have appropriate policies and procedures in place to evaluate non-audit services provided by the company’s auditors. Croteau reiterated the importance of this process and recommended that management and audit committees include ongoing monitoring efforts to mitigate the risk of “scope creep” in the provision of non-audit services. Based on recent issues in this area, Croteau emphasized that “advocacy” is prohibited and can manifest in many ways unrelated to formal lobbying.

**Audit Quality Indicators**

.75 Cynthia Fornelli, Executive Director of the CAQ, noted that the development of Audit Quality Indicators (AQI) is one of the top initiatives for the CAQ. In April, the CAQ released a paper detailing an approach to AQIs, which AQIs may be most relevant, and how they should be communicated to stakeholders. The CAQ believes AQIs should be directed at the audit committee, primarily focused on engagement level indicators, and use quantitative rather than qualitative data.

.76 Greg Jonas, Director of the PCAOB’s Office of Research & Analysis, expressed his hope that a PCAOB concept release on the AQI project will be issued in early 2015. He noted that the concept release will likely include a discussion on the background and purpose of the project, the nature of AQIs, the existing list of indicators, and the possible uses of the indicators. The final portfolio of AQIs should help the audit committee ask questions, but is not designed to answer them; AQIs are intended to encourage dialogue that will provide new insights to the audit committee.

.77 The PCAOB concept release is also intended to gather perspectives on how AQIs should be prepared and reported, whether they should be voluntarily provided by the auditor or whether they should be required, and whether they should be shared only with the audit committee or made publicly available. Both presenters cautioned that it is important to have context when communicating AQIs and establishing indicators that create a framework and initiate dialogue, rather than looking to them as a metric to be assessed against.

**PwC observation:**

We are supportive of the views expressed in the CAQ paper. We recognize the desire by our stakeholders for more insight into our audit practice and support the CAQ’s concept of using AQIs as a way to facilitate meaningful discussions between auditors and audit committees (as part of their oversight role of the auditor).

We believe that AQIs can be used to facilitate robust discussions with audit committees about a firm’s ability to support and perform quality audits by helping audit committees to understand the firm’s various support processes, their engagement team, and also to identity risks to audit quality that may exist on their engagements.

We are actively participating in the CAQ’s “field testing” of certain metrics that are applicable to individual audit engagements.
Appendix

The text of certain Conference speeches has been made available to the public. Click on the presenter’s name to access his or her speech.

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<thead>
<tr>
<th>Organization</th>
<th>Presenter</th>
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<tbody>
<tr>
<td>CAQ</td>
<td>Cynthia Fornelli, Executive Director</td>
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<td>FASB</td>
<td>Russell Golden, Chairman</td>
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<td>IASB</td>
<td>Ian Mackintosh, Vice-Chairman</td>
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<td>PCAOB</td>
<td>James Doty, Chairman</td>
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<td>Jay Hanson, Board Member</td>
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<td>Helen Munter, Registrations &amp; Inspections Director</td>
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<td>SEC</td>
<td>James Schnurr, Chief Accountant</td>
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<td>Brian Croteau, Deputy Chief Accountant</td>
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<td>Julie Erhardt, Deputy Chief Accountant</td>
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<td>Dan Murdock, Deputy Chief Accountant</td>
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<td>Kevin Stout, Senior Associate Chief Accountant</td>
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<td>Carlton Tartar, Associate Chief Accountant</td>
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<td>T. Kirk Crews, Professional Accounting Fellow</td>
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<td>Steve Mack, Professional Accounting Fellow</td>
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<td>Christopher Rogers, Professional Accounting Fellow</td>
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<td>Hillary Salo, Professional Accounting Fellow</td>
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Questions?

PwC clients who have questions about this In depth should contact their engagement partner. Engagement teams who have questions should contact Valerie Wieman, Toni Lockett, or a member of the appropriate team in the National Professional Services Group.

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