

2022 AICPA & CIMA Conference on Current SEC and PCAOB Developments

Compendium of significant accounting,
auditing and reporting issues

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Summary

Regulators and standard setters discussed a broad range of financial reporting topics and emerging issues this week at the annual AICPA & CIMA¹ Conference on Current SEC and PCAOB Developments (Conference) in Washington, D.C.

The speakers and panelists included representatives of the Securities and Exchange Commission (SEC or Commission), the Financial Accounting Standards Board (FASB or Board), the Public Company Accounting Oversight Board (PCAOB) and the International Accounting Standards Board (IASB), who shared their views on various accounting, financial reporting, auditing and regulatory issues.

They discussed the importance of high-quality, transparent financial information in the current macroeconomic environment and the role regulators, standard setters, preparers and auditors play in protecting investors.

SEC Commissioner Hester Peirce noted that the SEC's mission also includes encouraging capital formation and said that high-quality financial reporting helps drive capital to its highest and best use, which benefits society.

Regulators, standard setters and other speakers also reflected on improvements in financial reporting and audit quality in the 20 years since the Sarbanes-Oxley Act was enacted. However, they said the recent trend of increases in findings in PCAOB inspections of audit work needs to be reversed, and gatekeepers, including auditors, need to remain focused on maintaining high standards, especially given the current economic uncertainty that may increase the risk of fraud. They also reminded auditors of their responsibilities to be independent, ethical and skeptical.

Speakers also said the accounting and auditing professions need to focus on attracting and retaining a diverse group of individuals. American Institute of Certified Public Accountants (AICPA) Chair Anoop Mehta said developing talent is critical to meet the needs of the profession and to preserve trust in financial reporting.

Highlights included:

Fraud risk – SEC and PCAOB officials stressed that the current macroeconomic environment may increase the risk of fraud and said auditors should embed this risk in their planning processes and exercise professional skepticism. They also discussed how auditors, preparers and audit committees should respond to heightened fraud risks and the risk of management bias. Commissioner Peirce emphasized the importance of auditors exercising professional skepticism to detect fraud in the current environment.

Non-GAAP financial measures – The SEC staff discussed its continuing focus on non-GAAP financial measures and announced updates to its compliance and disclosure interpretations (C&DIs) on non-GAAP financial measures. The revised C&DIs, which the SEC staff said are intended to reflect views previously communicated, clarify what the staff believes constitutes a normal recurring operating expense, when the staff considers a non-GAAP measure misleading and when disclosures give undue prominence to non-GAAP measures.

Crypto assets – SEC and FASB representatives discussed the accounting, disclosure and auditing challenges posed by crypto asset arrangements, due to the unique risks and uncertainties associated with them and the fact that the arrangements continue to evolve. Commissioner Peirce said customers and counterparties of crypto entities should be asking questions about how these entities operate to make sure they mirror the best practices of traditional finance entities. The FASB staff discussed its project on the accounting for crypto assets, and the SEC staff indicated that it will continue to prioritize enforcement actions in cryptocurrency markets.

PCAOB activities – PCAOB members noted that audit deficiencies are increasing and that auditors need to demonstrate due professional care and professional skepticism, especially in the current macroeconomic environment (i.e., applying the same audit approach as last year may not be appropriate). They emphasized that auditor independence is foundational to audit quality and that management and the audit committee also play a role in auditor independence. PCAOB officials reiterated their plans to strengthen their enforcement and inspection activities. PCAOB officials also highlighted the PCAOB's [Strategic Plan](#) for 2022-2026 and its ambitious standard-setting and research agendas.

Accounting updates – SEC and FASB representatives discussed ways to provide investors with more transparent financial information, including more disaggregated financial information and more information on environmental, social and governance (ESG) matters. FASB representatives also discussed the FASB's post-implementation reviews of the revenue, leases and credit losses guidance and stressed the importance of stakeholder feedback throughout the standard-setting process.

Disclosures on ESG and cybersecurity matters – While the SEC is finalizing new rules on climate-related and cybersecurity disclosures, the SEC staff reminded registrants of the Commission's [2010 climate change interpretive guidance](#) and its [2018 statement and interpretive guidance](#) on cybersecurity disclosures. The SEC staff also indicated that it will continue to review registrants' climate-related disclosures and expects registrants to consider the 2010 guidance and the staff's [sample comment letter](#) on climate-change-related disclosures in their year-end reporting. Although the SEC staff did not comment on its proposals on climate-related and cybersecurity disclosures, preparers said they are establishing new controls and procedures to gather reliable data to comply with the proposed disclosures.

Remarks by SEC Acting Chief Accountant Paul Munter

SEC Acting Chief Accountant Paul Munter said inflation, rising interest rates, supply chain disruption, labor shortages and other macroeconomic factors create uncertainties that may create challenges for companies in making accounting estimates and judgments. He emphasized that in the current environment, companies should be more transparent about key judgments and estimates as well as estimation uncertainty.

Mr. Munter said auditors need to address the heightened fraud risk related to economic uncertainty in their audit planning process and companies need to consider how this heightened risk may impact the effectiveness of their internal control over financial reporting. Companies also need to consider whether their estimates reflect management bias, he said.

Lastly, he noted that audit committees need to consider fraud risks in carrying out their responsibilities and understand what management and auditors are doing to mitigate them. Mr. Munter noted that he addressed these topics in a previous [statement](#) on fraud detection.

Mr. Munter also shared his views on the following focus areas of the SEC's Office of the Chief Accountant (OCA).

OCA's focus on investors

Mr. Munter emphasized that, in carrying out its responsibilities, OCA considers what information will help investors better understand the risks inherent in an investment so they can make more informed investment decisions.

As part of its oversight role, OCA communicates with the FASB and PCAOB on how they can address investor needs, he said. He also said that OCA shared with the FASB some investor feedback on improving the accounting standard-setting process included in the recent [recommendations](#) from the SEC's Investor Advisory Committee (IAC).

Disaggregation of financial information

Mr. Munter said investors have asked for further disaggregation of certain information in the financial statements, and the FASB has responded with its projects on the disaggregation of income statement expenses (e.g., cost of sales, and selling, general and administrative expenses), segment information and income tax disclosures and its staff research on disaggregation of cash flows. Mr. Munter encouraged stakeholders to provide feedback on these standard-setting activities.

Mr. Munter also noted that companies can provide more disaggregated financial information to investors as long as they comply with the SEC's rules on non-GAAP financial measures. That is, they don't have to wait for new accounting standards to require further disaggregation.

Mr. Munter said that investors often question whether companies have the "right" number of segments. He noted that while US GAAP permits them to aggregate operating segments into reportable segments if certain criteria are met, companies can choose to further disaggregate segment information.

Mr. Munter also highlighted that investors have asked for more disaggregation of the information provided in the statement of cash flows. He noted that, while the direct method² of presenting cash flows from operating activities in the statement of cash flows is not required or widely used, academic research supports an argument that operating cash flow information presented under this method provides useful information to investors. He noted that investors have asked for more information about cash collected from customers, cash paid to employees and cash paid to suppliers, for example. He encouraged preparers to consider disclosing information they would provide under the direct method (even if they don't use the direct method on the face of the statement of cash flows) as they prepare for year-end reporting.

Auditor responsibilities

Mr. Munter emphasized that auditors are critical gatekeepers in the financial reporting system, and it is therefore important for them to maintain their independence in fact and in appearance and comply with their ethical responsibilities. Further, Mr. Munter noted that auditor independence and ethics have “to be embedded in the DNA” of professional accounting firms as a whole, not only in the audit service line. He noted that he made similar comments in a previous [statement](#).

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- ▶ Technical Line, [Accounting for digital assets, including crypto assets](#)
- ▶ To the Point, [SEC staff issues guidance on obligations to safeguard crypto assets](#)

“There are often some very unique risks inherent in those [crypto asset] arrangements that don't necessarily exist for other similar arrangements.”

— Paul Munter,
SEC Acting Chief Accountant

Remarks by senior SEC staff members

Crypto assets

Mr. Munter said that, while US GAAP doesn't directly address the accounting for crypto assets, OCA has considered accounting issues related to many types of crypto asset arrangements in consultations. He said the arrangements continue to evolve and noted that the SEC staff described many of the unique risks inherent in these arrangements in **Staff Accounting Bulletin (SAB) 121**, which addresses the rights and obligations of the parties to a crypto asset safeguarding arrangement.

Jonathan Wiggins, Senior Associate Chief Accountant in OCA, described a crypto asset lending consultation in which the staff did not object to the lender derecognizing crypto assets loaned since it had transferred control of those assets to the borrower. Mr. Wiggins said one of the factors that led the staff to determine that control had transferred was that, during the term of the loan, the lender no longer had the right to the economic benefit of the specific crypto assets subject to the lending arrangement. He said the staff also believes that it was appropriate for the lender to concurrently recognize a “loan receivable” to reflect its right to receive a specified amount of the same type of crypto asset from the borrower at the end of the loan. Mr. Wiggins said the receivable should be measured initially at the fair value of the underlying crypto assets at loan inception and subsequently at their fair value on each reporting date.

He also clarified that any initial gain and subsequent changes in the fair value of the loan receivable should be reflected in the income statement outside of revenue. Additionally, because the lending transaction exposes the lender to the borrower's credit risk, the staff believes it would be appropriate for the lender to recognize, at loan inception and at each subsequent reporting date, an allowance for expected credit losses applying the guidance in Accounting Standards Codification (ASC) 326, *Financial Instruments – Credit Losses*, or IFRS 9, *Financial Instruments*.

Mr. Wiggins also said entities should consider existing accounting guidance as a starting point for disclosures on crypto arrangements and should disclose sufficient information for stakeholders to understand the nature of their arrangements and the risks and uncertainties associated with them.

Anita Doust, Senior Associate Chief Accountant in OCA, discussed the complexities of auditing transactions involving crypto assets and said that both management and auditors need to consider whether they need individuals with specialized skills on their teams (e.g., specialists in cryptography or distributed ledger technology). She said that both management and auditors should perform thoughtful ongoing risk assessments and address risks such as the risk of misappropriation of assets and the risk that information pulled off the blockchain isn't reliable. Ms. Doust also noted that distributed ledger technology makes it difficult, or impossible, to reverse erroneous or fraudulent transactions.

Finally, she noted that auditors need to consider whether the financial statements are susceptible to material misstatement through transactions with related parties, as it can be difficult to identify the counterparty or parties in crypto transactions.

As part of her remarks, Cicely LaMothe, Acting Deputy Director in the SEC's Division of Corporation Finance (DCF), discussed disclosure considerations for entities involved in the crypto market. She pointed to the SEC staff's recent [sample comment letter](#) illustrating the types of comments the SEC staff may issue to companies impacted directly and indirectly by bankruptcies and the financial distress among crypto market participants.

Lindsay McCord, Chief Accountant in DCF, said the SEC staff focuses on the terms and conditions of the crypto asset offering when reviewing an entity's disclosures. She noted that these terms and conditions must be clearly disclosed to enable users of the financial statements to determine the rights of the crypto asset holder and the obligations (both explicit and implied) of the issuer of the crypto asset. Ms. McCord reminded issuers that they must clearly disclose their accounting policy for their crypto assets and recommended vetting that policy with the entity's auditors and audit committee before submitting a registration statement or offering document to the SEC. Finally, she noted that entities' disclosures under US GAAP should follow the accounting model applied.

Additionally, FASB Chairman Richard Jones and Helen Debbeler, FASB Deputy Technical Director, discussed the FASB's project on accounting for and disclosure of crypto assets. They summarized the tentative decisions the FASB has made to date, including the tentative decision to require entities to measure certain crypto assets at fair value. Ms. Debbeler said the FASB anticipates issuing a proposal in the first half of 2023.

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- ▶ Financial reporting developments, [Segment reporting](#)

Segment reporting

Melissa Rocha, Deputy Chief Accountant in DCF, said the SEC staff continues to focus on how registrants apply the guidance in ASC 280, *Segment Reporting*, and IFRS 8, *Operating Segments*, including how they identify operating segments, aggregate operating segments into reportable segments and disclose segment information.

Ms. Rocha focused on the identification of operating segments and emphasized the importance of an investor's ability to understand the business. She emphasized that a company's operating segment determination should be consistent with how management discusses the business outside of the financial statements (e.g., in its earnings releases). A company should also consider the total mix of information that is reviewed by the company's chief operating decision maker (CODM).

She said the SEC staff looks at segment reporting holistically and considers all publicly available information. This could include information in a registrant's public filings as well as information discussed in a registrant's earnings calls, transcripts of those calls or on its website.

She provided two examples of registrants that had disclosed a single operating segment. In both cases, the SEC staff discovered that the companies were providing more granular operating information about the business outside of the financial statements, suggesting that the CODM reviewed results at a lower level. During the review process, the companies said their CODMs regularly reviewed both the information disclosed for segment reporting purposes and information at a more disaggregated level. As a result, they revised their single operating segment conclusions to reflect more than one operating segment.

Ms. McCord said the SEC staff may object to companies presenting a consolidated segment profitability measure outside of the segment reporting note to the financial statements if the measure is considered misleading under Rule 100(b) of Regulation G. She said the SEC staff is not trying to prohibit companies from disclosing segment profitability measures. She reiterated that if a measure is required by GAAP (e.g., ASC 280), that measure does not meet the definition of a non-GAAP measure.

The FASB has proposed permitting companies to disclose multiple measures of segment profit or loss used by the CODM, provided that at least one of the measures is the measure used by the CODM that's most consistent with the measurement principles used in the consolidated financial statements. Ms. McCord said that the SEC staff generally supports the FASB's proposal.

How we see it

The SEC staff has observed registrants disclosing multiple measures of segment profit or loss in the notes to their financial statements and has said that registrants should not attempt to circumvent the non-GAAP rules by doing this. The FASB's proposal, if finalized, could change practice because it would allow an entity to disclose more than one measure of segment profit or loss.

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- ▶ To the Point, [FASB proposes amending leases guidance on arrangements between entities under common control](#)

Remarks by FASB Chairman and staff on its activities

FASB Chairman Richard R. Jones said that, as part of its mission to provide useful information to investors, the FASB conducts extensive outreach activities and recently issued the [2022 FASB Investor Outreach Report](#).

Mr. Jones also said that, because accountants and auditors apply accounting standards, they are in a unique position to identify potential improvements.

Over the past year, Mr. Jones said the FASB has focused on addressing issues that stakeholders identified as important, such as:

- ▶ **More disaggregation of financial information** – Mr. Jones said investors want more disaggregated financial information, and the FASB has responded with its projects on segment reporting and the following topics:
 - ▶ Disaggregation of income statement expenses – While the scope of this project has evolved, the overall objective is to provide greater granularity and disaggregation of certain income statement expense line items.
 - ▶ Targeted improvements to income tax disclosures – This project is focused on requiring more disaggregated information in the income tax rate reconciliation and disclosure of the amount of taxes paid by jurisdiction.
- ▶ **Crypto assets** – Mr. Jones noted that the FASB has tentatively decided to require certain crypto assets to be measured at fair value, as some stakeholders have requested. Hillary Salo, FASB Technical Director and Emerging Issues Task Force Chair, pointed out the unique financial reporting challenges associated with crypto assets, including liquidity, uncertainty and risk.
- ▶ **Accounting for and disclosure of software costs** – Ms. Debbeler said stakeholder feedback indicated that the two existing accounting models for software costs “are not really based on relevant categorizations and they can lead to very different conclusions about when and how much cost is capitalized.”

Mr. Jones also said the Board continues to conduct post-implementation reviews of ASC 606, *Revenue from Contracts with Customers*, ASC 842, *Leases*, and ASC 326, *Financial Instruments – Credit Losses*, to seek stakeholder feedback and consider amendments to the standards. Examples of recent amendments and proposed amendments include the elimination of the guidance on a creditor's accounting for troubled debt restructurings in light of the new credit losses standard and the FASB's recent proposal on leases involving entities under common control.

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- ▶ [Technical Line, A closer look at the SEC staff's scrutiny of non-GAAP financial measures](#)
- ▶ [SEC Reporting Update – Highlights of trends in 2022 SEC comment letters](#)

SEC regulatory update

Non-GAAP financial measures

Ms. McCord announced [updates](#) to the SEC staff's C&DIs on non-GAAP financial measures and said the updates reflect views the staff has previously communicated, not any new guidance.

C&DI Question 100.01 was updated to address how the staff considers whether operating expenses are "normal" or "recurring" and, therefore, whether their exclusion from a non-GAAP financial measure could be misleading. The updated C&DI notes that in making the determination of whether an operating expense is "normal," the staff considers how the nature and effect of non-GAAP adjustments relates to the company's operations, revenue generating activities, business strategy and regulatory environment. Further, it states the staff's view that an operating expense that occurs repeatedly or occasionally, including at irregular intervals, is recurring.

As an example, Ms. McCord said the staff would typically view the opening and closing of a retailer's stores (or restaurants in the hospitality industry) as a normal activity. She also noted that although a retailer may not open or close stores frequently, the costs associated with openings and closing would also be considered recurring expenses. Ms. McCord also said the staff would consider rent expense in the retail industry to be a normal, recurring operating expense.

Ms. McCord emphasized that whether an adjustment results in a misleading non-GAAP measure depends on a company's individual facts and circumstances, including the determination of whether restructuring costs constitute "normal" and "recurring" cash operating expenses that should not be excluded from a non-GAAP measure. She added that in assessing whether restructuring costs are "normal," registrants should consider how restructuring relates to the factors noted in C&DI Question 100.01 (i.e., operations, revenue generating activities, business strategy, industry and regulatory environment). Ms. McCord said that generally, in the fact patterns in which the SEC staff has seen a non-GAAP adjustment to exclude restructuring costs, such costs have not been "normal" or "recurring."

C&DI Question 100.04 was updated to provide examples of non-GAAP adjustments to both revenue and expenses that could have the effect of changing the recognition and measurement principles required by GAAP, thereby rendering them "individually tailored" and potentially resulting in a misleading measure. That could happen if a registrant presents a non-GAAP measure of revenue that deducts transaction costs as if the company acted as an agent in the transaction, when gross presentation as a principal is required by US GAAP, for example.

How we see it

Based on the SEC staff's remarks, we believe adjustments to exclude restructuring costs and acquisition-related costs from non-GAAP financial measures will generally continue to be allowed. However, registrants will need to exercise judgment, based on their facts and circumstances, to determine whether adjustments for restructuring costs and acquisition-related costs are appropriate.

The SEC staff also separated C&DI Question 102.10 into the following three questions that address disclosure presentations resulting in the undue prominence of non-GAAP measures:

- ▶ Question 102.10(a) provides additional examples of instances in which non-GAAP measures are more prominent than the comparable GAAP measures (e.g., a ratio where a non-GAAP financial measure is the numerator and/or denominator without also presenting the ratio calculated using the most directly comparable GAAP measure(s) with equal or greater prominence)

- ▶ Question 102.10(b) provides examples of disclosures that would cause the non-GAAP reconciliation required by Item 10(e)(1)(i)(B) of Regulation S-K to give undue prominence to a non-GAAP measure (e.g., starting the reconciliation with a non-GAAP financial measure)
- ▶ Question 102.10(c) clarifies that the staff considers to be a non-GAAP income statement one that comprises non-GAAP measures and includes all or most of the line items and subtotals found in a GAAP income statement

The SEC staff added new C&DI Question 100.05 to clarify that a non-GAAP financial measure (or an adjustment made to a GAAP measure) can be misleading if it is not appropriately labeled and clearly described. The C&DI includes examples of inappropriate labeling practices (e.g., failure to identify a measure as non-GAAP, presenting a non-GAAP measure with a label that does not reflect its nature, such as a non-GAAP measure labeled as “pro forma” but not calculated in accordance with Article 11 of Regulation S-X).

C&DI Question 100.06 was added to address the SEC staff’s view that disclosure cannot be used to cure a misleading measure. Lastly, Ms. McCord noted that when the staff concludes that a non-GAAP measure is misleading, it expects the company to address the issue by removing the measure or the portion of the measure that is misleading for all periods presented, including comparative periods, in the first filing following the staff’s conclusion. Ms. McCord emphasized that there is no transition period to address such matters in registrants’ filings.

How we see it

Companies that are considering making changes to their non-GAAP financial measures should assess how their overall corporate reporting would have to change if the SEC staff were to object to a measure or adjustment. Further, companies that receive questions from the SEC staff about non-GAAP financial measures should be prepared to revise their filings, earnings releases, earnings guidance and other documents containing such measures immediately following an SEC staff objection.

SEC comment letter topics and year-end reminders

Macroeconomic factors

Ms. McCord said management’s discussion and analysis (MD&A) continues to be a focus area of the DCF and a leading comment letter topic. She noted that this is in part due to the MD&A requirement to describe known trends or uncertainties, which need to update when conditions or events change.

As registrants approach year-end reporting, the SEC staff reminded them to continue to monitor world events and macroeconomic developments, including inflationary pressures and rising interest rates, the war in Ukraine, supply chain disruptions and the lingering effects of COVID-19, and update their risk factors and MD&A disclosures. The staff further noted that each macroeconomic factor and its impact should be discussed separately in the company’s disclosures.

The SEC staff also advised registrants to avoid describing existing conditions as future risks. For example, disclosures about inflation should address the current impact on the company.

Lastly, the staff noted that it has posted sample comment letters on the SEC website about the direct and indirect effects of [the war in Ukraine](#) and [climate-related disclosures](#) and issued disclosure guidance³ related to COVID-19.

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- ▶ Technical Line, [Effects of inflation and rising interest rates on financial reporting](#)
- ▶ To the Point, [SEC proposes enhancing and standardizing climate-related disclosures](#)
- ▶ To the Point, [SEC proposes requiring more cybersecurity disclosures](#)

Critical accounting estimates

Ms. McCord reminded registrants preparing for year-end reporting that they should provide the qualitative and quantitative information about critical accounting estimates that is necessary for investors to understand the estimation uncertainty and the impact the estimate had (or is reasonably likely to have) on the results of operations.

She encouraged registrants to avoid simply repeating information in the financial statements, challenge the sufficiency of their disclosures and consider providing a more robust analysis, especially when a potential impact is more likely or increases in magnitude. For example, with interest rates now rising, disclosures about the impact of interest rate assumptions may be material. Ms. McCord further indicated that a company might need to disclose the sensitivity of reported amounts to changes in the underlying assumptions since it is more likely that these changes would materially impact the estimate.

Board leadership structure and risk oversight

Ms. McCord noted that the staff has started issuing comments on board leadership and risk oversight disclosures required by Item 407(h) of Regulation S-K. The staff has observed that these disclosures in many cases tend to be “boilerplate” discussions and do not communicate the specific challenges addressed by boards. The staff said that comments in this area are intended to increase transparency in disclosures required by Item 407(h), not to create new requirements. For example, the staff has requested that companies address why they think their current board structure is appropriate and describe how the board carries out its oversight function. The staff also said that these comments are aimed at future disclosures and don’t require changes to filings under review.

Division of Corporation Finance practice matters

Pay versus performance implementation considerations

Ms. McCord clarified several points about the new **pay versus performance** (PvP) disclosures registrants are required to provide in proxy and information statements in the upcoming proxy season, including:

- ▶ Net income listed in the PvP table should be the net income presented in a registrant’s financial statements. The registrant is not permitted to use other subtotals, such as net income attributable to the registrant or net income attributable to continuing operations, in lieu of net income presented in the financial statements.
- ▶ To determine the executive compensation that is “actually paid” for the principal executive officer (PEO) and other named executive officers (NEOs), registrants are required to measure the year-end fair value of their outstanding and unvested equity awards year to year until the awards vest. Although a market condition is not considered a vesting condition under ASC 718, *Compensation – Stock Compensation*, the SEC staff indicated that it considers a market condition to determine whether an award is vested for the purpose of the executive compensation tables required under Rule 402 of Regulation S-K, and the same principle should apply when registrants prepare the PvP tables. The staff said that this differs from the accounting for market conditions under ASC 718.
- ▶ The staff expects registrants to measure the year-end fair value of their outstanding and unvested option equity awards using the same methodology and assumptions as required under US GAAP. For example, a registrant could not rely on a method to determine the expected term assumption that is not acceptable under US GAAP, such as simply subtracting the elapsed actual life from the grant date expected term assumption without considering any of the other factors for determining the expected term under US GAAP.
- ▶ When dividends are reflected in the fair value of equity awards, registrants should not include dividend amounts in executive compensation actually paid.

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- ▶ Technical Line, [**How to apply the SEC’s new pay versus performance disclosure requirements**](#)

How we see it

Based on the SEC staff's statement that it considers a market condition to determine whether an award is vested under Rule 402 of Regulation S-K, we believe registrants should remeasure awards with market conditions in the PvP table annually until they are exercisable (i.e., when the market condition is met).

The SEC staff said that valuing equity awards for the PvP disclosures generally should follow the measurement principles for valuing equity awards under US GAAP.

The SEC staff reminded registrants that they are required to disclose any valuation assumptions that materially differ from those disclosed at the grant date. Although the final rules are not prescriptive on the assumption disclosure, the staff believes the registrant could provide the disclosures about valuation assumptions as required under ASC 718 (e.g., including a range of assumptions when a range of assumptions are used).

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- ▶ To the Point, [SEC adopts rules to require 'clawback' policies and disclosures](#)

Clawback rules implementation considerations

Craig Olinger, Senior Advisor to Ms. McCord, noted that the SEC's **final** rule on the recovery of erroneously awarded incentive-based compensation applies to both "Big R" and "little r" restatements but not to out-of-period adjustments.

Mr. Olinger clarified that registrants should not check the box that will be added to the cover page of annual reports to indicate that the financial statements in the filing reflect the correction of an error to previously issued financial statements (i.e., the first box) when they:

- ▶ Apply a change in accounting principle retrospectively
- ▶ Revise previously issued financial statements to conform their presentation to that of the current period (e.g., for the disaggregation of financial statement line items)

How we see it

If a registrant concludes that it will check the first box to indicate the correction of an error to previously issued financial statements, it will need to assess whether the error correction is a restatement that requires a recovery analysis of incentive-based compensation and whether it needs to check the second new box to indicate that fact.

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- ▶ Technical Line, [Applying the SEC's new requirements for significant acquired businesses](#)
- ▶ SEC Reporting Series, [Pro forma financial information – A guide for applying Article 11 of Regulation S-X](#)

Observations on disclosure requirements for significant business acquisitions and disposals

The SEC staff discussed practice matters related to SEC rules on financial disclosures about significant acquisitions and disposals of businesses and real estate operations, including application of the significance tests.

Ms. Rocha clarified that the revenue component of the income test applies to acquisitions of both investees that are accounted for under the equity method and those that are accounted for at fair value. She also reminded registrants that they are not permitted to use the revenue component of the income test if either the registrant or the acquired business did not have material revenue in each of the two most recently completed fiscal years. Ms. Rocha indicated that the determination of material revenue should be made separately for the registrant and the acquired business (i.e., the point isn't to compare the revenue of the registrant with that of the acquired business).

Ms. Rocha further discussed the application of the significance tests when a business is acquired by a subsidiary that a registrant consolidates but doesn't wholly own (e.g., a registrant consolidates a 60%-owned operating company, which acquires 100% of an unrelated target), noting the following:

- ▶ For the investment test, if the registrant does not have an aggregate worldwide market value of its voting and non-voting common equity, it is required to use total assets in the denominator. In this case, the registrant should use 100% of the registrant's assets, and the numerator should reflect 100% of the consideration transferred by the operating company.
- ▶ However, for the income component of the income test, the numerator should reflect only 60% of the target's pre-tax income/loss. That is, the numerator excludes the pretax income/loss attributable to noncontrolling interests. The denominator would be the registrant's income/loss attributable from continuing operations before the income tax attributable to the controlling interest, which also excludes pretax income/loss attributable to noncontrolling interests.

Mr. Olinger addressed the treatment of transactions costs for a business combination in pro forma financial statements. He indicated that when either the registrant or the acquiree incurred and recorded transaction expenses in a historical period, there should not be a pro forma adjustment to remove them. Alternatively, if a registrant incurred transaction expenses after the historical periods, the registrant is required to include a pro forma adjustment in the latest annual period presented. However, the registrant should not make a pro forma adjustment to add transaction costs incurred by the acquiree after the historical period.

Mr. Olinger also reminded registrants that they may need to consider additional pro forma presentations based on a range of possible results depending on the structure of the transaction. He also reminded registrants that when multiple pro forma financial statements are presented for a range of results, the introductory paragraph required by Article 11 would need to provide adequate disclosure of the ranges presented.

Waiver requests associated with significance tests

Mr. Olinger said the SEC has received fewer requests for relief from the requirements to provide financial information about significant acquisitions since the Commission amended Rules 3-05 and 3-14 in 2020, but the staff continues to receive relief requests that are more complex. In responding to such requests, he said, the staff considers all relevant facts and circumstances, including the size of the acquiree in relation to the registrant's size (including all of the significance tests) as well as other financial statements and operating metrics.

He also reminded registrants requesting waivers from DCF associated with Rules 3-05, 3-14 and 3-09 to:

- ▶ Be as transparent as possible when describing the acquisition, including details about the transaction structure and the types of assets acquired, and explain what transaction disclosures will be provided
- ▶ Provide all significance test calculations, explaining any inputs that are not straightforward and why the results do reflect the relative size of the acquisition
- ▶ Explain why the required financial information is not necessary or material to investors, and include the information that the registrant proposes to present in lieu of the financial information for which the registrant is requesting a waiver

Mr. Olinger added that when a registrant requests a waiver to provide one year of 3-05 financial statements instead of two, it should also include a specific request in the relief letter to exclude the prior comparative interim period for interim financial statements when interim statements are required.

Transition matters related to new insurance accounting standards

Mr. Olinger discussed a transition matter for insurers that file a registration statement (i.e., Form S-3) in the year they adopt Accounting Standard Update (ASU) 2018-12, *Targeted Improvements to the Accounting for Long-Duration Contracts*, or IFRS 17, *Insurance Contracts*. Form S-3 requires retrospective revision of the pre-event audited financial statements that were incorporated by reference in the Form S-3 to reflect a subsequent change in accounting principle. Mr. Olinger clarified that the registrant in this situation would apply the transition provisions in the respective standards and that presenting the recasted financial statements would not impact the date of initial application (e.g., it would be 1 January 2021 for a calendar year-end issuer reporting under US GAAP and 1 January 2022 for a calendar year-end issuer reporting under IFRS).

Remarks from the SEC Division of Enforcement staff

Ryan Wolfe, Chief Accountant in the SEC's Division of Enforcement (Division), and members of the Division of Enforcement staff discussed the Division's activities and highlighted recent enforcement actions involving accounting and disclosure issues, auditor matters, and ethics. The SEC staff also noted that enforcement actions were brought in the areas of asset management, crypto assets, cybersecurity and ESG matters.

Mr. Wolfe said the enforcement program is critical to ensure the quality of financial reporting, and the Division will continue to take aggressive action to protect investors against those who might pose threats. He said that the Division obtained record penalties this year as noted in its 2022 enforcement [results](#).

Among the enforcement actions the staff discussed were allegations of fraudulent accounting practices, such as manipulating revenues, deferring expenses, inappropriate presentation of debt upon a covenant violation and noncompliance with GAAP requirements on the translation of foreign currency transactions. Mr. Wolfe said having a sophisticated system of internal control over financial reporting is especially important when companies have complex transactions requiring many estimates. He also said companies should have an overall understanding of fraud risks.

The SEC staff also discussed auditor-related enforcement matters involving allegations of an auditor's failure to meet auditing standards, improper professional conduct and noncompliance with audit documentation standards. Mr. Wolfe noted that auditors play a critical role as gatekeepers in capital markets and emphasized audit firms' responsibility to have a system of quality control to provide reasonable assurance that their personnel comply with the relevant professional standards.

Mr. Wolfe stressed the importance of auditors focusing on ethical requirements that are fundamental to the credibility of the profession.

International matters

Dr. Andreas Barckow, Chair of the IASB, [discussed](#) convergence between IASB and FASB standards and the IASB's priorities over the next five years.

Dr. Barckow noted the standard setters have shifted their focus on convergence from "jointly developing solutions to keeping converged standards converged."

Dr. Barckow discussed the IASB's goodwill and impairment project as an example of convergence. The IASB explored changing the impairment-only model but ultimately decided that there was not a compelling case for change. In doing so, the IASB exchanged information with the FASB, which removed its project on the subsequent accounting for goodwill from its agenda earlier this year. He said that maintaining convergence was an important consideration in the IASB's decision to not pursue changes to the impairment-only model.

However, he said the Board plans to move forward with a standard-setting project that could require a comprehensive set of new disclosures on business combinations that he believes would represent a compromise between the views of investors and preparers. The IASB also started the post-implementation review of the IASB's revenue recognition standard but postponed the lease accounting standard post-implementation review to the second half of 2023.

Dr. Barckow also highlighted the IASB's priorities for the next five years, which include focusing on finalizing existing projects and collaborating with the International Sustainability Standards Board (ISSB). The IASB also has added projects on intangible assets, the statement of cash flows and climate-related risks in financial reporting to its agenda.

He said the IASB did not add a project to its agenda on accounting for cryptocurrencies because existing IFRS standards may be applied. He also cited the lack of evidence that cryptocurrency is pervasive for companies reporting under IFRS.

PCAOB standard-setting and focus areas

PCAOB overview

PCAOB Chair Erica Williams, along with all of the members of the PCAOB, emphasized the importance of trust in the accounting profession and highlighted the improvements to audit quality and investor confidence in audits in the 20 years since the Sarbanes-Oxley Act was enacted. Ms. Williams noted that trust is earned and must be maintained, and there is a danger of complacency that must be managed. She highlighted the importance of auditors remaining vigilant in upholding the high standards expected of them.

Ms. Williams noted that the PCAOB recently issued a **Spotlight** publication that previews the PCAOB's 2021 inspection findings and says audit deficiencies are increasing. Ms. Williams said a number of firms have already taken steps to improve and maintain audit quality but cautioned that it may take time before the PCAOB sees such changes reflected in its inspections.

She called the increased rate of findings in 2021 inspections and the preliminary indication that 2022 inspection findings will also raise a "troubling warning sign." She highlighted that enhanced focus is needed in the current environment and that the PCAOB will not tolerate unethical behavior.

Ms. Williams reiterated that in the current macroeconomic environment, many companies are continuing to navigate challenges and uncertainties and that incentives for fraud may be heightened.

Ms. Williams and the other PCAOB members also discussed the PCAOB's recently issued **Strategic Plan** for 2022-2026 and its objectives to:

- ▶ Modernize the PCAOB's auditing standards
- ▶ Enhance the PCAOB's inspections
- ▶ Strengthen enforcement
- ▶ Improve organizational operational effectiveness

With respect to enhancing its inspection process, PCAOB members said they are assessing what other information should be included in PCAOB inspection reports to improve transparency. Board members also acknowledged that the PCAOB needs to improve the timeliness of its inspection reports.

“
The PCAOB means business when it comes to enforcement. We intend to use every tool in our enforcement toolbox and impose significant sanctions, where appropriate, to ensure there are consequences for putting investors at risk and that bad actors are removed.”

— Erica Williams,
Chair of the PCAOB

PCAOB members noted that they have an ambitious standard-setting agenda to update many of the interim auditing standards that the PCAOB adopted at its inception. Board members also noted that a Technology Innovation Alliance Working Group was created recently to advise the PCAOB and make recommendations on the use of emerging technologies by auditors and preparers. Board members said the auditor's use of automated tools and techniques does not diminish the importance of auditor judgment.

How we see it

Members of the PCAOB emphasized the importance of receiving input from all stakeholders, including investors, audit committee members, auditors, preparers and others, on standard-setting and other activities. We encourage stakeholders to comment on current and future PCAOB proposals.

PCAOB standard-setting update

Barbara Vanich, PCAOB Acting Chief Auditor, provided an update on the PCAOB's **standard-setting projects** and said the PCAOB anticipates taking action on many of them in the next 12 months.

A firm's system of quality control

Ms. Vanich discussed the recently issued **request for comment** on a proposed new quality control standard (QC 1000) aimed at enhancing accounting firms' quality control systems. She said the proposal is structured in a manner similar to new quality standards issued by the International Auditing and Assurance Standards Board (IAASB) and the AICPA to help audit firms to comply with the proposed requirements, and she said the differences between the standards and that being proposed were appropriate. Ms. Vanich also noted that the staff has developed a **comparison** of its proposed standard with the IAASB's International Standard on Quality Management No. 1, *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements* (ISQM 1), and the AICPA's Statement on Quality Management Standards No. 1, *A Firm's System of Quality Management* (SQMS 1).

All PCAOB-registered firms would have to design a compliant quality control system, she said, and she encouraged stakeholders to provide comments on the proposal by 1 February 2023.

Other active projects

Ms. Vanich also said the PCAOB expects to take action in 2023 on active projects considering changes to its standards with respect to interim attestations, the auditor's consideration of possible noncompliance with laws and regulations, use of data in audits, and the auditor's evaluation and reporting of a company's ability to continue as a going concern.

Ms. Vanich noted that the PCAOB will also consider at a meeting next week whether to issue for public comment a proposal to replace the existing confirmation standard with a new standard that is intended to strengthen and modernize the requirements.

Auditor independence and ethics

SEC and PCAOB officials also emphasized the importance of auditor independence and ethics to promote investor confidence in the quality of financial reporting and said audit committees and management share oversight responsibility for auditor independence. SEC OCA Deputy Chief Accountant Diana Stoltzfus also reminded auditors about the "general standard of auditor independence" set forth in Rule 2-01(b) of Regulation S-X, stating it is the heart of the Commission's auditor independence rule. It requires auditors to be independent in both fact and appearance.

PCAOB inspection matters

George Botic, Director of the Division of Registration and Inspections at the PCAOB, said that it is critical that auditors demonstrate due professional care and professional skepticism, given the current macroeconomic environment that heightens the potential for fraud risks. He added that auditors need to understand the business, including the purpose of any related party transactions, and perform their risk assessment at a granular enough level, given the potential pressures companies subject to audit are facing.

2022 inspection highlights

Mr. Botic said the PCAOB's 2022 inspections focused on audit areas that could be affected by economic conditions such as impairments of long-lived assets, revenue, inventory, going-concern assessments, allowances for credit losses and the increased risk of fraud. Mr. Botic said inspections also focused on critical audit matters (CAMs) and nontraditional topics, such as cash and cash equivalents and debt. Mr. Botic also said audit execution risk is heightened in light of employee turnover at audit firms and the remote work environment and that audit firms need to continue to focus on adequate training for new staff to address these challenges.

Inspection outlook for 2023

Mr. Botic said the PCAOB's 2023 inspections will focus on financial statement areas that are generally complex in nature, require significant judgment and may be particularly subject to change, given the economic environment. Mr. Botic highlighted the importance of auditors performing a robust risk assessment that includes a thorough understanding of the business and changes in an entity's internal control over financial reporting. Mr. Botic stated that 2023 inspections will also focus on the auditor's response to identified risks of material misstatement, including any new incentives and/or opportunities to commit fraud, independence with respect to performing non-audit services and how having private equity investors affects an audit firm's independence.

Endnotes:

- ¹ The Chartered Institute of Management Accountants (based in London).
- ² ASC 230, *Statement of Cash Flows*, provides two alternatives for presenting cash flows from operating activities. The direct method presents major classes of cash receipts and payments and the indirect method presents a reconciliation of net income to net cash flow from operating activities.
- ³ CF Disclosure Guidance: Topic No. 9A. <https://www.sec.gov/corpfin/covid-19-disclosure-considerations> and CF Disclosure Guidance: Topic No. 9, <https://www.sec.gov/corpfin/coronavirus-covid-19>

“
In this period
of continued
unpredictable
change, auditors
should not assume
that last year's
audit plan will
work this year - or,
said differently,
engagement teams
must avoid a
'same as last year'
mentality.”

— George Botic,
Director of Division
of Registration and
Inspections at the PCAOB

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