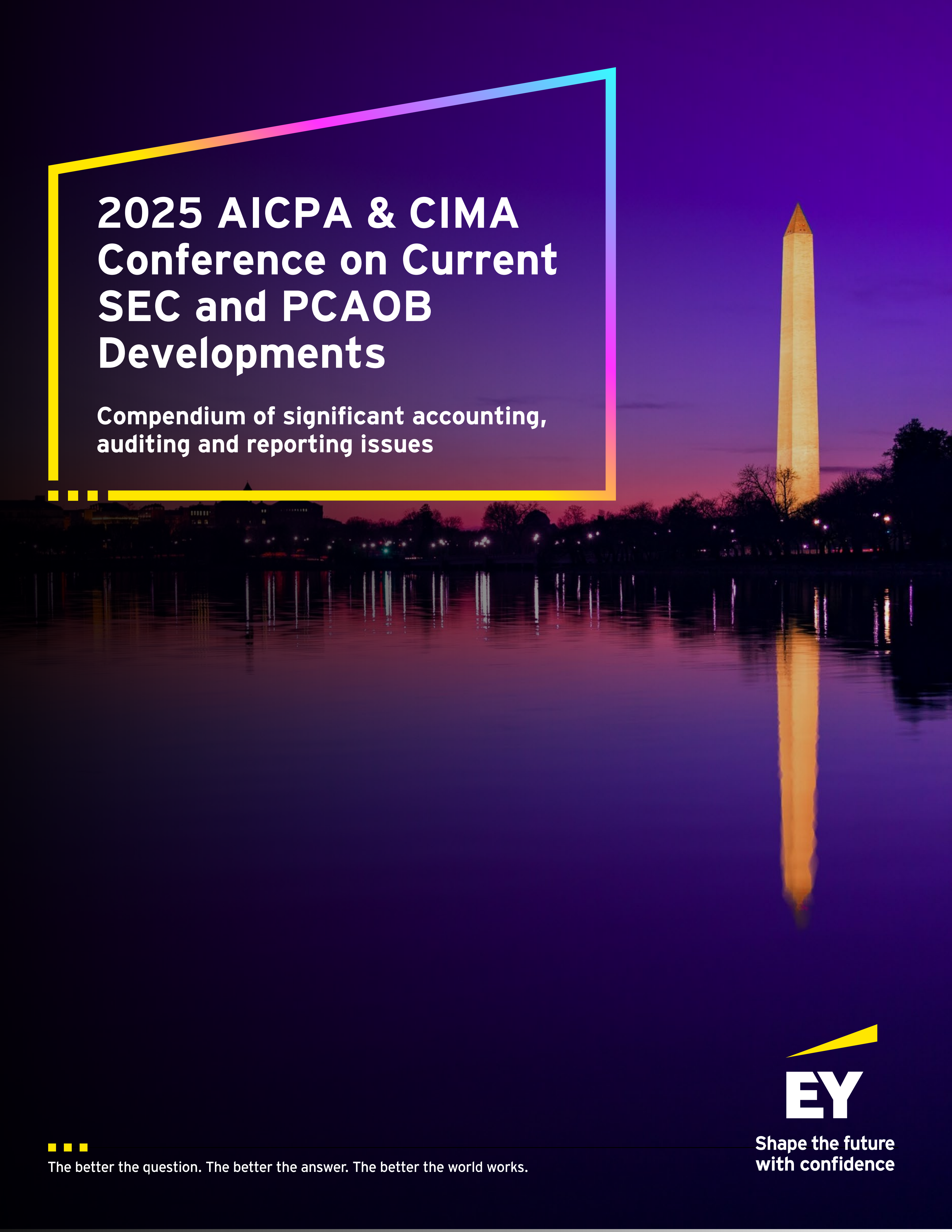

2025 AICPA & CIMA Conference on Current SEC and PCAOB Developments

Compendium of significant accounting, auditing and reporting issues

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Overview

Regulators and standard setters discussed a broad range of financial reporting and auditing topics this week at the annual AICPA[1] & CIMA[2] Conference on Current SEC and PCAOB Developments (Conference) in Washington, DC. The speakers and panelists included representatives of the Securities and Exchange Commission (SEC or Commission), including Chairman Paul Atkins, the Financial Accounting Standards Board (FASB or Board) and the Public Company Accounting Oversight Board (PCAOB), who shared their views on various accounting, financial reporting, auditing and regulatory issues.

Highlights included:

Audit quality and independence — Regulators and standard setters emphasized auditor integrity, objectivity and independence as vital for investor protection amid a changing landscape, including the emergence of artificial intelligence (AI) and alternative firm structures. SEC Chief Accountant Kurt Hohl highlighted the PCAOB's role in enhancing audit quality and encouraged the PCAOB to focus on firm-level systems of quality control in inspections.

International coordination — Mr. Hohl called for greater convergence between US and international auditing and accounting standards to lower compliance costs, reduce complexity and promote consistency across the financial reporting system. He discussed the importance of high-quality international accounting standards given the significant market capitalization of foreign companies listed on US markets. He also noted the SEC's monitoring of changes in the governance and funding of the IFRS Foundation and the SEC's interest in addressing the governance complexity at the International Auditing and Assurance Standards Board (IAASB) and the International Ethics Standards Board for Accountants.

AI — Speakers addressed the opportunities and risks of using AI in financial reporting and its role in reshaping the auditing profession. The SEC staff emphasized that registrants need a governance structure with the appropriate expertise to develop strategies, policies and guidelines for AI implementation, and that auditors should consider companies' use of AI in risk assessments. The SEC staff also provided key reminders for auditors evaluating an entity's use of AI in internal control over financial reporting, including the need to understand and document the model's design and the importance of maintaining human oversight in AI-driven internal controls.

Disclosure reform — Mr. Atkins called for efforts to combat the declining number of public companies, with an emphasis on the need for streamlined disclosures grounded in materiality and reduced complexity in financial reporting. He said that SEC rule proposals to address these matters are expected in the next year. Mr. Hohl also discussed the joint effort between the SEC and FASB to balance timely accounting standard setting with robust cost-benefit analyses.

Accounting and SEC reporting updates — The SEC staff highlighted accounting complexities in emerging issues, including private credit lending, stablecoins and AI data centers. The staff discussed considerations for determining the predecessor and the financial statements required when certain registrants enter into license arrangements, as well as spin-off and "put-together" transactions. The staff also shared observations on segment disclosures following the adoption of the FASB's Accounting Standards Update (ASU) 2023-07 and on financial statement presentation. The FASB provided updates on the items on last year's technical agenda and stressed the importance of stakeholder involvement in the standard-setting process.

Remarks by SEC Chairman

Mr. Atkins said the auditing profession should "get back to basics" and emphasized integrity, objectivity and professional skepticism as the cornerstones of investor protection.

When asked about the SEC's priorities and regulatory agenda, Mr. Atkins noted the decline in the number of public companies over the last three decades and called for efforts to "make IPOs great again." He identified disclosure overload, litigation risk and governance challenges as three barriers to companies becoming and remaining public. He also called for streamlined disclosures that are grounded in materiality and for reducing unnecessary complexity in financial reporting, citing examples related to the current length of companies' risk factor[3] and executive compensation disclosures. Mr. Atkins said he expects rule proposals to be issued on these topics in the next year.

On crypto-related regulation, Mr. Atkins said the SEC will propose rulemaking to provide clear guidelines for crypto markets and transactions. He said the SEC is focused on bringing normalcy to the crypto landscape without stifling innovation and will no longer regulate the crypto markets through enforcement. He emphasized the SEC's collaboration with the Commodity Futures Trading Commission and Congress to reduce uncertainty for market participants.

Mr. Atkins also discussed the SEC's oversight of the PCAOB and emphasized auditor independence and improving audit quality as key priorities. He cautioned audit firms about prioritizing their interests over investor needs and noted that alternative practice structures and private equity investments could create independence issues.

> "[…] we're going to insist on […] the rigorous independence and objectivity that the investors expect of auditors and accountants.
>
> — Kurt Hohl
> SEC Chief Accountant

Remarks by SEC Chief Accountant

Mr. Hohl outlined an ambitious agenda for the SEC's Office of the Chief Accountant (OCA) focusing on emerging issues, oversight of the FASB and PCAOB, and improving audit quality.

OCA is responding to emerging issues, such as AI and digital assets, to understand their effect on financial accounting and reporting, the development of auditing guidance and independence. Mr. Hohl echoed Mr. Atkins' remarks that audit firms' alternative practice structures and private equity investments create both opportunities and challenges, and he noted that OCA is focused on the related risks to auditor independence and objectivity.

Mr. Hohl discussed the PCAOB's importance to the capital markets and credited the organization with enhancing audit quality since its inception. He questioned whether the PCAOB should focus its inspections more on an audit firm's system of quality control, especially in light of the recent quality control standards issued by the PCAOB and the IAASB. He said by doing so, the PCAOB could reduce the number of individual engagement-level inspections and stressed that this approach could help hold firm leadership more accountable, instead of individual engagement teams.

Regarding inspection reports, Mr. Hohl questioned whether they effectively communicate audit quality. He highlighted his discussions with stakeholders about how they use PCAOB inspection reports. He noted that focusing PCAOB inspections more on a firm's system of quality control could allow the PCAOB to provide helpful context in inspection reports, but the restrictions in the Sarbanes-Oxley Act of 2002 (SOX) on quality control observations might make this challenging.

Mr. Hohl said the PCAOB's standard-setting agenda will be an important focus for the new PCAOB chair, who will be appointed by early next year. He urged the new chair to consider holding a public consultation on the standard-setting agenda, similar to what the FASB recently did. Mr. Hohl asked preparers to participate in the PCAOB's standard-setting process and encouraged stakeholders to consider ways to solicit that participation.

Some level of convergence between the PCAOB's standards and the IAASB's International Standards on Auditing (ISA) would be beneficial, Mr. Hohl said, noting that most large firms use the ISAs as the basis of their audit methodologies. However, he recognized the need for some differences between PCAOB standards and the ISAs and encouraged the PCAOB to identify where deviations would be most appropriate. He stressed that convergence could lower costs, reduce complexity and promote compliance throughout the financial reporting ecosystem, particularly related to audits of multinational entities.

Regarding international audit and ethics standards, Mr. Hohl observed they are governed by a complex structure involving multiple oversight bodies to address independence issues. He said that financial challenges and governance complexities raise concerns about whether the IAASB can continue to develop high-quality auditing standards and stressed the need for more involvement and support from the US if the PCAOB pursues using the ISAs as a baseline.

Mr. Hohl said that he and FASB Chairman Richard Jones would like to balance timely accounting standard setting with robust cost-benefit analyses. He cautioned against disclosure requirements that add complexity and high compliance costs that could dissuade companies from accessing the public market.

He also called for global convergence of accounting standards and urged cooperation between the FASB and the International Accounting Standards Board (IASB). He reiterated the importance of high-quality international accounting standards and noted the SEC's monitoring of changes in the governance and funding of the IFRS Foundation. Additionally, he said since the IFRS Foundation established the International Sustainability Standards Board (ISSB), it has allocated more funding to the ISSB and the development of sustainability standards than to the development of accounting standards.

FASB update

Mr. Jones emphasized the importance of stakeholder involvement in the FASB's standard-setting process and indicated the FASB and its staff have substantially completed all of the items on last year's technical agenda.

Mr. Jones said the FASB seeks to develop financial accounting and reporting standards that result in accounting that reasonably depicts the economics of a transaction. He said the Board takes into consideration the perspectives of investors, preparers and auditors when setting standards. Mr. Hohl and OCA Senior Associate Chief Accountant Gaurav Hiranandani encouraged stakeholders to engage early in the FASB's standard-setting process and provide detailed feedback, including the implementation costs of proposed changes.

FASB Technical Director Jackson Day summarized the invitation to comment (ITC) process. Mr. Jones discussed the recent ITCs seeking feedback related to the accounting for intangibles and financial key performance indicators. He outlined how the FASB determines which projects are included on the technical agenda each year.

Mr. Jones also discussed the post-implementation review (PIR) process, which begins immediately after a standard is issued. He said that its purpose is to determine whether the standard works, whether outcomes are inconsistent with the Board's intentions and whether there are potential lessons to be learned for future standard setting.

Mr. Jones, Mr. Day, FASB Deputy Technical Director Helen Debbeler and FASB Deputy Technical Director Rosemarie Sangiuolo discussed recent projects. Ms. Debbeler highlighted the FASB's recently issued ASUs related to the accounting for and disclosure of internal-use software costs, government grants, and credit losses for accounts receivable and contract assets. Ms. Debbeler also provided an update on the expected ASU on the accounting for environmental credit programs. Ms. Sangiuolo discussed the FASB's recently issued ASUs related to derivative scope refinements, purchased seasoned loans and hedge accounting.

How we see it

We believe that stakeholder input on FASB projects is important to the standard-setting process. We encourage stakeholders to provide practical feedback to the FASB on its exposure drafts, ITCs and agenda consultation process, including proposing actionable solutions for challenging or complex accounting models or transactions.

> "Independence is the linchpin of credibility, and without credibility the audit loses its meaning.
>
> — George Botic
> PCAOB Acting Chair

Remarks by PCAOB Acting Chair

PCAOB Acting Chair George Botic said the PCAOB's efforts have strengthened the financial reporting system and benefited investors. He outlined inspections, standards and transparency as key areas of investor protection provided by the PCAOB.

PCAOB inspections have an important role in promoting audit quality, Mr. Botic said, noting that PCAOB inspection teams work globally and consist of experts with significant audit experience. He cited research showing that in non-US inspections, companies audited by PCAOB-inspected auditors tend to raise more capital when their auditors receive positive inspection reports. Additionally, he said preliminary results for 2025 indicate a decrease in Part I.A findings, suggesting improvements in audit quality.

Mr. Botic highlighted the importance of strong auditing standards for reliable financial reporting and said that the audit of internal control over financial reporting and the adoption of the PCAOB's quality control standard, QC 1000, *A Firm's System of Quality Control*, both enhance audit quality. He encouraged firms to pilot aspects of QC 1000 before it officially takes effect on 15 December 2026, saying this would improve implementation of the standard by allowing firms to share their experiences with PCAOB staff to identify areas needing further guidance.

Additionally, he stressed that transparency is crucial for building investor confidence. He pointed to Form AP and critical audit matters (CAMs) as important tools for providing investors with insights into the auditor's work.

Mr. Botic said emerging technologies like AI and new firm ownership structures, such as private equity investments, are reshaping the auditing profession. He said that AI can bring benefits by automating manual tasks, improving risk assessment and allowing auditors to analyze large data sets more efficiently. However, he warned that relying too much on AI could undermine critical thinking, professional skepticism and judgment, leading to potential risks.

While private equity investments can provide resources for technology, recruitment and growth, Mr. Botic cautioned that the pressure to deliver high returns might lead to cost-cutting and aggressive profit-focused strategies that could compromise audit quality. He also expressed concerns that consolidation in the industry could limit auditor choices for smaller public companies.

Mr. Botic urged auditors to focus on five key priorities during year-end audits: maintaining independence, gaining a deeper understanding of the client's business, exercising professional skepticism, allowing enough time for audits and identifying potential CAMs. These priorities act as safeguards to protect audit quality and maintain investor trust, he said.

Remarks by Director of the Division of Corporation Finance

Division of Corporation Finance (DCF) Director James Moloney encouraged stakeholders to be engaged in the active SEC rulemaking period ahead and said that the SEC expects to propose a change to semi-annual reporting with the option to report quarterly for SEC registrants. He also highlighted DCF's efforts to review the backlog of over 1,000 registration statements following the recent federal government shutdown. He said that while the filings are being reviewed on a first-in, first-out basis, the SEC staff is prioritizing initial public offerings (IPOs).

Remarks by OCA staff on emerging accounting matters

Private credit lending by investment companies

SEC Professional Accounting Fellow Ella Karafiat noted the rising demand for private credit originating from entities outside the traditional banking sector, including private equity funds and business development companies. She said private credit encompasses a variety of structures, such as corporate direct lending, infrastructure debt and asset-based lending.

Private credit providers, such as private equity funds and business development companies, generally apply Accounting Standards Codification (ASC) 946, *Financial Services — Investment Companies*, which stipulates that investments are required to be measured at fair value according to ASC 820, *Fair Value Measurement*. Ms. Karafiat highlighted the inherent illiquidity of private credit instruments and their frequent lack of market transactions or observable data points, leading preparers to rely on unobservable (Level 3) inputs when determining fair value.

She reminded registrants that ASC 820 requires Level 3 inputs to represent market participant assumptions. Therefore, when using proprietary data, entities should consider whether adjustments are necessary to reflect market participant assumptions. For instance, if the credit risk associated with a loan increases, the valuation should include a risk premium to compensate market participants for this change during remeasurement.

Ms. Karafiat also emphasized the requirement under ASC 820 for entities to calibrate valuation techniques when an internal model initially produces a fair value different from the transaction price. This is important to make sure that the valuation technique does not generate artificial gains or losses in subsequent measurements.

Additionally, Ms. Karafiat stressed the importance of Rule 2a-5 under the Investment Company Act of 1940, which governs valuation practices and outlines the responsibilities of the board of directors in good faith fair value assessments.

Accounting for stablecoins

The accounting for digital assets continues to be a frequent topic of consultations, Ms. Karafiat noted. She described two recent consultations involving stablecoins.

One of them related to whether a stablecoin issuer should recognize reserve assets and the related redemption obligation on its balance sheet. In this fact pattern, the stablecoins were required to be fully backed by reserve assets, which were limited to specific assets such as short-term treasuries, and they were segregated from the issuer's other non-reserved proprietary assets. The issuer proposed that it should not recognize the reserve assets and the related redemption obligation on its balance sheet because it did not control the assets since the reserves were held in segregated accounts and subject to regulatory investment limitations.

The SEC staff objected to the issuer's accounting on the basis that the issuer (1) is a regulated stablecoin issuer, (2) is the sole obligor to redeem the stablecoins and (3) controls and manages the reserve assets within regulatory constraints, allowing the issuer to benefit from the resulting yield. Ms. Karafiat said that recognizing the reserve assets on the balance sheet provides investors with decision-useful information about the nature and value of the reserves relative to the redemption obligation for outstanding stablecoins.

In the second fact pattern, a registrant concluded that it was acceptable to classify a US dollar-pegged stablecoin as a cash equivalent in accordance with ASC 230, *Statement of Cash Flows*, noting that cash equivalents are defined as short-term, highly liquid investments that meet certain criteria. The registrant's conclusion was supported by the fact that the stablecoin issuer is subject to regulations requiring its stablecoins to be fully backed by an equivalent amount of specified liquid assets that otherwise meet the definition of cash equivalents, and that the registrant's agreement with the stablecoin issuer guaranteed redemption within two business days. Based on the registrant's facts and circumstances, the SEC staff did not object to classifying the stablecoin as a cash equivalent.

Accounting for AI data centers

Ms. Karafiat said that the expansion of AI presents potential accounting complexity and that it is important to consider how to apply existing guidance to AI, using the lifecycle of data centers as an example. She observed that there may be many parties involved in the development and operation of data centers, including the entity developing the AI, the entity financing construction and the entity providing energy sources, among others.

She noted that if the entity holding the data center is a variable interest entity (VIE), each variable interest holder would determine whether it is the primary beneficiary by evaluating whether it has (1) power over the activities that most significantly impact the VIE's economic performance and (2) an obligation to absorb losses or a right to receive benefits that could be significant to the VIE. One key aspect of this assessment is identifying those activities that most significantly impact the VIE's economic performance. Over the life of a VIE, such activities may include design and construction, leasing, operations and maintenance, and remarketing. This assessment requires significant judgment and is based on individual facts and circumstances.

Ernst & Young LLP resources

- *Financial Reporting Developments*, **Consolidation**
- *Financial Reporting Developments*, **Lease accounting**
- *Financial Reporting Developments*, **Impairment of long-lived assets**

Ms. Karafiat said that registrants should consider whether arrangements contain a lease (e.g., leasing a data center or power plant). She said lessees should evaluate their involvement in the construction of the asset since it may affect their accounting, including whether the lessee controls the asset during construction and is required to recognize the asset (i.e., construction in progress), and the determination of the lease commencement date.

She also reminded preparers that the evaluation of useful lives of long-lived assets, including those fixed assets within data centers, should be reassessed when there are indicators that an adjustment to the useful life could be necessary, which is not limited to when an impairment is recognized. She said the recognition of an impairment charge should not be viewed as an acceptable substitute for choosing the appropriate initial amortization or depreciation period or for subsequently adjusting this period as company or industry conditions change.

Additionally, she said that if an entity is performing a recoverability test of its long-lived assets, ASC 360, *Property, Plant, and Equipment*, requires an estimate of cash flows based on the entity's assumptions about its use of an asset or asset group, which should incorporate all available information. This includes information used by the entity in budgets and projections, incentive compensation or other information communicated to stakeholders.

Derivative scope exception for certain forward natural gas sales contracts

OCA Associate Chief Accountant Jonathan Duersch discussed the application of the normal purchases and normal sales (NPNS) scope exception to derivative accounting for certain forward natural gas sales contracts.

Mr. Duersch said the expansion of the liquified natural gas (LNG) market has resulted in an evolution of the pricing terms used in certain natural gas contracts. He noted a recent fact pattern that involved a contract for the sale of natural gas that was produced and delivered in the US but priced based on the Dutch Title Transfer Facility (TTF) index with a fixed percentage discount, which are not common pricing terms in the US.

One of the criteria in ASC 815, *Derivatives and Hedging*, that needs to be met to qualify for the NPNS scope exception is that any price adjustments must be clearly and closely related to the asset being sold, as discussed in ASC 815-10-15-30 through 15-33.

In evaluating whether the adjusted TTF index price is clearly and closely related to natural gas being sold in the US, the SEC staff considered, among other factors, whether other market participants use similar pricing terms for natural gas sales in the same US location, and whether the pricing is consistent with delivery of the natural gas to Europe (i.e., the fixed percentage adjustment to the TTF price index is a reasonable approximation of the cost that would be incurred by the buyer to deliver the natural gas to a European location, considering costs for liquification, transport and regasification). Mr. Duersch emphasized that this assessment would not require the seller to consider the buyer's ultimate use of the gas but would consider whether the pricing components known to the seller align with the delivery of the natural gas into the relevant European market.

In this fact pattern, the SEC staff concluded it would not object to the view that pricing based on the TTF index with a fixed percentage reduction was clearly and closely related to the natural gas being sold. Mr. Duersch said judgment is required based on the facts and circumstances of each transaction, particularly transactions in new or emerging markets that may have limited transparency.

Remarks by OCA staff on audit matters

AI in financial reporting

OCA Senior Associate Chief Accountant Nigel James discussed how OCA is monitoring AI use by preparers and auditors, focusing on the evolving risks and benefits. He referenced a report by the International Organization of Securities Commissions, ***Artificial Intelligence in Capital Markets: Use Cases, Risks, and Challenges***, that highlights how organizations are using AI for decision-making in areas such as investment research and compliance monitoring.

Mr. James said the rise of AI has led to new risk management and governance frameworks and emphasized the need for effective risk assessment by management and auditors, along with strategies to address emerging risks. He also emphasized the importance of those responsible for corporate governance having the right expertise to develop the strategies, policies and guidelines needed for AI implementation.

OCA Senior Associate Chief Accountant Anita Doutt said auditors evaluating an entity's use of AI in internal control over financial reporting need to understand and document how AI models are designed to perform their tasks, including the data and assumptions they use. She emphasized the importance of maintaining human oversight and involvement in AI-driven internal controls and discussed how the risk of fraud may evolve with increased AI use, including data poisoning and prompt engineering. She said auditors and issuers need to thoroughly understand and document model design and data integrity.

Additionally, Ms. Doutt said auditors need to adjust their approach when assessing an entity's IT general controls for AI models compared to traditional IT systems. She said AI models present unique risks, such as model drift and changes from third-party vendors, that require more proactive and frequent monitoring by both the registrant and the auditor.

How we see it

As companies explore increased use of AI in internal control over financial reporting, they will need to consider how it changes identified risks or introduces new risks. It is important for issuers and auditors to communicate early and often as AI continues to develop and risk assessments become more dynamic.

Auditing digital assets

OCA Associate Chief Accountant Fariba Nasary said current auditing standards were not designed with today's digital assets in mind and stressed the need for flexibility in standard setting and global alignment to promote audit quality. She highlighted how identifying diversity in practice has been informative to the SEC and PCAOB, including varying approaches to evaluating audit evidence, confirmations, custodial arrangements, and rights and obligations. Ms. Nasary said there may be value in creating additional or new standards as these technologies continue to develop to promote consistency, align regulatory and stakeholder expectations, and avoid expectation gaps.

Auditor independence

Ms. Doutt encouraged consultation related to auditor independence matters. She highlighted the concept of a financial reporting oversight role (FROR) and said that while Rule 2-01(f)(3)(ii) of Regulation S-X lists specific titles that qualify as FRORs (e.g., chief financial officer, chief accounting officer), issuers and auditors should not focus only on job titles when deciding if a role is a FROR.

Audit team members are required under Rule 2-01(c)(2) of Regulation S-X and SOX Section 206 to wait one year (a "cooling off" period) before taking on a FROR at that audit client. Ms. Doutt cautioned issuers against changing the responsibilities of a role that would normally be considered a FROR to comply with the cooling off period, noting that while this tactic might technically follow SEC independence rules, it goes against the spirit of the regulations.

Ms. Doutt also discussed the importance of partner rotation and encouraged professionals to reach out to OCA if they face unusual cases not clearly addressed by the current guidance.

She discussed a situation where a partner worked as an other engagement partner (i.e., not the lead partner) on the audit of a private company for one year. If that private company later went public, and the partner became the lead partner for the audits related to the IPO, which includes three years of financial statements, they would end up signing one PCAOB audit opinion for all three years. Ms. Doutt said the SEC staff's view in this case aligns with **FAQ G3 from their Frequently Asked Questions on the Application of the Commission's Rules on Auditor Independence**. This partner would only have served one year toward their lead partner rotation period, since they acted as the lead partner for all three years covered in the PCAOB audit opinion at the same time.

QC 1000, A Firm's System of Quality Control

Ms. Nasary discussed the importance of quality control standards PCAOB QC 1000 and IAASB International Standard on Quality Management (ISQM) 1. She noted that the effective date for QC 1000 has been deferred a year and highlighted some common concerns from comment letters sent by stakeholders regarding the challenges of implementing QC 1000. Many firms said that they would need to invest significant time and resources to create new systems and processes to comply with requirements that differ from those in ISQM 1.

Ms. Nasary said stakeholders were also concerned that firms might reach different conclusions about the effectiveness of quality control systems when using the QC 1000 framework compared to the ISQM 1 framework. She encouraged firms to consider such differences and how they will affect their audits.

Ms. Doutt said these quality control standards are leading to a major change in how firms perceive their systems of quality control. She echoed Mr. Hohl's comments and suggested that the PCAOB evolve its inspection program to include an assessment of a firm's quality control system, using engagement-level inspections to verify inspection observations at the system of quality control level.

Division of Corporation Finance practice matters

Predecessor determination and financial statement presentation

DCF Chief Accountant Heather Rosenberger said that predecessor determinations have become increasingly complex amid the rise in spin-offs and structures that involve the combination of multiple entities in a put-together transaction. She reminded registrants that identifying a predecessor hinges on whether the registrant has succeeded to substantially all of an assumed or acquired business, such that its historical operations before the succession appear insignificant in comparison. Ms. Rosenberger emphasized the SEC staff's views are based on the nature of each transaction.

Spin-off transactions

DCF Associate Chief Accountant Tricia Armelin said that the financial statements presented for a predecessor in a spin-off transaction may vary. She noted that, in some cases, they may consist solely of what an investor is ultimately investing in or they may reflect more than that. She said this difference could be caused by the legal form of the transaction in which, for tax or other reasons, a registrant could transfer to a SpinCo — a legal entity that historically consisted of multiple subsidiaries, not all of which will become a part of SpinCo.

Ms. Armelin said that in determining the financial statement requirements, the SEC staff considers how the business being spun off has historically operated and whether investors have seen separate results of the spun-off business. She provided two examples to illustrate the analysis of these factors.

In the first example, an existing registrant (i.e., the spinnor) was spinning off one of several business lines (i.e., the spinnee). The spinnee's operations had been comingled with other business lines in hundreds of legal entities. Ms. Armelin said the following factors were considered in determining the predecessor financial statement presentation: (1) the spinnee did not directly or indirectly hold assets, liabilities or operations related to the spinnor's continuing business at any point because, while the spinnee consisted of various legal entities, these legal entities were transferred only after the assets, liabilities, and operations staying with the spinnor were carved out; and (2) the business line being spun off had historically been a reportable segment of the spinnor and operated independently of other business lines.

The SEC staff viewed the registrant's proposal to present predecessor financial statements consisting solely of the assets, liabilities and operations being spun off as reasonable and noted that including the historical results of all of the related legal entities would have been quantitatively distortive to the financial statements.

In the second example, an existing registrant (i.e., the spinnor) was spinning off a legal entity (i.e., the spinnee) that held all of the historical operations for a particular foreign country. Ms. Armelin said that, while a few of the business lines that historically operated in the foreign country were not ultimately contributed to the spinnee (i.e., were retained by the spinnor), the historical business lines in the foreign country were complementary, had shared services and financing, and had the same chief executive officer and management.

The SEC staff determined the predecessor financial statements should reflect the entire historical results of the legal entity being spun off to provide a complete presentation consistent with how the transferred operations were historically managed and operated. Ms. Armelin said that in this fact pattern, the effects of the business lines that would not be contributed to the spinnee could be depicted in pro forma financial information.

Put-together transactions

DCF Acting Deputy Chief Accountant Melissa Raminpour said that while in many cases a predecessor is the accounting acquirer in a transaction, put-together transactions are a notable exception. In these transactions, even if a new registrant, or NewCo, is substantive and deemed the accounting acquirer, one or more of the acquired businesses would be viewed as predecessors because NewCo's operations appear insignificant compared to those of the acquired predecessor(s).

Ms. Raminpour reminded registrants that the SEC staff considers the acquisitions' timing, fair value and size, as well as the ongoing management structure, in determining the predecessor(s) in a put-together transaction. She said that although the identification of multiple predecessors is uncommon, put-together transactions are an example of the limited situations where more than one predecessor may be identified.

License arrangements

Ms. Raminpour said the SEC staff has received questions about the consideration of license arrangements as predecessors, particularly in the life sciences sector. She noted license arrangements may be viewed as operating rights that represent the acquisition of a business for SEC reporting purposes. She said this may result in circumstances in which the licensor, or a carve-out of the licensor's operations, is the predecessor, because the registrant is succeeding to the acquired business, and its historical operations are insignificant in comparison. Ms. Raminpour said that license arrangements may not represent the acquisition of a business in every instance.

How we see it

Determining whether a license arrangement constitutes a business requires an evaluation of the facts and circumstances as described in Rule 11-01(d) of Regulation S-X. A registrant must determine whether there is sufficient continuity of operations before and after the transaction so that disclosure of prior financial information is material to the understanding of future operations.

Ms. Raminpour highlighted areas that the SEC staff considers in determining the relevance of the licensor information to the predecessor financial statements, including the stage of development (with earlier discovery stages typically resulting in less comprehensive or relevant predecessor information than when the license is in a more advanced stage of the process, such as clinical development) and the terms of the license (including the licensee's permitted uses and how they compare to the licensor's use of the technology).

Ms. Armelin also discussed examples of fact patterns involving license arrangements. In the first fact pattern, a newly formed registrant entered into a license arrangement related to drug discovery (i.e., an in-license arrangement where the registrant was the licensee). The registrant intended to take on the discovery work and continue on with development work. The SEC staff determined a carve-out of the licensor's related drug discovery work was the predecessor because the registrant succeeded to the licensor's discovery activities. However, because an income statement and statement of cash flows would have consisted of a single line item for research and development (R&D) and there were no associated assets or liabilities, the SEC staff accepted quantitative disclosures in the audited notes to the financial statements instead of separate predecessor carve-out financial statements.

In the second fact pattern, a newly formed registrant entered into a license arrangement for intellectual property (IP) that it intended to use for the development and commercialization of a drug to treat a specific health condition. The licensor had historically used the IP to develop a drug to treat a different health condition, but the license allowed the registrant to use the IP for any potential use. Additionally, the data from the licensor's clinical trials was preserved for the registrant's use. The SEC staff determined that the registrant was succeeding to the licensor's related historical operations and that predecessor financial statements should be presented. However, the SEC staff accepted the presentation of abbreviated financial statements, given unique challenges the registrant would have faced in preparing a complete carve-out.

In the third fact pattern, a registrant had previously licensed its drug discovery program to a third party (i.e., it had entered into an out-license arrangement where it was the licensor). In a spin-off transaction, the registrant terminated the license arrangement and transferred cash, equity instruments and certain tax liabilities to a SpinCo, which entered into a new license arrangement with the same third party. The SEC staff determined that SpinCo did not succeed to any operations, and therefore, there was no predecessor because (1) the third-party licensee did not express interest in the registrant's historical or ongoing discovery work, (2) no aspect of the registrant's R&D was transferred to SpinCo and (3) SpinCo's business model focused on acquiring other biotech companies to conduct discovery work.

Ms. Rosenberger encouraged registrants to engage with the SEC staff when facing unique fact patterns to make sure that the appropriate financial statements are included in registration statement submissions to streamline the review process. She also underscored the importance of auditor involvement early in the process, including the firm's national office when appropriate. She said this is particularly important when the registrant's accounting analysis may help inform the SEC staff's view on the reporting conclusions.

Financial reporting requirements for forward and reverse spin-off transactions

Ms. Armelin discussed key differences between the SEC's filing requirements for a transaction accounted for as a forward spin-off and one accounted for as a reverse spin-off under US GAAP. She said that when the shares of the legal spinnee in a forward spin-off are registered, audited carve-out financial statements of the legal spinnee (which is also the accounting spinnee) are presented in the registration statement.

In contrast, Ms. Armelin highlighted that when a reverse spin-off occurs (i.e., the legal spinnee is the accounting spinnor), the legal spinnee's registration statement typically includes two sets of audited financial statements: the financial statements of the existing registrant (i.e., the legal spinnor and accounting spinnee) and the carve-out financial statements of the legal spinnee (i.e., the accounting spinnor). Ms. Armelin said when a reverse spin-off results in substantially all operations of the existing registrant being spun off, the SEC staff may allow the registration statement to only include the financial statements of the existing registrant.

After a reverse spin-off has occurred, the existing registrant will undergo a change in reporting entity. Accordingly, the historical financial statements that will be required in subsequent periodic filings for the existing registrant, which is the legal spinnor and accounting spinnee, would reflect the financial statements of only the retained business. Ms. Armelin said the financial statements of the legal spinnee (i.e., the new registrant) will reflect those of the existing registrant and discontinued operations, if the applicable criteria are met, of the operations retained by the existing registrant.

Segment reporting

DCF staff provided observations on segment disclosures under ASC 280, *Segment Reporting*, based on its filing reviews following the adoption of ASU 2023-07, *Segment Reporting (Topic 280): Improvements to Reportable Segment Disclosures*.

Disclosure of how the CODM uses reported segment profit or loss measures

DCF Associate Chief Accountant Jarrett Torno said the SEC staff has observed instances where the disclosure required by ASC 280-10-50-29(f) of how the chief operating decision-maker (CODM) uses each reported measure of segment profit or loss was omitted or incomplete, such as describing the measure used by the CODM without explaining how it is used. He suggested that registrants consider the examples in ASC 280-10-55-47(bb) when preparing their disclosures.

Determining the required measure of segment profit or loss

Mr. Torno shared examples illustrating how the staff approaches the identification of the measure of segment profit or loss required to be disclosed under ASC 280-10-50-28 (the required measure) when multiple measures are used by the CODM to assess performance and allocate resources. He reminded registrants that ASC 280 states the required measure is the measure most consistent with US GAAP.

Mr. Torno said when the CODM only uses non-GAAP measures, registrants should evaluate each measure's related adjustments, including the relative revenue and expense line items that have been excluded. For example, if the CODM uses earnings before interest, taxes, depreciation and amortization (EBITDA) and adjusted EBITDA that also excludes restructuring charges, EBITDA would be the required measure because the exclusion of restructuring charges in adjusted EBITDA increases divergence from US GAAP.

As another example, if the CODM uses adjusted gross profit and adjusted operating income, and both only exclude stock-based compensation, adjusted operating income would be the required measure because it includes additional US GAAP expense line items relative to adjusted gross profit.

Mr. Torno emphasized these examples were not exhaustive, and registrants should carefully consider their facts and circumstances when determining the required measure.

Single reportable segment entities

Ms. Raminpour said the SEC staff has observed instances where registrants with a single reportable segment included only a reference to the primary financial statements and did not include all of the required disclosures. She said that while ASC 280 allows entities to reference the primary financial statements to avoid duplicate disclosures, such reference alone may not be sufficient. That is because some required disclosures by their nature cannot be addressed through a reference to the primary financial statements (e.g., disclosure of factors used to identify the reportable segment, identification of the CODM, disclosure of how the segment measure of profit or loss is used by the CODM).

Even when a single reportable segment entity reports consolidated net income as the required measure, Ms. Raminpour said the application of the significant segment expense principle may require disclosure of additional segment expense categories when the significant segment expenses regularly provided to the CODM are different from those presented in the consolidated income statement. In such cases, a reference to the consolidated income statement alone would not be appropriate.

Conversely, if a registrant determines that referencing the consolidated income statement is appropriate because the expense information that is regularly provided to the CODM is the same as that presented therein, the registrant should make that clear in the disclosure, so readers understand that the CODM is not receiving additional information beyond what is presented in the consolidated income statement.

Significant segment expenses

Mr. Torno reminded registrants that when they are not required to disclose significant segment expenses for one or more of their reportable segments, they are required to provide disclosure of the nature of the expense information used by the CODM for each of those segments.

For example, if significant segment expenses are disclosed for five of a registrant's six reportable segments, the disclosure requirement would apply to the sixth reportable segment where expense information is not disclosed. Mr. Torno also reminded registrants that a qualitative description is required for the composition of the other segment items for each reportable segment, even when no significant segment expenses are disclosed.

Mr. Torno said the SEC staff has observed disclosures where it is unclear how a reported significant segment expense is measured or what amounts are included in the significant expense category (e.g., the disclosure of adjusted general and administrative expense without clearly disclosing the nature of the adjustments, the disclosure of "segment costs" without describing the nature of expenses included).

When significant segment expenses and measures of segment profit or loss are determined on a non-GAAP basis, Mr. Torno said registrants should provide clear disclosure of the composition of significant segment expense categories and how the reported significant segment expenses and measures of segment profit or loss are measured. He also said registrants should use naming conventions that clearly distinguish such measures from others determined on a basis consistent with US GAAP.

Interaction with the SEC's non-GAAP guidance

Mr. Torno said the SEC staff has observed some reconciliation formats that introduce a non-GAAP measure (e.g., a consolidated non-GAAP financial measure). He reminded registrants that the reconciliation to consolidated pretax income should start with the total of reportable segment profit or loss.

He also said the SEC staff has observed examples of other disclosures that raise additional non-GAAP considerations. These disclosures include consolidated totals of significant segment expense categories and other segment items, and segment information that combines a subset of an entity's reportable segments.

Financial statement presentation reminders

Statement of cash flows

DCF Deputy Chief Accountant Sarah Lowe said registrants should make sure the operating activities section in the statement of cash flows is sufficiently detailed and separately presents material components, including separate line items for changes in receivables, payables and inventories.[4] She noted DCF has issued comments related to an entity's incorrect use of net presentation for certain transactions and combining dissimilar items (e.g., other liabilities and other receivables) on the statement of cash flows.

Related parties

Ms. Lowe reminded registrants other than smaller reporting companies to present all material related party amounts on the face of the balance sheet, income statement and statement of cash flows, as required by Rule 4-08 of Regulation S-X.

Ernst & Young LLP resources

- Financial Reporting Developments, **Disaggregation of income statement expenses**

Presentation of revenue and expenses under Rule 5-03(b)

Ms. Raminpour shared some considerations for software arrangements, which may include licenses, updates, post-contract support (PCS) or software-as-a-service (SaaS) components. She reminded registrants that Rule 5-03(b)(1) of Regulation S-X requires separate presentation of revenue from tangible products and revenue from services on the face of the income statement when those amounts exceed 10% of net sales.

She also emphasized that Rule 5-03(b) of Regulation S-X establishes specific line items that must be presented on the face of the income statement. Those disclosures differ from the disaggregated revenue disclosures required by ASC 606 and the disclosure of the disaggregation of certain expense line items in the notes to financial statements required by ASC 220-40 (commonly referred to as DISE).

Disclosures related to the presentation of consideration paid to a customer

Ms. Armelin said disclosures related to incentives given by registrants that are agents to end users remain important, particularly for technology and platform companies that connect end users with suppliers. She said applying ASC 606 to determine whether an incentive provided by a registrant should be recorded as a reduction of revenue or as a marketing expense can be challenging, because it requires determining the agent's customer, and whether the agent has an explicit or implicit promise to provide the incentive or whether the supplier has a valid expectation that it will.

She said when a company concludes that an incentive may be classified as a marketing expense, DCF may issue a comment to understand that conclusion. She also emphasized that investors should understand the impact of incentives on operating results, so material incentives classified as marketing expense should be quantified and discussed in management discussion and analysis (MD&A).

Presentation of revised quarterly financial information in annual reports

Ms. Lowe said quarterly summarized financial information presented in Form 10-K in accordance with Item 302(a) of Regulation S-K is not required to be repeated in subsequent annual reports if there are no new events requiring further retrospective disclosures. She noted that if revised quarterly financial information for 2025 were included in the 2025 Form 10-K due to a discontinued operation, the SEC staff would not object to the omission of that information from the 2026 Form 10-K, provided there are no further retrospective disclosure requirements.

Ernst & Young LLP resources

- **SEC Reporting Update — Highlights of trends in 2025 SEC staff comment letters**

Management's discussion and analysis

Ms. Rosenberger emphasized that registrants should review MD&A annually to make sure material current events and macroeconomic factors are adequately disclosed, including tariffs, trade restrictions and AI. For tariffs, she advised disclosing the business impact, mitigation strategies, related pricing adjustments and the effects on profitability, financial condition and liquidity. She also emphasized the need for appropriate controls for identifying and disclosing uncertainties that are reasonably likely to have a material impact on future operations.

Non-GAAP measures

Ms. Rosenberger said that evaluating whether non-GAAP measures could be misleading under Rule 100(b) of Regulation G often depends on a registrant's facts and circumstances.

Ms. Lowe said registrants should contact the staff for clarification if they receive a comment questioning whether a non-GAAP measure is misleading and the basis for the comment is not clear. When the staff objects to a non-GAAP measure, she said registrants should immediately discontinue the use of the measure for all periods presented and contact the staff if they need additional time or find it overly burdensome to immediately discontinue the use of the measure based on their facts and circumstances.

Common control reorganizations

Ms. Rosenberger outlined the guidance in Section 13410.4 of DCF's Financial Reporting Manual (FRM) addressing when consolidated or combined financial statements can be presented instead of separate financial statements when a reorganization occurs before an IPO. This guidance highlights that there are situations in which a recently organized shell company could omit the registrant's financial statements if permitted under the separate guidance in Section 1160.1 of the FRM.

She also reminded registrants to properly label the separate financial statements of the registrant and the entities to be reorganized and to disclose the effects of the forthcoming reorganization, including in the capitalization table and/or the pro forma financial information.

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- Technical Line, Reminders on reporting and filer status considerations for SEC registrants

Accelerated filer status determination for certain SRCs

Ms. Lowe discussed Exchange Act Rules Compliance and Disclosure Interpretation (C&DI) 130.05 that states a registrant that qualified as a smaller reporting company (SRC) based on the two-part revenue and public float test and, therefore, was a non-accelerated filer will remain a non-accelerated filer for filings due in the year after it loses SRC status.

For example, a calendar-year registrant that met the two-part revenue and public float test as of 30 June 2024 but lost SRC status on 30 June 2025 would remain a non-accelerated filer for filings due in 2026 (i.e., the year after losing SRC status), including the 2025 Form 10-K. However, the registrant would not be eligible for SRC accommodations beginning with its Form 10-Q for the first fiscal quarter of 2026.

The C&DI does not apply to registrants that qualified as SRCs based on the public float test only. Ms. Lowe noted that an emerging growth company (EGC) to whom the C&DI applies would retain such status if it does not meet any of the other EGC status exit criteria.

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- Technical Line, Navigating the requirements for merging with a special purpose acquisition company

Clarification on co-registrants' reporting obligations following a special purpose acquisition company transaction

Ms. Lowe summarized the guidance in C&DI 253.03 and reiterated that the SEC staff will not object to each target company in a special purpose acquisition company (SPAC) transaction filing a Form 15 to suspend its Section 15(d) Exchange Act reporting obligations in reliance on Rule 12h-3, if certain criteria are met, once the de-SPAC transaction has closed. She clarified that a target company that files a Form 15 after its year end but before the annual report on Form 10-K is due would not be required to file a Form 10-K.

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- Technical Line, [Applying the SEC's requirements for significant acquired businesses]

"Building and maintaining a strong quality control system is one of the best ways to sustain or further strengthen audit quality.

— Christine Gunia
PCAOB Division of Registration and Inspections Director

Application of Rule 3-05 to the acquiree of an acquiree

Ms. Rosenberger reminded registrants that Rule 3-05 of Regulation S-X does not apply to a previously acquired or to-be-acquired business of an acquiree. As stated in FRM section 2905.5, registrants should consider whether the omission of the financial statements of the acquiree's acquired or to-be-acquired business would render the acquiree's financial statements filed pursuant to Rule 3-05 misleading or substantially incomplete.

PCAOB standard-setting activities, inspections and enforcement

Standard-setting activities

PCAOB Chief Auditor and Director of Professional Standards Barbara Vanich discussed recent standard-setting activities, including QC 1000 and the amendments related to aspects of designing and performing audit procedures that involve technology-assisted analysis of information in electronic form (TAA amendments). She said the PCAOB has provided resources and tools for auditors to assist in implementing these standards.

She said that the one-year deferral of the effective date of QC 1000 was granted to give firms more time to comply, based on feedback related to implementation challenges. She noted the requirements have not changed and encouraged firms to use the additional time to finalize system design, perform dry runs and train personnel.

Ms. Vanich said that questions about the TAA amendments have focused on Auditing Standard (AS) 1105 paragraph .10A, which requires auditors to evaluate the reliability of external electronic information by understanding its source and the company's processes and by testing the information or relevant controls. She referenced the PCAOB **Board Policy Statement** and guidance describing circumstances when separate testing under .10A(b) may not be needed.

Additionally, Ms. Vanich called for stakeholders to engage with the PCAOB on questions about the application of new auditing standards to help auditors "get it right the first time."

Inspection highlights from 2025

PCAOB Division of Registration and Inspections Director Christine Gunia highlighted key practices and initiatives driving audit quality improvements and outlined strategies for sustaining high-quality audits.

A robust quality control system and strong tone at the top are key drivers of improved audit quality, Ms. Gunia said. She noted that high-quality audits often reflect effective personnel management and engagement performance, such as involving specialists throughout the audit, conducting voluntary consultations for complex transactions and tailoring risk assessments to individual engagements.

Strengthened engagement acceptance and continuance processes have also contributed to improvements, Ms. Gunia noted, commending firms on their efforts aimed at simplification, standardization and consistency, including more in-person work, technology-driven supervision, enhanced training, standard workpapers and expanded pre-issuance monitoring.

Ms. Gunia said that maintaining audit quality cannot be a "one and done" effort and urged firms to remain vigilant and proactive, regardless of the recent reduction in inspection findings. She said building and maintaining a strong system of quality control is one of the best ways to sustain improved audit quality, whether by implementing QC 1000, monitoring current systems or implementing self-correcting actions when issues arise. She encouraged open dialogue with PCAOB staff during inspections.

Additionally, Ms. Gunia highlighted some areas inspectors will focus on in 2026 and beyond and cited private equity investments in accounting firms and AI as key examples.

Enforcement

PCAOB Division of Enforcement and Investigations Chief Counsel William Ryan discussed key enforcement priorities, including significant audit failures, independence violations, ethical violations and quality control violations. He said these areas have remained consistent in recent years and continue to drive most enforcement actions.

The PCAOB's recent actions included sanctions against auditors and firms for allegedly signing off on incomplete work papers, violating independence rules and allowing widespread answer-sharing on training exams. Mr. Ryan said these violations often reflect a lack of professional skepticism and weaknesses in a firm's system of quality control.

Endnotes:

[1] The American Institute of Certified Public Accountants.

[2] The Chartered Institute of Management Accountants (based in London).

[3] Required in Part I of the Form 10-K.

[4] ASC 230-10-45-28.

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