2010 AICPA National Conference on Current SEC and PCAOB Developments

Summary

Representatives of the Securities and Exchange Commission (SEC, Commission) addressed accounting and reporting matters at the AICPA National Conference on Current SEC and PCAOB Developments December 6-8, 2010 in Washington, DC. Representatives of the Public Company Accounting Oversight Board (PCAOB), Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) also shared their views on a variety of matters. Major themes included:

► Restoring investor confidence and public trust
► SEC rulemaking, including implementation of financial regulatory reform
► SEC reporting and disclosure, including loss contingencies and non-GAAP financial measures
► Accounting matters, including issues surrounding consolidations and debt and equity accounting
► Internal control over financial reporting
► Convergence of US GAAP and International Financial Reporting Standards (IFRS)
► Matters affecting the auditing profession

Senior SEC officials, including Chairman Mary Schapiro, Chief Accountant Jim Kroeker and Deputy Chief Accountant Paul Beswick also provided an update on the SEC’s proposed roadmap on the potential incorporation of IFRS into the financial reporting system for US issuers. Beswick also provided an update on the SEC’s proposed roadmap on the potential incorporation of IFRS into the financial reporting system for US issuers. Beswick discussed a possible way forward that would retain a role for the FASB. Our Hot Topic, IFRS issues featured at AICPA Conference (BB2057), discusses their comments in detail.

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Remarks of senior SEC officials

SEC Chairman urges accountants to help restore investor trust

SEC Chairman Mary Schapiro highlighted the important role that accountants play in the capital markets. With public trust shaken by recent scandals and the financial crisis, regulators are working to restore that trust. However, these efforts will only succeed if investors have faith in a company’s financial reporting. Chairman Schapiro said accountants must “lead the fight” against investor skepticism. “[T]he foundation of successful markets is accurate and transparent financial reporting – and honest verification of that reporting by an independent, objective party.”

To help foster public trust, Chairman Schapiro encouraged accountants to ask themselves the following questions when preparing or auditing financial statements:

- Could I be doing more to ensure that the information is accurate?
- Are the results I am reporting an exercise in wishful thinking or a true portrait of actual results?
- Even if the numbers reported are accurate, do they convey a fair picture or is there a need for additional disclosure?

Additionally, auditors should ask themselves, “Do I understand the company I am auditing well enough to recognize red flags?”

Chairman Schapiro urged accountants to have courage to challenge their responses to these questions and to review questionable accounting and disclosures with the “highest levels of management” and the audit committee. While the SEC can prosecute public companies that deceive shareholders, Chairman Schapiro noted that shareholders benefit substantially from the ability “to rely on accurate accounting and effective auditing up front.”

Chairman Schapiro also summarized the SEC’s regulatory efforts to restore investor confidence and improve investor trust. These efforts include:

- Rule amendments to provide additional safeguards if an SEC registered investment adviser (RIA) has custody of client funds and securities (client assets), which require, with some exceptions, the following:
  - An annual surprise exam by an independent public accountant to verify client assets
  - An internal control report relating to the custody of client assets from a PCAOB-registered public accounting firm if the RIA is a, or uses an affiliated, qualified custodian

- Money market fund rules intended to strengthen money market fund resilience to economic stresses, reduce the risk of investor runs on money market funds and improve investor and SEC monitoring

- Revitalized enforcement and examination units

- Circuit breaker rules intended to prevent brief, severe disruptions of the US equity markets like the one that occurred on 6 May 2010

- Support for the PCAOB’s efforts to (1) inspect non-US PCAOB registered firms and (2) fill open PCAOB positions with individuals of integrity and commitment to the interests of investors

- Contemplation of methods to update certain rules for, and PCAOB oversight of audits of, broker-dealers

- Efforts to increase the transparency of potential systemic risk areas such as asset-backed securities

SEC Chief Accountant encourages professionalism

SEC Chief Accountant James Kroeker emphasized the importance of public trust, including the “confidence that the numbers the investing public receives are accurate, unbiased, and subject to examination by a truly independent and objective third party.” Kroeker challenged accounting professionals to explore ways to demonstrate leadership in enhancing trust and suggested a few ideas to enhance the public’s trust in the profession.

Auditors should “rethink who the client is in the audit relationship”

Kroeker emphasized that the role of auditors is to provide assurance to investors, not to serve as advocates for management. He suggested auditors refrain from referring to management of companies under audit as the “client.” Instead, auditors should regard investors as their client. In his view, such a shift in terminology and perspective could help reinforce the auditor’s role among all financial reporting constituents, strengthen auditor independence and enhance public trust.

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4 On 10 June 2010, the SEC approved the NYSE, NASDAQ and other national securities exchanges’ proposal for a five-minute trading pause when an individual stock included in the Standard & Poor’s 500 Index (S&P 500) experiences a price change of 10% or more during a five-minute period.
Accountants “must not let complexity stand in the way of transparent financial reporting”

Kroeker stressed that limitations in accounting standards should not adversely affect the provision of transparent and complete disclosures to investors. Additionally, “the use of inappropriate accounting to manage numbers ... or structuring a transaction to be complex in an attempt to achieve an accounting objective continues to be an issue” and doesn’t foster public trust.

Audit firm leaders should “ensure that the audit is never again treated like a commodity”

Kroeker emphasized that “the audit function should be the very soul of the public accounting profession.” Kroeker said he hopes accounting firms consider the public perception of their audit practices and that significant investments to pursue other lines of business don’t compromise the emphasis on audit quality in “multi-disciplinary” audit firms.

Accounting professionals should “contribute to the advancement of education”

Kroeker said accounting professionals can each do more to build the profession’s reputation and commitment to public service. Government service, working at standard setters or volunteering to serve as a treasurer of a charity are examples of ways accountants can contribute to the “advancement of education, the development and integrity of financial reporting, and the broader fabric of our system.”

Deputy Chief Accountant Mike Starr initiatives program to identify emerging financial reporting issues and risks

SEC Deputy Chief Accountant Mike Starr, who oversees policy support and market monitoring, announced an initiative to inform regulators and standard setters of emerging issues and risks related to financial reporting. The goal is improving regulatory and standard setter responsiveness to changes and risks, thereby improving financial reporting. Starr plans to identify emerging issues and trends through the following initiatives:

- Public roundtables (three to four meetings annually beginning in 2011)
- Internal projects, such as analyzing existing SEC data, and quarterly discussions with the PCAOB and FASB
- Consistently seeking input from outside stakeholder groups (e.g., Center for Audit Quality, banking regulators), the PCAOB and FASB

The planned roundtables will be multi-disciplinary and include all key standard setters, preparers, investors and other stakeholders who have relevant experience. The roundtables will focus on discussing and diagnosing emerging issues and trends that “are placing pressure on the financial reporting process.” Starr emphasized that the roundtables won’t become decision-making bodies or advisory groups for the SEC. Instead, the SEC staff will notify the appropriate standard setter of any accounting, auditing or other regulatory issues identified as part of the roundtable discussions. Starr also clarified that this initiative supplements the SEC’s existing outreach activities.

Deputy Chief Accountant Brian Croteau reflects on issues affecting the auditing profession

SEC Deputy Chief Accountant Brian Croteau6 highlighted matters affecting the PCAOB and auditor oversight, including observations related to the PCAOB’s standards setting and inspection functions that are important to improving audit quality.

Auditor oversight matters

Croteau noted that the Supreme Court’s June 2010 decision related to the appointment and removal of PCAOB board members didn’t affect the day-to-day operations of the PCAOB. However, in his view, the court’s decision, which modified the Sarbanes-Oxley Act of 2002 (SOX) to allow the SEC to remove PCAOB board members “for cause,” further solidified the SEC’s oversight role over the PCAOB.

With respect to the PCAOB inspection of foreign registered firms, Croteau noted that the PCAOB continues its efforts to reach agreement in jurisdictions such as the European Union, Switzerland and China. The Dodd-Frank Wall Street and Consumer Protection Act (Dodd-Frank Act) provided the PCAOB with the authority to share information with foreign regulators, which eliminated a significant impediment to the PCAOB’s efforts to reach agreements in certain jurisdictions. Given the importance of PCAOB inspections to investor protection as envisioned by SOX, the Commission is actively working with the PCAOB as it negotiates the various agreements. Croteau expects the PCAOB to be able to make substantial progress in performing inspections in these jurisdictions in 2011.

Engagement quality review

Croteau encouraged auditors performing engagement quality reviews (EQRs) in accordance with the PCAOB's new standard\(^7\) to consider taking the following steps:

- Starting the year-end portion of EQRs early enough to allow sufficient time for comments to be meaningfully addressed
- Adequately evaluating the audit team's assessment of, and response to, significant risks, including those related to fraud
- Challenging the engagement team's judgments, including those around materiality and the severity of identified internal control deficiencies, and their documentation of those judgments

Croteau also noted that the implementation of this standard will likely be a focus of upcoming PCAOB inspections.

Auditor independence

Croteau highlighted two areas related to auditor independence for which there are frequent requests for SEC consultation. First, Croteau noted compliance with SEC and PCAOB independence standards is required for all years for which audited financial statements are included in an SEC registration statement. Therefore, a private company should consider the possibility that it might decide to raise public capital when evaluating the services provided by its independent auditor. Because SEC and PCAOB independence standards differ from those of the AICPA, adequate planning will help to avoid potentially costly delays when a company attempts to access the public capital markets. Croteau noted that bookkeeping and preparation of financial statements and related footnotes, particularly related to income taxes, were common independence issues in initial public offerings.

Second, Croteau noted that SEC and PCAOB independence requirements apply not only to audit clients but to affiliates of audit clients. For example, for a company controlled by a venture-capital or private-equity firm, auditor independence requirements apply to upstream affiliates as well as brother-sister companies also controlled by the venture-capital or private-equity parent.

Director of the Division of Corporation Finance highlights rulemaking and filing reviews

Meredith Cross, Director of the SEC's Division of Corporation Finance (the Division), reviewed the Division's 2010 rulemaking and summarized the active agenda required by the Dodd-Frank Act. The Division has "lots of rules to write" to implement components of the Dodd-Frank Act with "extremely demanding deadlines." Cross emphasized that the Division's rulemaking workload will have no effect on the Division's review of registrant filings.

Rulemaking

Cross highlighted the following 2010 SEC rulemaking activities that affect registrants across all industries:

**Proxies** – The SEC adopted proxy disclosure enhancement\(^8\) and proxy access\(^9\) rules since the last AICPA Conference. The SEC also issued a Concept Release to seek public comment on all aspects of the US proxy infrastructure ("proxy plumbing").\(^10\) The many public comments on the Concept Release should result in "a lot of spirited debate" regarding the role of proxy advisory firms, advance voting instructions and fees charged by intermediaries. Cross said the SEC staff plans to make progress on the proxy plumbing project in 2011.

**Short-term borrowing rule proposal and related interpretive release** – In September 2010, the SEC issued a rule proposal that would require new qualitative and quantitative disclosures about short-term borrowings in Management’s Discussion and Analysis of Financial Condition and Results of Operations (MD&A).\(^11\) The SEC staff is currently considering public comments on the proposal before making a recommendation to the Commission in the new year. Therefore, a final rule won’t be effective for calendar year-end companies in their upcoming Form 10-K, but the SEC staff hopes that the new disclosures will be effective for Form 10-Q beginning with the first quarter of 2011. The SEC also published interpretive guidance (FR-83),\(^12\) which was immediately effective and intended to improve liquidity and capital resource disclosures in MD&A.

The Division began its Dodd-Frank Act rulemaking in 2010 with proposed rules on say-on-pay, say-on-frequency and golden parachutes.\(^13\) Cross noted that Dodd-Frank Act\(^14\) rulemaking will continue with various corporate governance matters related to executive compensation to be proposed through the summer of 2011, including (1) disclosure of the ratio of CEO pay to the median total compensation of other employees, (2) disclosure of “pay-to-

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\(^7\) PCAOB Auditing Standard No. 7, Engagement Quality Review


\(^12\) Our Hot Topic, SEC issues MD&A guidance: Liquidity and capital resources (CC0304), discusses the interpretive guidance in detail.


\(^14\) Our Q&A on the Dodd-Frank Wall Street Reform and Consumer Protection Act (FV0006) discusses the SEC’s implementation of the Dodd-Frank Act in greater detail.
The SEC staff updates the FRM on a quarterly basis. The Division Financial Reporting Manual (FRM) has been useful to registrants and their auditors, the SEC staff has posted the FRM to the SEC’s website. The SEC staff updates the FRM on a quarterly basis.

**Filing review processes**

Cross explained that the SEC staff is taking a “fresh look” at its registrant filing review process to determine whether the Division can be more effective and consistent. The SEC staff is considering:

- “Targeted” reviews (e.g., a governance disclosure review or a risk-related review)
- The process and efficiency of reviews of smaller reporting companies
- Continuous review of disclosures of selected larger issuers on a “real time” basis (e.g., reviewing an earnings press release and providing comments before the Form 10-Q is filed)

**Chief Accountant of the Division of Corporation Finance emphasizes communication to encourage compliance and transparency**

Wayne Carnall, Chief Accountant of the SEC’s Division of Corporation Finance, highlighted the Division’s various communication methods with registrants, which include:

**Pre-clearance process** – The Division has a process to address registrant compliance with SEC rules and regulations (e.g., application of Rule 3-05 of Regulation S-X, Financial Statements of Business Acquired or to Be Acquired) on a pre-filing basis. Carnall advised that a registrant is “better off” asking for permission on SEC compliance issues prior to filing rather than “asking for forgiveness” after receiving an SEC staff comment letter. The Division generally responds to registrant pre-clearance requests within 10 business days.

**The Division Financial Reporting Manual (FRM)** – The FRM is designed to be an SEC internal reference document for Division staff regarding Regulation S-X and Regulation S-K. However, because the information in the FRM has been useful to registrants and their auditors, the SEC staff has posted the FRM to the SEC’s website. The SEC staff updates the FRM on a quarterly basis.

**Dear CFO Letters** – The Division posts sample or illustrative letters on its website as a way to communicate areas of focus to registrants. During 2010, the SEC staff issued the following “Dear CFO” letters:

- Sample Letter Sent to Public Companies Asking for Information Related to Repurchase Agreements, Securities Lending Transactions, or Other Transactions Involving the Transfer of Financial Assets

- Sample Letter Sent to Public Companies on Accounting and Disclosure Issues Related to Potential Risks and Costs Associated with Mortgage and Foreclosure-Related Activities or Exposures

**PCAOB outreach programs** – The Division staff participates in PCAOB forums for smaller audit firms and auditors of smaller companies. The SEC staff seeks to improve SEC compliance and the quality of financial reporting for smaller companies, which constitute the majority of companies filing with the SEC.

**Director of Enforcement Division acknowledges registrant concerns on new whistleblower proposal**

Robert Khuzami, Director of the SEC’s Division of Enforcement (Enforcement), discussed the SEC’s rule proposal to implement Section 922 of the Dodd-Frank Act. The proposal would establish a new program to reward eligible whistleblowers who voluntarily share information with the SEC about a federal securities law violation. The proposed whistleblower program would provide:

- Features to further protect whistleblowers from employer retaliation
- Rewards of up to 30% of funds recovered for information leading to a successful SEC enforcement action with over $1 million in sanctions

Khuzami acknowledged registrant concerns that the SEC’s new whistleblower program could undermine existing corporate ethics and hotline programs. To address those concerns, the proposal includes the following provisions:

- A 90-day grace period to report information to the SEC (i.e., individuals can first report concerns internally to their company and still maintain their “place in line” as the original source of information to the SEC)
- An exclusion for individuals who obtain information as a result of their role in the legal, compliance or internal audit functions
- Providing the largest rewards to whistleblowers who first report evidence internally before communicating with the SEC

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16 The “Dear CFO” letter is available at: http://www.sec.gov/divisions/corpfin/guidance/cforepurchase0310.htm

17 The “Dear CFO” letter is available at: http://www.sec.gov/divisions/corpfin/guidance/cfoforeclosure1010.htm
SEC reporting and disclosure

Loss contingencies
The SEC staff noted that the accounting and disclosure of loss contingencies continues to be an area of focus in filing reviews. The SEC staff observed that (1) registrants don’t always comply with existing disclosure requirements and (2) the disclosure requirements of US GAAP and Regulation S-K differ (i.e., the two disclosures shouldn’t be identical).

Specifically, the SEC staff stated that it will challenge a registrant’s assertion that it cannot estimate the loss or range of loss associated with a loss contingency that is deemed reasonably possible of occurring. The SEC staff reminded registrants that US GAAP doesn’t require a level of “certainty” or “confidence” when estimating the range of loss. A registrant may find that aggregating the required disclosures, including disclosure of a reasonably possible range of loss, is appropriate.

If a company concludes that no range of loss can be reasonably estimated, the SEC staff expects such a conclusion to be supported by a substantive process. Further, a registrant should reassess whether sufficient information is available to reasonably estimate the range of loss at the end of each period. Management also should evaluate the disclosures (or lack thereof) each reporting period. The SEC staff commented that it generally would expect disclosures to evolve over time to include more quantitative information as the loss contingency progresses. Finally, when loss contingencies are settled, the SEC staff reviews the adequacy of prior disclosures and the appropriateness of the amount and timing of prior accruals.

How we see it – Loss contingency disclosures
Registrants should consider the SEC staff views as well as US GAAP and Regulation S-K disclosure requirements when drafting the next Form 10-Q or 10-K. The 2010 calendar year-end disclosures are of particular importance due to the FASB’s re-deliberation of the exposure draft, Disclosure of Certain Loss Contingencies. The FASB directed the FASB staff to review loss contingency disclosures in financial statements for the 2010 calendar year-end reporting cycle to determine if the SEC staff’s focus has led to improved compliance with existing disclosure requirements.

Non-GAAP financial measures
The SEC staff highlighted guidance issued in 2010 related to non-GAAP financial measures. The SEC staff discussed a few commonly noted deficiencies in the application of the guidance, including:

- A registrant’s failure to disclose how the non-GAAP financial measure is useful to investors.
- Presenting non-GAAP financial measures with greater prominence than GAAP measures, which is prohibited. This prohibition applies not only to the order of presentation but to the degree of emphasis (e.g., the SEC staff will challenge a discussion of non-GAAP financial measures that significantly exceeds the length of the discussion of the corresponding GAAP measures).
- Presentation of a non-GAAP financial measure that fails to describe the nature of any adjustments to a standard measure using clear terminology (e.g., a measure that includes adjustments to EBITDA should not be labelled “EBITDA”).
- Any presentation of non-GAAP earnings per share should be based on, or accompanied by a presentation of, non-GAAP diluted earnings per share, which should give effect to any dilutive potential common shares outstanding even if they were antidilutive to the computation of diluted GAAP earnings per share (potentially resulting in different denominators for the GAAP and non-GAAP per share measures).

When a registrant decides to exclude a non-GAAP financial measure from its SEC filings that it has publicly disclosed elsewhere, the SEC staff generally will not require the registrant to disclose the non-GAAP measure in its SEC filings, provided that the message underlying the company’s public communications (e.g., press releases and SEC filings) is consistent.

Segment reporting
The SEC staff said it continues to issue comment letters related to segment reporting, particularly when management describes the business within MD&A, press releases or webcasts in a manner inconsistent with its financial statement segment note. When such inconsistencies are identified, the SEC staff will request information provided to a company’s Chief Operating Decision Maker (CODM), Board of Directors and Audit Committee to evaluate a company’s identification of its operating segments. The SEC staff will be skeptical to the extent a company asserts that financial information provided to its CODM isn’t actually used by the CODM to make decisions about how to allocate resources or assess performance.

On 11 January 2010, the SEC staff released a series of Compliance and Disclosure Interpretations (C&DIs) with respect to non-GAAP financial measures. The C&DIs superseded the SEC staff’s 2003 FAQs on non-GAAP financial measures. The C&DIs interpret, but do not modify, Regulation G and Item 10(e) of Regulation S-K. The C&DIs are available at: http://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm. Our Hot Topic, SEC staff issues revised guidance on non-GAAP financial measures (CC0290), discusses the interpretive guidance in detail.

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16 Item 103 of Regulation S-K requires registrants to briefly describe any material pending legal proceedings, to which the registrant or any of its subsidiaries is a party or of which any of their property is subject.
How we see it – Segment reporting
Consistent with the SEC staff’s remarks, we have observed that the SEC staff frequently challenges a registrant’s conclusion regarding the determination and aggregation of operating segments. In developing comments, the SEC staff routinely expands its review of information about a registrant to company websites and industry or analyst presentations, and asks the registrant to explain any perceived inconsistencies. Reconciling those perceived inconsistencies often is time consuming and results in multiple rounds of comments on segment reporting.

Stock compensation in initial public offerings
A company completing an initial public filing with the SEC often considers estimates used to determine stock-based compensation critical to the preparation of its financial statements. These estimates can be complex and highly subjective, in part, to the fact that the stock underlying the instruments granted is privately held. The SEC staff noted that a company should consider the following disclosures in their IPO registration statements:

► A description of the methods and assumptions used in estimating the fair value of the underlying stock and the instruments granted
► A table disclosing the number of instruments granted, exercise price, fair value of the underlying stock and fair value of the instruments granted for the 12-month period preceding the most recent annual or interim balance sheet date
► Narrative disclosures describing the factors contributing to significant changes in the fair value of the underlying stock during the 12-month period preceding the most recent annual or interim balance sheet date, including how those changes relate to changes in assumptions.20

Further, the SEC staff highlighted that while an independent valuation performed contemporaneously is a best practice, the disclosures suggested above should be provided regardless of how or when the privately-held stock was valued.21

Significance tests for acquisitions and equity investees
The SEC staff discussed recent interpretive changes affecting the “income test” to assess significance under Regulation S-X. Under SEC rules, a registrant is required to present financial statements of an acquired business or an equity method investee if deemed significant. The SEC staff noted that a registrant must measure significance under Regulation S-X using the greatest result of three prescribed tests: the “asset test,” “investment test” and “income test.” The SEC staff focused its comments on the income test, which is based on the registrant’s share of the acquiree’s or investee’s pre-tax income from continuing operations, exclusive of amounts attributable to non-controlling interests, for the most recently completed fiscal year (i.e., the numerator) compared to such income of the registrant (i.e., the denominator). The SEC staff noted that there have been three recent changes to interpretations about the income test:

► Changes related to income averaging – In some circumstances, the denominator in the income test may consider a five-year average pre-tax income rather than solely using the most recently completed fiscal year. The SEC staff highlighted the guidance provided in Computational Note 2 to S-X 1-02(w), which indicates that “if the registrant’s income for the most recent fiscal year is 10% or lower than the average of the registrant’s income for the last five fiscal years, then the average income of the registrant should be used for this computation. Any loss year should be omitted for purposes of computing average income.” The SEC staff previously prohibited the use of averaging as described in the Computational Note when the registrant incurred a pre-tax loss in the most recent year. The SEC staff recently revised its interpretation to allow a registrant to apply averaging as described in the Computational Note regardless of whether the registrant has pre-tax income or loss in the most recent year. The SEC staff also clarified that in computing the five-year average, any loss years should be assigned a zero value, and that the cumulative amount of income during the five years should be divided by five.

► Changes related to calculating significance of an equity method investee – The SEC staff clarified that the numerator of the income test should be calculated based on the registrant’s proportionate share of the pre-tax income from continuing operations, exclusive of the amount attributable to non-controlling interests, reported in the separate financial statements of the investee. This income or loss should be adjusted only for any basis difference in accordance with Accounting Standards Codification (ASC) 323, Investments - Equity Method and Joint Venture. Previously, the SEC staff required the numerator to be based on the equity income recorded in the financial statements of the investor. For example, under previous SEC staff guidance, the numerator of the income test was

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20 The SEC staff noted that the disclosures can be based on information disclosed elsewhere in the registration statement of the significant internal and external events affecting the company and that the nature and extent of disclosure should be commensurate with the level of changes in the valuations and may depend on whether such changes are consistent with the company’s development, financial position and results of operations.

21 This SEC staff guidance regarding the extent of disclosures when contemporaneous independent valuations are obtained differs from the recommendations in the 2004 AICPA Practice Aid, Valuation of Privately-Held Company Equity Securities Issued As Compensation.
required to also include, among other things, (1) any impairment loss recognized by the investor on its equity investment and (2) any gains or losses related to the sale of a portion of the investor’s equity interests. The SEC staff also emphasized that amounts used in the computation must be based on US GAAP, as would any summarized financial information about the investee in the registrant’s financial statements.

Changes related to calculating significance for disposed business — The SEC staff clarified that when evaluating the significance of a disposed business under the income test, the registrant should complete an assessment of whether the disposed business is a discontinued operation. If yes, the denominator of the income test should exclude the disposed business. If the disposed business isn’t a discontinued operation, the denominator of the income test should include the disposed business.

Financial statements of guarantors and issuers of guaranteed securities

Based on the definition of a security in the Securities Act of 1933, a guarantee of a security is a security. As a result, offers and sales of both the guaranteed security and the guarantee must be registered under the Securities Act of 1933 unless otherwise exempt from registration. In addition, once the registration statement is declared effective, both issuers and guarantors become subject to the periodic reporting requirements under the Exchange Act of 1934. However, Exchange Act Rule 12h-5, Exemption for Subsidiary Issuers of Guaranteed Securities and Subsidiary Guarantors, specifically exempts from Exchange Act reporting subsidiary issuers or subsidiary guarantors permitted to omit financial statements by paragraphs (b) through (f) of S-X Rule 3-10.

Under these provisions, condensed consolidated financial information, or disclosure only information, could be presented in the parent company’s financial statements. The SEC staff highlighted some reminders to registrants regarding the relief in Rule 3-10 of Regulation S-X:

- To qualify for parent company condensed consolidating information footnote disclosure, a subsidiary issuer and/or subsidiary guarantor(s) must be 100% owned by the parent. One hundred percent generally means every voting share for corporate entities and every ownership interest for non-corporate entities.
- To qualify for parent company condensed consolidating information footnote disclosure, the guarantees must be full and unconditional throughout the debt’s term. To qualify for the relief, a guarantor cannot have the ability to opt out of the guarantee.
- Any condensed consolidating financial information must be reported, at a minimum, at the level specified by Article 10 of Regulation S-X, Interim Financial Statements.
- To qualify for narrative footnote disclosure in lieu of the condensed consolidating financial information, the parent company cannot have any independent operations or assets and all direct and indirect subsidiaries must have guaranteed the securities issued by their parent company. These criteria also are met when any non-guarantor subsidiaries are minor (i.e., total assets, stockholders’ equity, revenues, income from continuing operations, individually and in the aggregate are less than 3% of the parent’s consolidated totals).
- The conditions to qualify for relief from full 1934 Exchange Act reporting for registered guarantee securities must continue to be met at each quarterly and annual reporting date.

Form 8-K filings related to a change in a registrant’s certifying accountant

Item 4.01 of Form 8-K requires a registrant to file a Form 8-K within four days of a change in certifying accountant. The Form 8-K requires disclosure of, among other things, whether the accountant resigned, declined to stand for re-election or was discharged. The SEC noted that in situations in which a registrant dismissed its independent accountant because the auditor was involuntarily deregistered by the PCAOB, registrants should disclose that fact. In these circumstances, audit reports issued by the deregistered accounting firm should no longer be included in a registrant’s filings made on or after the date the firm’s registration was revoked, even if the accountant’s report was issued before the date of revocation. Financial statements previously audited by a firm whose registration has been revoked generally would need to be re-audited by a PCAOB-registered firm prior to inclusion in future filings. The re-audit requirement applies to all periods presented in the financial statements.

The SEC staff said it frequently issues comment letters on two other Form 8-K issues:

- An explanatory paragraph in the audit report describing uncertainty about the company’s ability to continue as a going concern is a report modification as to uncertainty, as discussed in Item 304 of Regulation S-K, and should be disclosed in the Form 8-K.
- The “subsequent interim period” for purposes of disclosing disagreements and reportable events includes the period since the most recent audited year-end through the termination date. The SEC staff has requested that a company amend its filing if the entire period isn’t covered by the disclosure.

The SEC staff also reminded registrants that the Exhibit 16 letter signed by the former accountants requires timely filing.
Finally, consummation of a reverse merger by two registrants usually requires filing an Item 4.01 Form 8-K. If the independent accountant is not the same for both companies, a Form 8-K must be filed indicating the change in accountant. In addition, a registrant generally must file a Form 8-K upon the merger of the registrant’s auditor with another firm.

**Internal control over financial reporting**

Both PCAOB and SEC officials provided a number of reminders related to evaluations of internal control over financial reporting (ICFR).

*Auditor ICFR attestation report exemption for non-accelerated filers* - The Dodd-Frank Act exempted non-accelerated filers from the auditor attestation requirement of SOX Section 404(b). However, it is important to note that a registrant does not exit accelerated filer status unless its worldwide public float at the annual measurement date is less than $50 million. That is, worldwide public float below $75 million at the annual filer status measurement date does not automatically exempt a filer from Section 404(b). Therefore, a registrant with public float less than $75 million, but greater than $50 million, may remain subject to Section 404(b) of SOX if the registrant was an accelerated filer in the prior year. Thus, some smaller reporting companies will continue to be subject to SOX 404(b). The Dodd-Frank Act did not modify management reporting on internal control over financial reporting for non-accelerated filers pursuant to the SEC’s rules implementing SOX Section 404(a). In addition, under SEC rules, management reports on ICFR now are considered “filed” rather than “furnished.”

*Evaluations of ICFR* - Both registrants and auditors were reminded to take a fresh approach to the evaluation of ICFR each year to challenge whether a company’s system adequately addresses changes in the company’s economic or business conditions. Such consideration is integral to providing investors with the benefits intended by ICFR reporting.

An important element of effective internal control over financial reporting is a thorough process for evaluating non-routine transactions. The evaluation process should include an analysis of the substance of the transaction, review of the relevant accounting literature, review of other relevant information and, if necessary, obtaining the views of other knowledgeable professionals. The SEC staff observed that evaluations that don’t adequately include these steps, including failing to identify and evaluate relevant provisions of related contracts or agreements, may represent a deficiency in a company’s ICFR.

The SEC staff also observed that disclosures of material weaknesses continue to be a lagging indicator of internal control deficiencies. That is, disclosures of material weaknesses usually are reported in connection with a restatement when in many cases the material weakness likely existed before the restatement. The SEC staff reminded registrants that a conclusion about the severity of a control deficiency depends upon an evaluation of both the likelihood and magnitude of an error occurring without being prevented or detected by a company’s ICFR, not only when a material error occurs.

If a company restates its financial statements during the year, the SEC staff encourages it to carefully consider the effect of the restatement on the company’s conclusions related to the effectiveness of ICFR and its disclosure controls and procedures (DCP). To the extent a company determines that ICFR or DCP (or both) were effective despite the restatement, the SEC staff will inquire about the basis of the company’s conclusions and may request additional disclosure of the company’s rationale in its periodic filing. Similarly, the SEC staff may question situations in which a registrant concludes that DCP are effective when it has concluded that ICFR is ineffective.

*ICFR and ICFR-related disclosures* - With respect to disclosures of identified material weaknesses, the SEC staff expects a company to disclose the nature of the deficiency in ICFR that resulted in a material weakness and not merely the result of the weakness (e.g., the identification of the error in the financial statements). In addition, when a company remediates a previously reported material weakness, the SEC staff expects disclosure of the material changes in internal control that occurred during the quarter of remediation pursuant to Item 308(c) of Regulation S-K.

*Foreign business operations, acquired businesses and equity investees* 

**Knowledge of US GAAP**

The SEC staff highlighted that foreign private issuers, and other companies with primarily foreign operations, that report under US GAAP must have appropriate knowledge of US accounting standards. The SEC staff may ask a registrant with substantially all its operations in a foreign country about the background and qualifications of those preparing its financial statements. Such an entity without accounting and finance resources possessing the appropriate professional qualifications, education, training and/or experience relative to US GAAP may have a material weakness in ICFR.

*MD&A disclosures related to foreign operations* 

**Risks and uncertainties**

Many companies have foreign operations subject to material political and currency risks, and other uncertainties. The SEC staff noted a registrant should consider MD&A disclosures of trends and uncertainties related to its foreign operations, and disaggregated disclosure may be appropriate. For example, a registrant with material Venezuelan operations should disclose business and
financial risks, and related cash flow effects. Such disclosures might include discussions of the effect of pricing controls, any related changes in business practices, and the risks of further currency devaluation, as well as disaggregated financial information about the assets and liabilities held in Venezuela highlighting any monetary assets or liabilities denominated in the Bolivar Fuerte.

**Disclosure related to income taxes associated with foreign earnings**

The SEC staff continues to question registrants with respect to MD&A discussion of income taxes. In particular, the SEC staff expressed concern about the transparency of the effect of foreign earnings on the effective tax rate and the effect on liquidity when a registrant intends the indefinite reinvestment of foreign earnings. A registrant may report a relatively low effective tax rate if it derives substantial income from low tax rate jurisdictions. In these circumstances, the registrant’s income tax reconciliation may include a large reconciling item related to these low tax rate jurisdictions. The SEC staff believes a registrant should challenge whether this reconciling item should be disaggregated such that the effect of the low tax rate is presented separately from other items (e.g., separate from permanent differences such as tax amortization of foreign entity goodwill). The SEC staff also believes an investor should be able to easily determine the effective tax rate attributable to a registrant’s domestic and foreign operations. To this end, the SEC staff noted that in addition to the US GAAP disclosure requirements related to income taxes, Article 4-08(h) of Regulation S-X requires disclosure of the amount of pre-tax income (loss) and income tax expense (benefit) generated from domestic and foreign sources. Further, the SEC staff believes that a registrant’s assertion that foreign earnings are indefinitely reinvested may have implications beyond income tax accounting. In particular, the SEC staff has challenged registrants to consider the effect such an assertion has on the registrant’s liquidity.

**IFRS for SMEs**

The SEC staff noted that financial statements of acquired businesses or equity investees that meet the definition of a foreign business may be prepared under International Financial Reporting Standard for Small and Medium-sized Entities (“IFRS for SMEs”), published by the IASB in July 2009. Reconciliation to US GAAP is required when the significance of the foreign acquiree or foreign equity investee to the registrant exceeds 30%. The SEC staff stated it would not accept financial statements prepared under IFRS for SMEs for issuers, predecessors of issuers, domestic acquired businesses or domestic equity method investees.

**Equity investees of US companies**

The SEC staff clarified that if a US registrant whose financial statements are prepared under US GAAP holds an equity method investment in a foreign business whose financial statements are prepared other than under US GAAP (e.g., IFRS or home country GAAP), the basis of accounting used by the US registrant to calculate its share of income of the foreign business should be US GAAP. In those circumstances, the SEC staff also clarified that when the US registrant’s financial statements must include summarized financial data of the foreign business under S-X 4-08(q), the basis of accounting for presenting that data also should be US GAAP. Further, the SEC staff emphasized that even if the differences between US GAAP and the investee’s basis of accounting do not materially affect the amounts reflected in the US registrant’s consolidated financial statements (and even if that fact is noted in the registrant’s financial statements), it would not be acceptable to present summarized financial data of a foreign business other than on a US GAAP basis.

**Foreign private issuers and IFRS considerations**

**Reporting issues for Foreign Private Issuers**

The SEC staff reminded Foreign Private Issuers (FPIs) that the ability to omit the US GAAP reconciliation of their financial statements is limited to those issuers that (1) file on Form 20-F and (2) prepare their financial statements in accordance with IFRS as issued by the IASB. Under Form 20-F, an FPI is eligible to omit the reconciliation to US GAAP only if it states, unreservedly and explicitly in its report, that the financial statements are in accordance with IFRS as issued by the IASB. Also, the independent auditor must include in its report that the financial statements comply with IFRS as issued by the IASB. Otherwise, the SEC staff will issue a comment requesting the inclusion of such an assertion or that the FPI provide the US GAAP reconciliation.

**Reviews of IFRS filers**

The SEC staff emphasized that the financial statements of all SEC registrants are subject to the same level of review, regardless of whether they are prepared in accordance with US GAAP, IFRS or home country GAAP. Regarding its reviews of IFRS financial statements, the SEC staff is considering how registrants have applied IFRS including accounting policy choices that are:

- Permitted by IFRS
- Required when IFRS relies on management judgment
- Required when IFRS does not provide specific guidance (e.g., in which case the registrant must look to other country accounting standards)

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23 ASC 740-10-50-12, Income Taxes
The SEC staff noted an increase during the past year in both the number of comment letters issued on financial statements prepared in accordance with IFRS and the number of comments per letter. The SEC staff stated that their comments were more probing than in prior years and have resulted in changes to the IFRS financial statements, including restatement and additional disclosure. The SEC staff identified several common themes in comment letters issued on IFRS financial statements, which were consistent with the themes in comment letters issued to US GAAP filers, such as expanding disclosure around the fair value of financial instruments, the impairment of assets, the financial statement presentation and classification of cash flows, the factors used to identify operating segments and revenue recognition.

SEC filing review process

The SEC staff provided an overview of the filing review process and explained that while every registrant is reviewed at least every three years as mandated by SOX, many registrants are reviewed more frequently. The SEC staff also performs reviews of all IPOs and Form 8-Ks on items 4.01 and 4.02, in addition to selected proxy statements and registration statements. The SEC staff noted that comments may be initiated through review of a variety of source documents and company communications including the registrant’s SEC filings, websites, press releases and analyst calls.

The SEC staff explained that comments often fall into one of three categories:

- **Provide supplementary information** – A company may be asked to provide additional information about how certain transactions were accounted for or the basis for a particular accounting or disclosure decision. This type of comment does not necessarily presume that a registrant’s accounting or disclosures are incorrect.

- **Please disclose in future filings** – A company may be asked to make certain disclosures in future filings, which will be reviewed by the SEC staff when filed. The SEC staff recommends that a company provide a draft of the proposed disclosure to determine the revised disclosure meets the SEC staff’s expectations.

- **Revise your financial statements or disclosures** – A company may be required to revise its financial statements or disclosures due to a material deficiency, which generally requires an amended filing.

The SEC staff drafted comments specific to a registrant’s facts and circumstances. The SEC staff warned that a registrant responding to SEC comments should not “cut and paste” responses made by other registrants to similar comments, but should tailor the responses to the registrant’s unique facts and circumstances. Although the SEC staff may not have objected to a particular response by another registrant, all the facts and related considerations may not be obvious from the publicly available information.

The SEC staff stated that it is helpful to directly contact the SEC reviewer when a registrant needs additional time to respond to comments or if additional clarification is needed. In general, the SEC staff encouraged registrants to be more proactive throughout the comment process and expressed a willingness to meet with registrants in person or via teleconference.

Accounting and disclosure

**Standard setting and compliance in financial reporting**

The SEC staff believes that improved compliance with and enforcement of both the letter (i.e., explicit requirements) and the spirit of existing accounting and disclosure standards would allow the FASB and IASB (collectively, the Boards) to more effectively pursue their missions and focus their standard setting efforts. The SEC staff cited the FASB’s project on disclosures of certain loss contingencies as an example of standard setting efforts resulting from registrants not complying with the letter of existing disclosure requirements. In the SEC staff’s view, continued deficiencies in compliance with the existing disclosure requirements related to loss contingencies, as well as criticism from investors that existing disclosures do not provide adequate information to evaluate the potential effect on a company’s financial results, led to the FASB’s current standard setting project as well as increased efforts by the SEC staff to improve disclosure in this area. Specifically, enhancing disclosure related to the potential loss or range of loss related to loss contingencies was a primary goal of the current project.

Additionally, the SEC staff noted that when accounting standards and related guidance do not address every issue related to the topic or provide only minimal disclosure requirements, registrants should consider the intent of the related accounting standards, other areas of guidance that may be applied by analogy, as well as the Concept Statements that provide the foundation for the financial reporting requirements. The SEC staff again utilized the recent loss contingency project to illustrate this point, noting that while recoveries through insurance or indemnification agreements were addressed as part of the FASB’s project, existing guidance related to loss contingencies as well as the Concept Statements that provide the foundation for the financial reporting requirements provides a framework for accounting for such arrangements in the context of loss contingencies. In addition, the SEC staff highlighted the guidance provided in FASB Concept Statement No. 8, which notes that the purpose of financial reporting “is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and

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other creditors in making decisions about providing resources to the entity.” In the SEC staff’s view, reflecting on this principle when developing accounting positions and related disclosures should assist registrants in developing disclosures that achieve the objectives intended in the standards.

The SEC staff also cautioned that a failure to achieve the measurement and recognition objectives of a standard could lead to standard setting solely to cure abusive practices. Standard setting with such a focus often results in standards with long lists of prescriptive guidance and disclosure requirements. The SEC staff noted, “this may then lead to seemingly uneconomic accounting results in some fact patterns, which, in turn, may lead to new standard setting.” The SEC staff hopes that improved compliance and enforcement efforts could prevent this cycle from recurring. Further, a financial reporting environment that embraces accounting and disclosure as a means to provide transparent information to investors will allow standard setters to focus on the development of objectives-based standards.

Consolidation

The SEC staff provided several observations on adoption and implementation of the FASB’s amended consolidation standard on variable interest entities (VIEs). Under the amended guidance, the primary beneficiary of a VIE is the enterprise that has (1) the power to direct the activities of the VIE that most significantly impact the VIE’s economic performance and (2) the obligation to absorb losses or the right to receive benefits that could potentially be significant to the VIE. In determining the primary beneficiary of a VIE, the SEC staff comments emphasized:

- The importance of properly identifying the activities of a VIE that most significantly impact the VIE’s economic performance (i.e., activities that are “significant and necessary to the entity accomplishing its purpose and design”). The SEC staff summarized certain fact patterns in which registrants had failed to appropriately determine the most significant activities of the VIE.
- The proper consideration of all potential sources of power, which may be embedded in arrangements held within various levels of an entity’s structure (e.g., activities within management, servicing or financing arrangements). In particular, the SEC staff highlighted the need for careful consideration regarding entities that by design may have only a limited range of activities. The SEC staff reiterated its skepticism regarding assertions that power is shared among parties.

- Related party considerations, noting that power cannot be shared among related parties. The SEC staff said that “[t]he determination of which member of a related party group is most closely associated with a variable interest entity generally is qualitative and dependent on the facts and circumstances. When determining which member is most closely associated with the variable interest entity, consider approaching the task plainly and with attention to the overall objective and control premise of the model.”

Debt and equity accounting

Extenuishment of debt with related parties

The SEC staff shared its thoughts on whether a registrant’s non-troubled debt extinguishment transaction with a related party may be in essence a capital transaction as discussed in ASC 480, Distinguishing Liabilities from Equity. The SEC staff cited several inquiries in this area over the past year and believes a full analysis of the transaction based on the individual facts and circumstances is required to account for the substance of the transaction.

The SEC staff discussed a particular transaction in which an executive (and significant shareholder) of the registrant exchanged non-convertible debt for the registrant’s common stock with a fair value significantly lower than the carrying amount of the debt. Some of the questions asked by the SEC staff included:

- What was the role of the related party in the transaction?
- Why would the related party accept the registrant’s offer that resulted in accepting common stock with a significantly lower value than the carrying amount of the debt?
- Was the substance of the arrangement a forgiveness of debt that was owed to a related party?

Given the facts and circumstances, including consideration of the information obtained in response to its questions, the SEC staff noted that the specific transaction was in essence a capital contribution.

Application of the indexation guidance to equity-linked instruments (and embedded features)

SEC staff from the Division of Corporation Finance also discussed the application of guidance in ASC B15, Derivatives and Hedging, on the evaluation of whether an instrument (or embedded feature) is considered indexed to an entity’s own stock. Under the indexation guidance, an entity is required to evaluate whether an equity-linked financial instrument (or embedded feature) is considered indexed to

27 Originally issued as FASB Statement No. 167, Amendments to FASB Interpretation No. 46(R), and primarily codified into ASC 810, Consolidation
28 The “indexation guidance,” codified from former EITF Issue No. 07-5, Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity’s Own Stock (EITF 07-5)
its own stock. The guidance prescribes a two-step approach, which requires evaluation of both the contingent exercise provisions (if any) and the determination of the settlement amount.

In general, to be considered indexed to an entity’s own stock, any contingent exercise provision must not relate to an external market price or index, and the settlement amount must equal the difference between a fixed number of shares and a fixed monetary amount (or a fixed amount of the entity’s securities in conversion). The only exceptions to the “fixed-for-fixed” settlement are for variables that are an input to the valuation model for a fixed-for-fixed forward or option contract on the issuer’s equity shares. The indexation guidance provides many examples illustrating the application of the guidance to specific instruments and features. If the instrument (or embedded feature) is not considered indexed to the entity’s own stock, it generally would be classified as an asset or liability (or bifurcated), and subsequently measured at fair value each reporting period with changes in fair value recognized in the issuer’s operating results.

Stock purchase warrants and embedded conversion options are typical examples of financial instruments for which the SEC staff noted issues with the application of the indexation guidance. The SEC staff has raised questions about both transition to the guidance as well as its initial application to new instruments, more often at small to medium sized registrants. The SEC staff often uncovers these issues when asking for more detailed disclosures of what are described in the footnotes as simply “standard anti-dilution features” of these instruments (or embedded features).

One frequent problem the SEC staff has observed is with “down round” features, or terms by which the exercise price is adjusted if the issuer subsequently sells equity at a price lower than the exercise price of the warrant (or conversion price in a convertible instrument) or issues an equity derivative with a strike price lower than the exercise price (or conversion price). ASC 815-40-55-33 and 55-34 (Example 9) establishes that an instrument (or embedded feature) with this particular term cannot be considered indexed to the issuer’s own stock.

Related to down round provisions, the SEC staff also noted errors in the valuation of liability or asset classified warrants (or bifurcated embedded derivatives), especially when the instrument (or feature) fails the fixed-for-fixed indexation criteria. In these circumstances, the SEC staff has observed inappropriate use of the Black-Scholes option valuation model. For example, in circumstances in which inputs are not static (i.e., not fixed-for-fixed) throughout the life of the instrument, the Black-Scholes model does not incorporate the potential variability in the terms. The SEC staff noted that under such circumstances other valuation models (e.g., a binomial model or the Monte-Carlo simulation model) are necessary to give effect to such features.

Accounting for foreclosed real estate involving loan participations

The SEC staff discussed the accounting by banks involved in a loan participation when the bank forecloses on the real estate collateralizing the loan. The SEC staff has been involved in discussions with banking regulators about the accounting by banks when (a) the banks foreclose on the real estate collateralizing a loan, (b) a participation interest in that loan had been transferred to one or more other banks and (c) a separate legal entity is not formed to hold title of the foreclosed property.

In such circumstances, the SEC staff noted that careful analysis is required in considering how a bank (i.e., either the Lead Bank or Participating Bank) should account for its pro-rata share of the foreclosed real estate. The staff discussed three alternatives:

- The Lead Bank could recognize the entire property on its books with a liability to the Participating Bank for its share
- Each bank could account for its interest using the equity method
- Each bank could report its pro-rata share in the real estate, similar to how the loan is accounted for prior to foreclosure

In considering these issues, the SEC staff observed that (1) legal title to the foreclosed property may be held in a variety of ways and (2) there are not standard contractual terms for participation agreements. As a result, the SEC staff indicated there is not a “blanket conclusion that can be applied under the current accounting standards.” Rather, the SEC staff noted that “an understanding of all terms of the arrangement, including the rights and obligations of the Lead Bank and the Participating Bank(s), is critical to any accounting conclusion.” Depending on the facts and circumstances, the SEC staff noted that one way to evaluate the transaction may be to focus on the manner in which title is held, while another may be to evaluate the transaction through the principles in the general guidance on accounting for real estate transactions.

Depending on the facts and circumstances, the SEC staff noted that “it might make sense in some cases to account for an interest in foreclosed real estate in a manner that continues to give effect to the previous partial sale.” The SEC staff noted that the extent of each bank’s rights to participate in decisions about significant financings, development, sale or operations may be of particular importance.

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30 In a loan participation, a Lead Bank originates a loan and transfers an undivided interest in the loan to one or more Participating Banks. If the criteria for sale accounting are met, the Lead Bank accounts for the transfer of the undivided interest in the loan as a sale and derecognizes the portion of the transferred loan.
31 By Lead Bank, the SEC staff is referring to the bank to which the debtor is legally obligated under the debt agreement.
32 By Participating Bank, the SEC staff is referring to banks to whom the Lead Bank has sold an undivided interest in the debt agreement between the Lead Bank and the debtor.
The SEC staff acknowledged that its views will continue to be informed by the EITF’s efforts to the extent this issue is discussed as part of the EITF discussion about when an investor should deconsolidate a subsidiary that is in-substance real estate.

Allocation of goodwill in a partial disposal of a reporting unit

Upon a partial disposal of a reporting unit, ASC 350, Intangibles-Goodwill and other, requires that goodwill associated with a disposed business be included in that business’s carrying amount when determining the gain or loss on disposal. The goodwill associated with the disposed business is generally determined using an allocation of the relative fair values of the retained reporting unit and the business disposed. The SEC staff provided an example of a recent issue involving an entity that disposed of a business and contemporaneously entered into a franchise arrangement requiring the acquirer to make royalty payments based on the future sales volume of the recently disposed business. Specifically, the SEC staff was asked whether the value of the franchise arrangement should be included as part of the fair value of the business that was disposed or part of the reporting unit that was retained. Based on the facts provided, the SEC staff did not object to the reporting entity including the value of the franchise arrangement as part of the fair value that was retained.

Derecognition for transfers of businesses not in legal entities

The SEC staff discussed its recent experience with the derecognition/deconsolidation of businesses by registrants when the transferred business was not held in a separate legal entity. Additional facts in the example discussed included:
- The third party has the right to sell the business back to the registrant in the future for the fair value of the business at the date of the initial transfer
- The registrant continues to operate the business under a management contract
- If the put option is exercised, the business reverts to the registrant
- The registrant has the unilateral right to extend the management contract for several years if the put option is not exercised
- The registrant retains the risks and rewards of the cash flows of the business while serving as the manager

The SEC staff indicated that the registrant’s analysis of whether the business should be derecognized consisted of evaluating whether the third party should be consolidated. The registrant concluded that the third party should not be consolidated and recorded a gain upon transfer of the business.

The SEC staff questioned the appropriateness of the registrant’s derecognition conclusion despite the registrant’s determination that it should not consolidate the third party. The SEC staff’s concern was that a business transferred outside of a legal entity could be derecognized with gain or loss recognition regardless of the nature of the continuing involvement. The SEC staff said this approach was inconsistent with the “conceptual underpinning” of ASU 2010-02, “which is that a transfer of real estate, financial assets or a group of assets constituting a business should not receive different accounting treatment when the assets are in a legal entity than when they are not.” Rather, the SEC staff believes the accounting analysis requires “looking not only at whether the acquirer should be consolidated, but also looking at whether there has ceased to be a controlling financial interest over the particular business that was transferred.”

How we see it – Derecognition/deconsolidation of a business

While we may share the SEC staff’s concern about derecognition/deconsolidation of a business in this circumstance, the accounting literature does not provide guidance as to the manner in which such an analysis should be performed. That is, the consolidation literature addresses controlling financial interest held in a legal entity, not assets (e.g., a business). We note that the SEC staff did not provide the business purpose for the transaction in its example. However, it seemed apparent that the SEC staff was troubled by the substance of the transaction. We don’t believe that the SEC staff’s remarks result in a new deconsolidation accounting model for businesses.

Consultation process with Office of the Chief Accountant (OCA)

The SEC staff encouraged registrants to consider using, as appropriate, the consultation process with the OCA. The SEC staff noted that the formal consultation process is frequently initiated when a registrant approaches OCA with a specific consultation question. As part of this process, OCA engages in a rigorous approach, involving numerous individuals and extensive research with particular emphasis on whether there has been a faithful application of authoritative literature. The formal process culminates in whether OCA will “object” or “not object” to the proposed positions. In addition, the SEC staff is available for informal consultations, though registrants will merely

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35 Accounting Standards Update No. 2010-02, Consolidation (Topic 810): Accounting and Reporting for Decreases in Ownership of a Subsidiary—a Scope Clarification
receive the views of the particular accountant to whom they speak within OCA. As a result, the informal consultation process does not necessarily reflect the views of OCA. Guidance for consulting with OCA is located on the SEC’s website.36

Remarks of the FASB and IASB Chairmen

FASB Acting Chairman Leslie Seidman and IASB Chairman Sir David Tweedie discussed the Boards’ collaborative efforts to remove the significant differences between US GAAP and IFRS. Seidman emphasized that throughout the process “both Boards are knowledgeably, enthusiastically and obsessively pursuing the goal of improving the decision-usefulness of financial reporting.” The chairs highlighted the benefits of a single set of high-quality accounting standards, and noted that it is a “critical time” for determining whether the world will achieve a global set of accounting standards.

As to their goals, Seidman commented, “We are trying to remove the most significant differences between US GAAP and IFRS so that we can have consistent reporting on the most common and significant types of transactions.” Seidman described how the specific objectives and methods of working together have evolved over the years and been affected by external events such as crises in financial reporting. At times, these factors have “caused the Boards to address urgent deficiencies in financial reporting, but on different timetables.”

On convergence, Tweedie described the twelve months ahead as a “window of opportunity” for the Boards to meaningfully improve financial reporting and progress towards a single set of standards. Seidman stated, “national borders should not be an impediment to the need for comparable information.”

Seidman and Tweedie discussed the Boards’ priority joint projects, which include accounting for financial instruments, revenue recognition, fair value measurement, leases and insurance. Tweedie acknowledged that “the world is waiting for us to complete these,” but noted that “both Boards are working very hard to try and bring these [projects] together with acceptable solutions and high quality standards.”

Seidman also described a number of the FASB’s other priorities, which include expanding the Board from five members to seven members, further considering private company reporting matters and establishing a disclosure framework.

Convergence and standard setting update

FASB and IASB staff discussed current accounting standard-setting projects as well as the cooperation between the FASB and IASB. The Boards’ staff noted that the FASB and IASB have been working together over the last year to improve the convergence process as established by the Memorandum of Understanding.37 The Boards’ staff highlighted the benefits of working closely together to develop global accounting standards, including (1) combining the resources of the two Boards, (2) having the collective discussions of 20 members of the Boards to develop high-quality and sustainable decisions and (3) drawing upon existing networks of interested parties.

The Boards’ staff discussed the priority projects of revenue recognition, leases, insurance and financial instruments, and noted the IASB and FASB:

- Published joint exposure drafts for revenue recognition and leases
- Reached shared conclusions for insurance contracts, allowing the IASB to publish an exposure draft (ED) and the FASB to publish that ED as a Discussion Paper
- Developed a staff draft of an ED on financial statement presentation
- Completed the first phase of the Conceptual Framework
- Worked together on consolidations, fair value measurement, emissions trading schemes, financial instruments with the characteristics of equity, reporting entity and other smaller projects

The FASB staff noted the target dates (i.e., June 2011) for completing the major projects; however, the FASB staff stressed that the more important objective is to produce quality standards and observed that quality would not be sacrificed to meet an “arbitrary date.”

### How we see it – Completion of projects by June 2011?

Given both the SEC and the Boards’ emphasis on high-quality standards, while the Boards strive to meet the targeted completion date of June 2011 for priority projects, it wouldn’t be surprising if the Boards are unable to meet this deadline. Additional time may be required given the magnitude of the effects of the new standards on financial reporting, need for field testing certain aspects of the proposed standards and public outreach activities. This additional time spent on due process will further improve the chances of having global accounting standards that are widely accepted.

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36 [http://www.sec.gov/info/accountants/ocasubguidance.htm](http://www.sec.gov/info/accountants/ocasubguidance.htm)

37 The FASB and the IASB previously agreed to a “best efforts” convergence approach to make their standards fully compatible as soon as practicable.
Revenue recognition ED

The IASB and the FASB published a joint exposure draft proposing changes to how and when revenue is recognized under both IFRS and US GAAP. The comment period ended in October 2010. The FASB staff noted that the Boards have received significant feedback on the joint revenue recognition exposure draft through their outreach efforts, public roundtables and the nearly 1,000 comment letters submitted. The Boards’ staffs indicated that while constituents generally supported the revenue recognition model proposed in the exposure project, they raised concerns about certain aspects of the model and highlighted the need for further clarifications as discussed below:

Control – The proposed concept of transfer of control may need to be articulated differently for goods and services. In addition, the final standard needs to clarify under what circumstances the recognition of revenue based on a continuous transfer of control is deemed to be an appropriate method.

Performance obligations – The proposed separation criteria may need to indicate more clearly the objective of separation (i.e., to reflect the effects of differences in timing of delivery and differences in margins for the identified performance obligations) and in a manner that can be applied by all industries. In addition, the FASB staff indicated that the Boards would re-examine the proposed onerous obligation model because most respondents indicated that these types of obligations should be identified at a higher level than individual performance obligations (i.e., at the contract level or higher).

Transaction price – Respondents highlighted certain concepts that would be difficult to implement (e.g., probability-weighted estimates, collectability and time value of money), and therefore the costs may outweigh the benefits.

Accounting for warranties – Many respondents indicated they would prefer to keep the current model under US GAAP for accounting for warranties, given the complexities of separating warranties for latent defects and warranties that provide coverage beyond defects that existed at the time of sale. Failing that, respondents indicated that a model whereby all warranties are treated as a performance obligation would be preferable to the dual model proposed in the ED.

The Boards’ staffs acknowledged the significant amount of time required for these and other issues to be redeliberated, for the model to be refined, for further education of the investor and analyst community to take place, and for testing of the completed model and/or re-exposure to occur.

Lease ED

The FASB staff also discussed the joint leases project by discussing the terms of the exposure draft39 as well as summarizing initial feedback from outreach activities, including concerns about the following:

► The definition of lease term (defined as the longest possible term that is more likely than not to occur, including renewal options)
► Lease payments that include uncertain payments (e.g., contingent rentals) and are calculated using a probability-weighted approach
► The lessor model (conceptual basis and application of the performance obligation and derecognition approach)
► Lack of guidance for certain lease-specific matters (e.g., lease incentives, leasehold improvements)

The FASB staff noted that many of these concerns would be addressed in the Boards’ redeliberation.

Remarks of senior PCAOB officials

Acting Chairman highlights 2010 accomplishments

PCAOB Acting Chairman Daniel Goelzer39 focused on three areas: inspections, standard setting40 and enforcement.

Inspections – During 2010, the PCAOB conducted over 230 inspections covering portions of more than 900 audits. In September, the Board issued a report41 that highlights inspection observations about areas affected by the economic crisis. The report identifies the Board’s view of deficiencies in auditing of fair value measurements, impairment of goodwill, indefinite-lived intangibles and other long-lived assets, allowance for loan losses, off-balance sheet structures, revenue recognition, inventory valuation and income taxes. Goelzer commented, “In my view, the report neither shows that audit failures caused the financial crisis nor that better auditing could have prevented it. What it does show is that the major firms must do a better job in adjusting to emerging audit risks as economic conditions change so that investors will have reliable information about the performance and financial position of public companies under economic stress.”

39 For a detailed review of the joint leases project exposure draft, refer to our Technical Line, Proposed leases guidance exposed (BB1990) or our Financial Reporting Development publication, Proposed accounting for leases (BB2012).
38 The full text of the speech of PCAOB Acting Chairman Daniel Goelzer is available at: http://pcaobus.org/News/Speech/Pages/12072010_GoelzerAICPAConference.aspx
40 Refer to the section titled, Chief Auditor discusses standard setting, within this publication for a discussion of the PCAOB’s standard-setting activities.
41 The Report on Observations of PCAOB Inspectors Related to Audit Risk Areas Affected by the Economic Crisis can be found at: http://pcaobus.org/Inspections/Documents/4010_Report_Economic_Crisis.pdf
The PCAOB’s inspections process has continued to place emphasis on identifying the root causes of deficiencies and registered firms need to shift their internal inspection programs from identifying discrete audit deficiencies towards identifying and remediating the root causes of the deficiencies.

In 2011, PCAOB inspections will continue to focus on those areas previously mentioned, as well as exploring the effect, if any, that fee pressures may have had on audit performance. Goelzer noted that the PCAOB will also evaluate whether pressures on audit fees are the root cause of any identified audit deficiencies.

**Enforcement** – During 2010, the PCAOB opened 27 formal and informal investigations, which address a mix of both smaller- and larger-firm matters. In addition, the PCAOB announced settlements in seven proceedings.

Under SOX, the PCAOB may not publicize ongoing enforcement proceedings until it imposes sanctions. If an auditor that is the subject of an enforcement proceeding chooses to litigate that proceeding, it significantly delays the public’s knowledge about the matter. Goelzer stated, "I do not believe that investors, the general public, or the profession are well-served by enforcement that occurs behind closed doors.” As a result, the PCAOB has requested that Congress amend SOX to allow the PCAOB to make public any enforcement proceedings once the investigation is complete and the PCAOB has approved the charges.

Goelzer summarized the PCAOB’s priorities for 2011, which include:

**Broker-dealer audits** – One of the PCAOB’s most significant tasks in 2011 will be implementing its new responsibility for oversight of auditors of broker-dealers. Goelzer noted that this new responsibility would have a significant effect on the PCAOB’s work and require focus on three main areas:

- Developing auditing standards applicable to the audits of broker-dealers and attestation standards application to compliance reports
- Developing a broker-dealer audit inspection program
- Assessing and collecting a portion of its accounting support fee from broker-dealers

Goelzer expects that the PCAOB will begin proposing rules and discussing these areas in open meetings as early as December 2010.

**Foreign inspections** – In 2011, the PCAOB will have to address the “continuing obstacles to conducting inspections of auditors of US public companies in certain foreign jurisdictions.” While the PCAOB has conducted over 250 inspections of firms in over 30 different jurisdictions, at this time, the PCAOB cannot conduct inspections in several key jurisdictions, including China, the European Union and Switzerland.

Goelzer discussed the steps the PCAOB took during 2010 and possible additional responses the PCAOB may take in 2011 to address this issue. In 2010, to better explain to US investors what the PCAOB can and cannot do, the PCAOB included on its website clear disclosure of countries in which it cannot inspect the audits of registered audit firms and disclosure of those SEC registrants whose audits are not currently subject to inspection. The PCAOB also announced that it will no longer routinely approve registrations from auditors in jurisdictions in which it cannot inspect, in order to prevent the pool of uninspectable firms from growing.

Goelzer outlined other potential actions the PCAOB may consider taking in 2011 to evaluate that audits are being properly performed:

- Requiring disclosure in SEC-filed audit reports that the principal auditor was not subject to inspection
- Requiring disclosure, in the report of a principal auditor that uses the work of a non-US auditor, of (i) the identity of the firm not subject to inspection, (ii) the nature of the work performed by such non-US auditor and (iii) steps performed by the principal auditor to assess the adequacy of the work
- Requiring that the work performed by a firm not subject to PCAOB inspection be supervised and reviewed by a firm that is subject to inspection

Goelzer acknowledged that these options may “raise some difficult issues in terms of our relationships with other regulators and in terms of the way cross-border issuer audits are conducted.”

**The auditor’s reporting model** – The PCAOB, along with several other organizations such as the International Organization of Securities Commissions (IOSCO), the International Auditing and Assurance Standards Board (IAASB) and the European Commission, is revisiting the auditor’s reporting model. Goelzer acknowledged that the PCAOB “will have to make some difficult choices next year if it decides to change the time-honored pass/fail report.” There have been many suggestions about what should be included in the auditor’s report, such as more information about the audit process and how the auditor performed the audit, the auditor’s views on management’s judgments or a separate report similar to MD&A. There are also many questions about how the auditor would prepare such reports and what additional work would be required as part of the audit to prepare an expanded auditor’s report.

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42 SEC Release No. 34-62991 (September 2010) requires 2010 audits of broker-dealers to be performed in accordance with AICPA standards.
The Office of the Chief Auditor is conducting research to explore reporting model alternatives and plans to present its findings to the PCAOB at a public meeting in early 2011.

**Chief Auditor discusses standard setting**

PCAOB Chief Auditor Martin Baumann provided an overview of the current audit environment, PCAOB standards-setting activities and the potential audit implications related to the FASB/IASB convergence projects.

The current audit environment — Ongoing economic challenges and uncertainties continue to pose significant risks for financial reporting and auditing. Baumann provided several key reminders for auditors by referring to recent PCAOB Staff Practice Alerts and reports of the Board and commented that many of the auditing challenges described in these documents remain prevalent in the current audit environment.

Baumann discussed the following important matters related to the current economic environment that he believes will require additional auditor attention in 2010:

► Fraud risk — Fraud risk remains elevated in the current economic environment. Pressures on companies to meet earnings expectations and contain costs create incentives and rationalizations for financial reporting fraud. The recently released COSO study, *Fraudulent Financial Reporting: 1998-2007*, indicates that the CEO/CFO had some level of involvement in 89% of fraud cases and that fraudulent revenue recognition practices were identified in over 60% of fraud cases.

► Mortgage documentation — Recently, mortgage documentation has received widespread attention and may have audit implications including possible improper accounting for recourse liabilities, complexities in accounting for litigation or other loss contingencies and the related disclosures.

► Maintaining audit quality — Auditors should (1) plan and perform audits with “due professional care” and “exercise professional skepticism,” (2) remain focused on audit quality when responding to demands for significant audit fee reductions and (3) not reduce audit hours unless there is an identifiable decrease in audit risk or other commensurate change in circumstances.

**PCAOB standards-setting activities** — Baumann indicated that the PCAOB’s standard-setting process focuses on those standards in most need of improvement, responds to changes in the environment and attempts rebuild investor confidence. He expects the Board to take action on the following in the first half of 2011.

► Proposed standards to be adopted as a final standard: *Communications with Audit Committees and Confirmations*

► Concept releases on which to issue proposed standards — *Failure to Supervise and Signing the Audit Report in the Engagement Partner’s Name*

Baumann discussed the high-priority projects currently on the PCAOB standards-setting agenda, as well as two additional items that are not currently on the PCAOB’s standards setting agenda:

► Codification — Although a solution isn’t imminent, a project is underway to address the integration, or codification, of the PCAOB’s Interim Standards with subsequent PCAOB standards.

► Independence — The PCAOB regularly considers emerging issues potentially affecting auditor independence to determine if further rulemaking is necessary. Aware of the increase in non-audit services at many firms, the PCAOB is working through its Inspections Division to consider whether these services influence auditor independence.

**FASB/IASB convergence projects — potential audit implications** — The PCAOB is closely monitoring the FASB/IASB convergence projects. Baumann provided an overview of identified areas of concern in which the volume and nature of the accounting changes may have potential audit implications:

► The ability of preparers and auditors to absorb the extent of change

► The significant decrease in guidance in certain proposed standards

► The increase in judgments and estimates, as well as the use of fair value measurements, in proposed standards

The PCAOB, with advice of the Standing Advisory Group, will consider whether new auditing standards are necessary in light of the changes in the accounting framework, so that audit quality and the reliability of financial reports are not adversely affected.

**Interim SEC Review of PCAOB Inspection Reports**

Effective 7 September 2010, the SEC adopted Rule 140, *Interim Commission Review of PCAOB Inspection Reports*, of Regulation P to facilitate requests by registered auditing firms for interim Commission review of PCAOB inspection reports when the registered auditing firm is not able to resolve concerns about PCAOB inspection finding(s). The SEC hopes that most matters can be resolved between a registered auditing firm and the PCAOB.
without involving the SEC and expects a firm to address all matters identified through the PCAOB’s inspection process prior to requesting an SEC review. However, when concerns cannot be resolved, a firm may request a review by the SEC.

A registered auditing firm can request an interim review of any of its findings within 30 days of either the receipt of its final inspection report or within 30 days of receiving notice that the PCAOB determined that the registered firm didn’t appropriately remediate one or more quality control findings. However, in the latter case, the firm cannot request review of the original quality control finding if that request was not made within 30 days of receiving the final inspection report.

Rule 140 provides specific instructions regarding the information to submit to the SEC as part of requesting a review. The SEC advises firms to consider those instructions and comply with all aspects of the Rule prior to submitting their request. The SEC will make an initial determination as to whether to grant or deny the review request and any incomplete submissions may result in denial of the request. In addition, when requesting a review of an unfavorable determination by the PCAOB regarding the remediation of a quality control finding, firms should consider all points raised by the PCAOB in the report the firm receives from the PCAOB (sometimes referred to as a “4009 report”). The report from the PCAOB provides details regarding the Board’s determination that a firm should address when submitting a review request to the SEC. The SEC has noted some firms simply repeat their original submission to the PCAOB related to their remediation efforts without addressing the points raised in the PCAOB’s 4009 report, which may hinder the analysis as to whether to grant the review. The SEC staff has also stated that the SEC does not intend to routinely grant review requests absent indication of a valid concern.

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