

# 2018 AICPA Conference on Current SEC and PCAOB Developments

Compendium of significant accounting and reporting issues

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## Summary

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

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

The overall theme of the Conference was how regulators, standard setters, preparers and auditors are responding to changes in accounting and auditing standards, new technologies and other risks and uncertainties in the market.

### Highlights included:

**New accounting standards** – SEC staff members said their comments to registrants on their application of the new revenue recognition standard have focused on areas of significant judgment, such as the identification of performance obligations and the timing of revenue recognition. The staff encouraged companies to continue to improve and refine their disclosures based on their increasing experience with the standard and disclosures provided by their peers.

While several preparers cited the lack of available information technology (IT) solutions as a major challenge to their implementation of the new leases standard, representatives from the SEC and the FASB said the effective date of the standard will not be deferred.

The FASB staff reminded companies that the new standard on credit losses will affect companies in all industries and shared their commitment to supporting preparers as they implement all of the new accounting standards.

**Brexit and LIBOR** – SEC officials expressed concerns about the quality of Brexit disclosures many companies are currently providing and urged registrants to improve their disclosures in SEC filings about the material effects and implications of Brexit. The SEC staff stated that in its reviews of public filings it will monitor disclosures about the potential effects of Brexit, including areas such as taxes, assets, financing and business operations.

The SEC staff said it is also monitoring developments with respect to the anticipated phaseout of the London Interbank Offered Rate (LIBOR) in the coming years. The staff expects registrants to start thinking about potential effects of this transition and provide more detailed disclosures if the effects are expected to be material.

For both Brexit and LIBOR, the SEC staff expects a registrant's disclosures to evolve over time as more information becomes available.

**Cybersecurity** – The SEC staff reminded registrants to provide company-specific cyber disclosures. Staff members also stressed the importance of disclosing how the board of directors oversees cyber risks and the company's controls and procedures so that information about significant cyber incidents is communicated to those in management with responsibility for public disclosures. The SEC staff is expected to focus on cybersecurity disclosures in its reviews of public company annual reports and proxy statements.

**Non-GAAP financial measures** – The SEC staff said using non-GAAP financial measures can help management tell its story and encouraged companies to provide transparent and robust disclosures about why the measures are useful to investors. The staff also addressed how to evaluate whether non-GAAP financial measures involve individually tailored accounting principles that may be inappropriate under Regulation G. In addition, the staff emphasized the importance of having disclosure controls and procedures to make sure non-GAAP disclosures aren't misleading.

**PCAOB and critical audit matters** – PCAOB officials discussed the fresh approach they are taking in standard setting, inspections and other aspects of the PCAOB's mission to improve audit quality. They also are focusing on the use of emerging technologies (e.g., data analytics, artificial intelligence, robotics, blockchain) to inform future standard setting and to consider whether current auditing standards potentially impede the use of these technologies.

Staff members of both the PCAOB and SEC praised audit firms' preparations, including dry run programs, to implement the new PCAOB requirement to discuss critical audit matters (CAMs) in the auditor's report. They also discussed the presumption identified in the PCAOB's adopting release that at least one critical audit matter would be identified in each audit and shared their expectation that the descriptions of CAMs should be specific to each individual audit.

### **A conversation with SEC Chairman Clayton and SEC Chief Accountant Bricker**

SEC Chairman Jay Clayton and SEC Chief Accountant Wesley Bricker shared their views on the roles of preparers, auditors, audit committees, investors and regulators in the US financial reporting system.

Chairman Clayton reiterated his belief that high-quality audited financial statements are the bedrock of our capital markets system.

Messrs. Clayton and Bricker stressed the importance of delivering high-quality financial information to investors and recommended that all participants in the process review the schematic, *U.S. Financial Reporting Structure for Public Issuers*, on the SEC website to gain a better understanding of the framework and their role in it.

They also said that high-quality financial reporting starts with boards and management. Audit committees should strive to make a candid assessment of what is not working well in a registrant's system of internal control over financial reporting (ICFR) and disclosure controls and procedures, they said.

Messrs. Clayton and Bricker also said they are pleased with the work of the new members of the PCAOB. In particular, they noted that the new board has demonstrated a commitment to engaging with stakeholders by, among other things, requesting input on the PCAOB's strategic plan and establishing a new Office of External Affairs. They also pointed to the participation of all board members at the Conference as a welcome sign of collaboration at the PCAOB.

Messrs. Clayton and Bricker also discussed collaboration between the SEC and the PCAOB, including the joint statement<sup>1</sup> they issued with PCAOB Chairman Duhnke on 7 December 2018. The joint statement describes challenges US regulators face in accessing the financial reporting records of SEC registrants with operations in certain non-US jurisdictions, such as China, as well as the records of their audit firms.

For example, those governments restrict access to information the SEC needs to conduct enforcement actions and the PCAOB needs to conduct inspections. While such restrictions may be intended to protect national security and state trade secrets, they impede the efficiency of the global capital markets and undermine investors' confidence in the completeness and accuracy of information about the affected companies, the joint statement said. Chairman Clayton said these restrictions on access hurt the transparency of financial reporting, which investors then "price into" the securities of those companies.

Chairman Clayton highlighted the continued efforts by both the Commission and the PCAOB to work with their counterparts around the world to more efficiently and effectively regulate the global capital markets.

Chairman Clayton also reiterated that his strategic priority is to foster capital formation in the US capital markets through rulemaking intended to eliminate burdensome financial reporting requirements that do not contribute materially to the total mix of information provided to investors.

### **Remarks by Russell Golden, Chairman of the FASB**

FASB Chairman Russell Golden said the FASB is focused on improving future standards by enhancing the FASB's educational resources, performing extended outreach on key projects and preparing for the potential effect of emerging technologies on financial reporting.

#### ***Educational resources***

After completing major standard setting projects on revenue recognition, leases, credit losses and hedging over the past few years, the FASB is enhancing its educational resources for stakeholders to help them understand and implement the new standards, Mr. Golden said. "Education can make the difference between a standard that works and one that doesn't," he said, observing that people need to understand and consistently apply a standard for it to meet its objectives.

Mr. Golden pointed to the FASB's implementation web portal, transition resource groups, educational videos, webcasts and plain-language documents as examples of the FASB's efforts to make it easier for accountants to understand its standards. Mr. Golden also highlighted the FASB's creation of a forum to help providers of continuing professional education prepare and deliver accounting courses, manuals and other publications that reach a wide audience.

### ***Outreach on technical agenda***

Mr. Golden said the FASB is performing extended outreach on key projects that could result in new standards in the next three to five years. “To develop the right accounting solutions, the FASB must first identify the right accounting issues,” he said. Mr. Golden pointed to the outreach the FASB is performing on the following projects as examples of efforts expected to result in more successful standards and more helpful information to financial statement users:

- ▶ Distinguishing liabilities and equity
- ▶ Disaggregated performance reporting
- ▶ Segment reporting (specifically the aggregation criteria)

### ***Effect of technology on financial reporting***

Mr. Golden noted that new technologies are already affecting what information is useful, who consumes it and how the information is consumed. He said the FASB is preparing for the potential effects of new technologies on future financial reporting requirements, including standards for structured data (or electronically tagged business and financial reports). He said the FASB’s mission is to develop accounting standards that “can evolve to meet the changing needs of investors.” Mr. Golden noted the FASB has launched a study to help it understand the technologies companies and investors are using, how those technologies may evolve and what the FASB may need to do to adapt its standards to those changes.

### **A discussion with the PCAOB**

All five members of the PCAOB participated in a panel at the Conference and shared their views about the PCAOB’s strategic plan for improving its inspection program, standard setting and enforcement activities.

#### ***Inspections***

Chairman William Duhnke said the PCAOB is taking a “clean sheet” approach to reexamining its inspection program, including how audits are selected for inspection, the procedures performed during inspections and how findings are communicated.

Board member Duane DesParte discussed some of the changes the PCAOB expects to implement in the 2019 inspection cycle, including putting more emphasis on audit firms’ systems of quality control, engaging with audit committee chairs of all of the entities selected for inspection and forming a dedicated team of inspectors to perform inspection procedures on targeted areas across a number of audit firms. The PCAOB has yet to determine its focus areas in these targeted reviews. He also said the PCAOB’s goal is to enhance the timeliness and relevance of its inspection reports. Board member James G. Kaiser said future inspection reports will use less-technical language, provide information about the nature and severity of findings and identify leading practices.

Board member Jay Brown observed that audit committees have become more interested in understanding how audit firms are improving their systems of quality control to respond to deficiencies identified by the PCAOB during inspections.

#### ***Standard setting***

Board members also said one of their strategic priorities is to regularly evaluate and refine the audit framework to make sure it remains effective. Board member Kathleen M. Hamm said that, in its standard setting, the PCAOB is considering the use of emerging technologies (e.g., data analytics, artificial intelligence, robotics, blockchain) in audits. The PCAOB also wants to understand the quality controls audit firms implement to make sure new audit tools and techniques work as intended, including how they train personnel to use the new tools.

### ***Enforcement***

The PCAOB reaffirmed its commitment to enforcing compliance with its rules and standards as well as the federal securities laws. Ms. Hamm called enforcement actions a tool of last resort in addressing issues that pose the most risk to investors and driving audit quality improvement. Ms. Hamm also shared the PCAOB's plan to reexamine its process for identifying, investigating and litigating cases and to increase its use of data and technology for these purposes.

## **Accounting and disclosure matters**

### **New accounting standards**

#### ***General observations by FASB staff***

FASB Technical Director Sue Cospers provided an overview of the FASB's activities related to the implementation of the new accounting standards on revenue recognition, leases, hedging, credit losses and cloud computing. Ms. Cospers said the FASB continues to focus on supporting entities as they adopt the new accounting standards and is starting its post-adoption evaluation of whether reporting under the new standards is meeting the FASB's objectives. The FASB has devoted staff to help stakeholders understand its intent with respect to the new accounting standards and provide clarifications to these standards as needed.

Ms. Cospers also highlighted some of the FASB's current areas of focus in its technical and research agendas, including its projects on the disclosure framework, goodwill and intangible assets, segment reporting and other disclosure improvements.

#### ***Revenue recognition***

Sagar Teotia, a deputy chief accountant in the SEC's Office of the Chief Accountant (OCA), said the new revenue recognition standard in Accounting Standards Codification (ASC) 606 has been the top area of consultation for OCA over the past year. He commended preparers and other stakeholders on their strong commitment to implementing the new standard, which was effective for public entities for fiscal years beginning after 15 December 2017.

Sheri York, a professional accounting fellow in OCA, and Sarah Esquivel, an associate chief accountant in OCA, discussed evaluating whether an entity is a principal or an agent and identifying performance obligations, which they said were OCA's two most frequent consultation topics. Ms. Esquivel also discussed evaluating whether a significant financing component exists.

#### ***Principal versus agent considerations***

Ms. York said that applying the new principal versus agent guidance can be particularly challenging when an entity does not obtain physical possession of a good before it is transferred to a customer. Ms. York noted that an entity is required to evaluate the definition of control when determining whether it is a principal or an agent in an arrangement and explained that this will often require an entity to consider the indicators of control. She noted that inventory risk is only one of those indicators and that, in some cases, physical possession is not determinative of control of a specified good.

Ms. York said the SEC staff continues to view the principal versus agent guidance as an area of the new standard that requires significant judgment but emphasized that judgment does not equate to optionality on the presentation. She said registrants need to rigorously analyze the facts and circumstances to faithfully apply the principal versus agent model to their specific transactions and arrangements.

The SEC staff acknowledged that the application of reasonable judgments by preparers could lead to some diversity.

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### ***Ernst & Young LLP (EY) resources***

- ▶ Financial reporting developments, [Revenue from contracts with customers \(ASC 606\)](#) (SCORE No. BB3043)

### *Identification of performance obligations*

An entity may need to apply significant judgment to evaluate whether a promised good or service is separately identifiable. The evaluation requires a thorough understanding of the facts and circumstances present in each contract.

Ms. Esquivel explained that when the customer has a choice to use a service with goods or other services that are provided in the contract, that may indicate the service does not significantly affect the utility of the goods or other services provided. Therefore, the identified promises may not significantly affect each other and would be separately identifiable.

### **How we see it**

We believe the evaluation of whether an entity is a principal or an agent in an arrangement and the identification of performance obligations will continue to be areas of focus for entities, their stakeholders and the SEC staff due to the significant judgments that may be required to apply these aspects of the revenue standard.

### *Existence of a significant financing component*

Ms. Esquivel said that OCA did not object to a registrant's conclusion that a significant financing component did not exist in a contract to license an intangible with a large up-front payment. The registrant concluded that the timing difference between the up-front receipt of consideration and the transfer to the customer of the right to use the intangible over time was for reasons other than providing financing. Ms. Esquivel explained that the up-front payment protected the registrant from the possibility that the customer might fail to adequately complete some or all of its obligations under the contract. In reaching its conclusion, the registrant considered the following:

- ▶ The up-front payment was critical to incentivize the customer to maximize value and profit and to use the registrant's brand appropriately. This was driven in part by the registrant's negative experiences with other parties in previous contracts without up-front payments.
- ▶ The registrant did not have financing needs and concluded it would be able to obtain financing at favorable rates in the marketplace, if needed, so the payment terms of this contract were not intended to finance the registrant's operations.
- ▶ The parties didn't contemplate structuring the transaction without a large up-front payment.

### **SEC staff comment letters on ASC 606**

Cicely LaMothe, Associate Director in the SEC's Division of Corporation Finance (DCF), and Patrick Gilmore, a deputy chief accountant in DCF, shared observations related to recent staff comment letters on the new revenue standard. Ms. LaMothe said the staff will continue to review the application of the new revenue standard and disclosures as part of its review process and will question registrants when it suspects that they are not complying with the standard or they are omitting material disclosures.

While Mr. Gilmore said it's premature to highlight any trends, he said the staff has focused on areas of significant judgment, including the identification of performance obligations, the timing of revenue recognition, gross versus net presentation and disaggregated revenue disclosures.

Mr. Gilmore stressed that registrants need to provide clear and transparent disclosures about the significant judgments they made to apply the standard for each material revenue stream. Kyle Moffatt, DCF Chief Accountant, encouraged companies to continue to improve and refine their disclosures based on their increasing experience with the standard and disclosures provided by their peers. When responding to SEC staff comments, registrants should consider and address materiality if the revenue streams on which the staff is commenting are not material, he said.

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#### **EY resources**

- ▶ SEC Reporting Update, [2018 trends in SEC comment letters](#) (SCORE No. 04322-181US)

## How we see it

So far, registrants appear to be resolving the majority of the comments on ASC 606 by providing more information to help the staff gain a better understanding of the judgments made by management and, in certain cases, providing additional disclosures in future filings.

We encourage companies to continue to improve their revenue disclosures in their year-end filings and to keep contemporaneous documentation of the significant judgments they make in applying the new standard to facilitate dialogue with the SEC staff during the comment process.

### Leases

#### *Implementation*

Staff members of both the SEC and FASB emphasized their commitment and continued focus on easing the burden and reducing the cost of implementing the new leases standard, ASC 842, *Leases*. The FASB's Ms. Cosper provided an overview of the FASB's recent standard setting activities to address implementation issues and said the issues were identified through technical inquiries and communications with stakeholders.

While preparers have cited the lack of available IT solutions as a major implementation challenge, the SEC's Mr. Teotia said he expected registrants to implement the standard on time. Mr. Golden, the FASB Chairman, emphasized that the effective date of the standard will not be delayed.

Andrew Pidgeon, a professional accounting fellow in OCA, discussed several consultations related to the new leases standard.

#### *Lessee transition – change in the composition of minimum rental payments*

Mr. Pidgeon discussed two consultations related to the transition guidance in ASC 842 that requires an entity to use the minimum rental payments calculated under ASC 840 to measure the initial lease liability.

Given that there is diversity in practice about whether executory costs should be included in minimum rental payments under ASC 840, the SEC staff had previously said it would not object to registrants consistently applying their historical accounting policy on whether to include executory costs in minimum rental payments.

In a recent consultation, the SEC staff did not object to a registrant applying ASC 250, *Accounting Changes and Error Corrections*, to voluntarily change its historical accounting policy for minimum rental payments regarding the exclusion or inclusion of executory costs, Mr. Pidgeon said. ASC 250 permits a registrant to change its generally accepted accounting principle to another generally accepted accounting principle, if the change is preferable.

A second consultation related to a lessee's measurement of minimum rental payments that are based on an index or a rate. ASC 842 requires a lessee to measure variable lease payments that depend on an index or a rate using the prevailing index or rate at the measurement date (e.g., lease commencement date for initial measurement). However, ASC 840 does not specify whether indexed future minimum rental payments disclosed by a lessee (i.e., payments included in the measurement of the initial ASC 842 lease liability) should be measured using the prevailing index or rate at lease inception or the current index or rate, which has resulted in diversity in practice.

Mr. Pidgeon said the staff did not object to a registrant consistently applying its historical ASC 840 accounting policy for measuring future minimum rental payments based on an index or a rate for the purpose of measuring its lease liability in transition to ASC 842. He said that the staff also did not object to a registrant applying ASC 250 to voluntarily change its policy

### EY resources

- ▶ Financial reporting developments, [Lease accounting](#) (SCORE No. 00195-171US)

from using the index or rate at lease inception to the current index or rate. Mr. Pidgeon said that the staff believes it would be reasonable for a registrant to consider whether the lease obligation that results from using the current index or rate represents a better measurement of the registrant's current lease obligations when assessing preferability under ASC 250.

## How we see it

Companies that plan to change their historical ASC 840 accounting policy for measuring minimum rental payments should evaluate whether such a change is quantitatively or qualitatively material before applying ASC 250.

### *Certain lessee and lessor costs*

Mr. Pidgeon also discussed two consultations related to certain costs a lessee and lessor may incur to prepare an asset for its intended use after lease inception but before lease commencement (e.g., costs to mobilize the asset).

Mr. Pidgeon said the staff did not object to a lessee making an accounting policy election to capitalize the costs paid to a third party other than the lessor by analogizing to the guidance in ASC 360, *Property, Plant, and Equipment*, on bringing an asset to the condition and location necessary for its intended use, if the costs are not within the scope of other topics in US GAAP. Similarly, Mr. Pidgeon said the staff did not object to a lessor making an accounting policy election to defer the costs it incurred by analogizing to the guidance on contract fulfillment costs in ASC 340-40, *Other Assets and Deferred Costs – Contracts with Customers*, if the costs are not within the scope of other topics in US GAAP and would qualify for deferral if the lease were in the scope of ASC 606.

Mr. Pidgeon encouraged registrants that elect either accounting policy to apply the policy consistently and include appropriate disclosure of the policy, if material.

### *Credit losses*

Kevin Vaughn, a senior associate chief accountant in OCA, shared observations on the interaction between the subsequent events guidance in ASC 855 and the new credit losses standard. Mr. Vaughn observed that questions have arisen about how entities should apply the subsequent events guidance because the credit losses standard requires the use of forward-looking assumptions in the estimate of expected credit losses.

He discussed fact patterns in which information that differed significantly from management's expectations was received after the balance sheet date but before the financial statements were issued or were available to be issued.

Mr. Vaughn indicated that the staff would object to a registrant not considering loan-specific information about factual conditions that existed at the balance sheet date in its estimate of expected credit losses, such as a servicer report that contained information about payment experience (e.g., delinquencies, prepayments) or an appraisal report that provided information about the fair value of collateral as of the balance sheet date.

If before completing its estimation process a registrant receives subsequent information that is not loan specific, such as the US government's report on unemployment data for a period that includes the balance sheet date, Mr. Vaughn indicated that the staff would not object to the registrant choosing to either consider or not consider that information in its estimate of expected credit losses. However, the registrant would have to consider whether the information received is evidence of a deficiency in the registrant's process or an error in the estimate such that the estimate would have to be revised.

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### **EY resources**

- Financial reporting developments, [Credit impairment under ASC 326 \(SCORE No. 04488-181US\)](#)

## How we see it

The new credit losses standard does not significantly change the application of the subsequent events guidance. In other words, the allowance for credit losses should be adjusted for any changes in estimates resulting from recognized subsequent events.

Entities will need to apply judgment when evaluating information that relates to its reasonable and supportable forecast of future economic conditions. We believe entities should consider whether evidence received after the balance sheet date relating to forecasted economic conditions (such as unemployment data) supports management's initial estimate.

In many cases, differences between the actual results and the forecasted results will reflect the imprecision inherent in the forecast and, as a result, will not require adjustment. However, if there is a significant difference between actual results and forecasted results, entities should evaluate whether the forecasting process needs refinement and whether the estimate as of the balance sheet date should be updated.

Rahim Ismail, a professional accounting fellow in OCA, shared observations from consultations related to determining when to charge off a loan after adopting ASC 326, *Financial Instruments – Credit Losses*.

First, Mr. Ismail focused on whether charge-offs should be determined at the individual loan level or at the pool level when applying the standard.<sup>2</sup> While the new standard requires entities to pool loans that share risk characteristics to measure the allowance, the staff did not object to an entity concluding that it could assess the loans individually to determine whether they should be charged off, because the loans retain their individual characteristics.

Mr. Ismail also addressed a question related to the information to be considered in determining whether a loan is uncollectible under ASC 326. The SEC staff did not object to a registrant considering all relevant information, including individual loan attributes and relevant historical loss experience for similar loans, to determine whether a loan is uncollectible.

Separately, Mr. Teotia stated that the SEC is currently evaluating conforming amendments to Staff Accounting Bulletin 102, *Selected Loan Loss Allowance Methodology and Documentation Issues*, to align it with ASC 326.

## How we see it

The SEC staff continues to reinforce the [need for procedural discipline regarding internal controls](#), processes and documentation related to the credit losses estimate because the standard gives entities significant flexibility in how to determine the estimate.

Registrants will need to change or enhance their policies, processes and controls, including controls over historical credit loss data that will be necessary to perform key computations and to satisfy the additional disclosure requirements.

The FASB's Ms. Cospers reminded entities that, while the FASB has focused on aspects of ASC 326 that primarily affect financial institutions, entities in all industries will be affected by the standard. She also noted that the FASB plans to issue two proposals to further support implementation efforts. One would require entities to disclose in the vintage disclosure tables gross write-offs and gross recoveries based on the year the loan or receivable was originated. The other would allow entities to make a one-time election, upon the adoption of ASC 326, to measure financial assets using the fair value option.

**EY resources**

- ▶ To the Point, [FASB adds new benchmark interest rate for hedge accounting](#) (SCORE No. 04808-181US)

**Transition away from LIBOR**

Mr. Ismail provided a brief overview of the move to replace LIBOR with alternative reference rates. He highlighted the participation by the SEC staff and other regulators on the Alternative Reference Rates Committee as well as their monitoring of other stakeholders' efforts to support the transition. Mr. Ismail noted that the FASB's recent Accounting Standards Update (ASU)<sup>3</sup> adds the overnight index swap (OIS) rate based on the Secured Overnight Financing Rate (SOFR) to the list of US benchmark interest rates in ASC 815 and that the Board has a new project focused on the effects of transitioning from LIBOR to SOFR.

Mr. Ismail discussed a consultation about the effect that the transition to an alternative rate could have on existing cash flow hedges of variable rate debt instruments where the hedged item is documented as LIBOR-based interest payments. The SEC staff did not object to an entity considering it probable that the hedged forecasted transaction (i.e., LIBOR-based interest payments) would occur, even though some of the forecasted interest payments are expected to be made after LIBOR is no longer quoted. The staff did not object to the conclusion that the hedge documentation implicitly considers a rate that would replace LIBOR, allowing an entity to continue to assert that it is probable that the hedged transaction will occur.

The SEC staff also considered whether a hedging relationship can be deemed to be highly effective on a prospective and retrospective basis and whether an entity therefore can maintain hedge accounting. The staff did not object to an entity concluding that the transition from LIBOR would affect both the hedged item and the hedging instrument in a similar manner and that the assessment of the effectiveness of the hedging relationship therefore would not be affected by the change.

The FASB's Ms. Cospers called the Board's project on the effects of the transition one of the most important on the FASB's agenda because the transition will affect debt arrangements, leases and other arrangements in addition to hedging relationships. She said the Board is committed to easing the burden of the transition and expects to make significant progress in 2019.

Finally, DCF staff members discussed the transition from LIBOR to alternative rates. They have started to review disclosures to see whether entities describe the types of backstop arrangements that may be in place if LIBOR is no longer quoted, noting that they expect registrants to start thinking through potential effects and making more detailed disclosures. Potential areas of consideration for such disclosures include hedge accounting and floating rate bonds and, for financial institutions, products geared to LIBOR.

**How we see it**

The transition from LIBOR could have unintended accounting consequences such as earnings volatility. We believe that earnings volatility is inconsistent with the economics of affected hedging relationships and the objective of replacing LIBOR with a better reference rate. Therefore, we support the FASB's decision to consider changes to US GAAP that may be needed to facilitate a smooth transition from a financial reporting perspective, and we encourage entities to consider raising issues they identify in their transition planning with the SEC staff.

**Hedging**

The FASB's Ms. Cospers provided an overview of the Board's efforts to support implementation of the new hedging standard, noting that the standard has been well received. She said the FASB expects to issue an exposure draft in the first quarter of 2019 that includes additional Codification improvements. These amendments are expected to clarify the Board's view that an entity is not required to automatically dedesignate a cash flow hedging relationship when the hedged risk changes, among other things.

Ms. Cospers further noted that during the final stages of deliberations on ASU 2017-12, the Board received a significant amount of feedback on additional items that stakeholders wanted the Board to consider. In response, FASB Chairman Golden has directed the staff to conduct pre-agenda research on potential hedge accounting issues beyond those addressed in ASU 2017-12. The Board is expected to consider whether to add a project to its agenda that could expand the use of hedge accounting.

### **Other reporting considerations**

#### ***Brexit***

With the March 2019 legal deadline for the United Kingdom to withdraw from the European Union (i.e., Brexit) looming, Chairman Clayton and members of the SEC staff have said they will focus on disclosures of company-specific risks associated with Brexit. “We’re already seeing the real-world effects of Brexit,” said SEC Chairman Clayton, and the SEC’s Mr. Bricker said the financial reporting implications “will be brought to bear this year end.”

Registrants with operations and/or investments in the UK and the EU need to monitor developments and consider the accounting and financial reporting implications of the uncertainty related to Brexit, including the possibility that there may not be a final agreement in place by the deadline.

William Hinman, the Director of the SEC’s Division of Corporation Finance, said his staff has reviewed a sample of 100 companies’ Brexit-related disclosures, which ranged from a single bullet item in the list of international operations risk factors to more thoughtful and company-specific disclosures that would be helpful for investors. Examples he cited as good disclosures included a discussion of topics such as licensing matters, regulatory approvals and a company’s ability to continue to receive goods in its supply chain effectively. Mr. Hinman said that if companies have information that would be material for investors, they should be disclosing it.

The SEC staff has stated in its reviews of public filings that it will monitor disclosures about the potential effects of Brexit on matters such as taxes, assets, financing and business operations. It also expects companies to modify disclosures over time as developments occur and companies learn more about how they will be affected. Additional disclosures may be necessary in the notes to the financial statements, in management’s discussion and analysis or in other parts of a registrant’s next periodic report.

#### ***Cybersecurity matters***

Chairman Clayton highlighted the importance of cybersecurity and related disclosures, noting that registrants must broadly increase board-level focus on these matters. Specifically, he said “having a forward-looking conversation in the boardroom is essential to moving the cybersecurity issue forward.” The SEC staff will assess whether cybersecurity-related disclosures in 2018 year-end filings comply with the [interpretive guidance](#)<sup>4</sup> the Commission issued in February 2018.

The SEC’s Mr. Hinman called compliance with the interpretive guidance a “mixed bag.” However, he said the SEC staff is starting to see fewer boilerplate disclosures, and he reminded issuers that the staff expects these disclosures to be company-specific. He also stressed the importance of disclosures about how the board of directors oversees cyber risks, as well as the controls and procedures the company has in place to make sure material information about cyber risks and events is communicated to those responsible for making disclosure decisions. Finally, he recommended that companies revisit their insider trading policies in light of the potential materiality of cybersecurity incidents.

Ms. LaMothe said the SEC staff monitors the news for reports of cyber incidents and may contact affected companies. She also cautioned against using language such as “we may experience a cybersecurity breach,” suggesting that attacks have not yet occurred if, in fact, they have.

‘The financial reporting implications of Brexit will be brought to bear this year end.’

–Wesley Bricker,  
SEC Chief Accountant

### ***EY resources***

- ▶ SEC Reporting Update, [SEC issues guidance on cybersecurity](#) (SCORE No. 01030-181US)
- ▶ To the Point, [SEC highlights the need for companies to focus on controls that prevent cyber-related fraud](#) (SCORE No. 04815-181US)

Stephanie Avakian, Co-Director of the Division of Enforcement, said the SEC will continue to prioritize investigations of hacking, accounting intrusions and failures to protect customer information. She also pointed to the Division's October 2018 investigative report<sup>5</sup> on frauds involving email communications, which highlighted the need for companies to focus on their procedures and internal controls over the authorization of transfers of cash and changes to vendor master files. Marc Panucci, a deputy chief accountant in OCA, encouraged registrants to consider the report in the context of their assessments of ICFR.

## Regulatory update

### SEC rulemaking update

The SEC's Mr. Hinman spoke about President Trump's request that the staff study whether to require semiannual reporting rather than quarterly reporting. He noted that the staff began looking at this topic in conjunction with the SEC's 2016 concept release on Regulation S-K, and the Commission plans to issue a request for comment on 19 December 2018.<sup>6</sup> He said the SEC will seek feedback on:

- ▶ Whether quarterly earnings guidance encourages short-term decision making
- ▶ Whether investors would benefit from narrowing the gap between the timing of quarterly earnings releases and the filing of Form 10-Q by streamlining the Form 10-Q disclosure requirements
- ▶ Whether it might be appropriate to permit certain issuers to report less frequently than quarterly

Mr. Hinman also said the SEC hopes in 2019 to propose amendments to S-X Rule 3-05 on significant acquiree financial statements and Article 11 pro forma financial information. The SEC staff is considering recommending amendments that would simplify the significance tests and provide greater flexibility in preparing pro forma financial information by allowing management to more fully reflect its plans for the combined business (e.g., permitting adjustments to reflect expected synergies).

Mr. Hinman said the SEC hopes to issue a final rule before the end of 2019 to amend S-X Rules 3-10 and 3-16 to simplify financial disclosure for guaranteed and collateralized debt securities and thus encourage more public offerings of debt securities with such credit enhancements. He said the staff is also working on a proposal that Chairman Clayton requested to raise the threshold for accelerated filer status to reduce the number of registrants required to file their periodic reports on an accelerated timeframe and obtain auditor attestation on their ICFR.

### Division of Corporation Finance process matters

#### *Emerging growth company (EGC) transition issues*

The SEC staff said it has received numerous interpretive questions from EGCs that have elected transition date relief<sup>7</sup> for new or revised accounting standards (i.e., deferred adoption until the private company effective dates).

Because ASC 606 is effective for private companies in annual periods beginning after 15 December 2018 and interim periods in the following year, a calendar-year EGC that chooses to do so can wait to apply the new revenue standard until its annual report for the year ending 31 December 2019. In the quarterly financial data table in its 2019 Form 10-K, the EGC would not be required to recast its 2019 quarters to reflect ASC 606 but should have clear disclosure that the accounting in the quarters differs from the annual period. However, the SEC staff said it believes, in 2020 Form 10-Qs, the EGC should present the comparable 2019 interim periods in accordance with ASC 606, irrespective of its transition method.

An EGC that uses the private company effective dates should apply ASC 606 to the results it presents for comparable periods in its 2020 Form 10-Qs.

The staff also explained the transition provisions for new accounting standards for a registrant that loses EGC status. An EGC that has used the deferral and not yet adopted the standard can no longer defer adoption once it ceases to be an EGC even if it loses EGC status on the last day of the year. Upon losing EGC status, a registrant would have to adopt the standard in its next filing as of the beginning of that year (e.g., 1 January 2018 if status is lost on 31 December 2018, 1 January 2019 if status is lost on 31 December 2019). While a registrant would not need to revise previously filed Forms 10-Q, it would need to reflect the adoption of the new standard in all quarterly reports filed after losing EGC status, as well as for all quarters of the year of adoption in the quarterly financial data table in the Form 10-K.

The SEC staff further clarified that if the company adopted a new standard using a delayed effective date but before it lost EGC status, the SEC staff would not require the registrant to readopt the standard as of the public business entity adoption date. For example, a registrant that loses EGC status in 2020 would not need to readopt ASC 606 as of 1 January 2018, the effective date for public business entities, because it already adopted the standard in 2019 using the effective date for private companies.

Whenever quarterly information reflected in the quarterly financial data table is reported using a different standard than that used in the Form 10-Q for the respective period, the SEC staff noted it expects clear and transparent disclosure of this difference.

Finally, the SEC staff reiterated its view that a non-EGC submitting or filing an initial registration statement would have to apply the effective date for public business entities, even if it already adopted an accounting standard using the private company date.

### How we see it

EGCs that elect transition date relief should be mindful of when they might lose EGC status so they are prepared to adopt the new revenue standard in a way that complies with the SEC staff's transition guidance.

#### *Comments on non-GAAP financial measures*

Regulators, preparers and other stakeholders acknowledged the importance of non-GAAP financial measures to help management tell its story and observed that the quality of non-GAAP disclosures has generally improved in recent years.

Notwithstanding the improvement, the SEC's Mr. Hinman emphasized that companies need to clearly disclose how they use non-GAAP measures and why they are useful for investors, and the SEC's Mr. Moffatt said companies need to have disclosure controls and procedures for reporting non-GAAP financial measures to prevent misleading disclosures. In particular, various speakers expressed the importance of transparency when registrants make changes in how they calculate and define their non-GAAP financial measures.

The SEC's Mr. Gilmore noted that preparers have found it challenging to apply the SEC staff's guidance that says individually tailoring an accounting principle in a non-GAAP financial measure could violate Regulation G.

To clarify the staff guidance, Mr. Gilmore referred to the definition of a non-GAAP financial measure under Regulation S-K<sup>8</sup> (i.e., a numerical measure that includes or excludes adjustments that are excluded or included from the most directly comparable GAAP measure). Because the definition does not refer to adjustments that modify recognition and measurement, the SEC staff believes such adjustments and the related measures could be inappropriate, he said.

Mr. Gilmore suggested that registrants ask the following questions to determine whether non-GAAP financial measures individually tailor accounting principles in a way that may violate Regulation G:

- ▶ Does the adjustment shift the accounting from an accrual basis to a cash basis (e.g., by including cash receipts as a proxy for revenues that should be recognized over time under GAAP)?
- ▶ Does the adjustment add transactions reflected on another company's books (e.g., by reporting items gross when the company is an agent in a revenue transaction, by proportionately consolidating amounts for entities accounted for under the equity method)?
- ▶ Does the adjustment reflect part but not all of the accounting concepts (e.g., by considering taxes paid but not accounting for deferred taxes)?
- ▶ Is the adjustment inconsistent with the economics of an agreement or transaction (e.g., by reflecting revenues from sales-type or finance leases as if they were revenues from operating leases)?

The SEC staff confirmed that it would not object to non-GAAP financial measures presented to show the effect of a new accounting standard for the purpose of facilitating a comparison during the transition period. However, the SEC staff would question measures that continue to reflect legacy accounting after transition.

### How we see it

The staff provided much-needed clarity about the concept of individually tailored accounting principles. However, we expect that identifying these measures will continue to require significant judgment, and we recommend that companies review their current non-GAAP adjustments in light of the clarifications.

#### ***Seeking waivers or financial reporting alternatives under Rule 3-13 of Regulation S-X***

SEC staff members in the DCF discussed relief the staff has provided in response to requests for financial statement waivers or modifications under Rule 3-13 of Regulation S-X.

Mr. Gilmore provided the following examples of relief the staff has provided for significant acquired businesses:

- ▶ When an acquisition is significant solely due to the income test, the staff has looked at other measures of operating activity such as revenue and gross operating margin in addition to the asset and investment test as support for waiving the financial statement requirements for some or all periods.
- ▶ When an acquisition is significant only under the investment test, the staff has considered why the acquirer is paying an apparent premium for the acquired business. If the acquisition includes highly valuable assets, the staff may allow a registrant to provide an abbreviated statement of acquired assets and liabilities at fair value in lieu of full historical financial statements of the acquiree.

The staff encouraged registrants with similar fact patterns to contact the staff members listed in the introductory section of the Financial Reporting Manual to discuss potential relief. They also are considering ways to make the relief process more transparent.

## International matters

### IASB

Hans Hoogervorst, Chair of the International Accounting Standards Board (IASB), discussed current risks in the global financial system and questioned whether enough actions are being taken to prevent another financial crisis.

Mr. Hoogervorst stated that, while the guidance on credit losses in US GAAP and IFRS is not the same, both new standards use an expected loss model rather than the incurred loss model that was criticized for not providing sufficient and timely information during the last financial crisis. The new models are expected to result in the earlier recognition of credit losses, which could help prevent a future financial crisis, he said.

He also said the IASB will continue to focus on the implementation of IFRS 17, *Insurance Contracts*, and is currently working on improvements to IFRS 3, *Business Combinations*, and IAS 36, *Impairment of Assets*. In addition, the IASB is working to improve the structure and content of the primary financial statements, especially the statements of financial performance and the disclosure of performance measures.

Mr. Hoogervorst said the IASB issued *Definition of Material*<sup>9</sup> in October 2018 to align the language in IFRS Standards with the *Conceptual Framework for Financial Reporting (Conceptual Framework)*. In her comments, Jenifer Minke-Girard, Interim Deputy Chief Accountant in OCA, stated that the amendment would not change the evaluation of materiality under the US securities laws for SEC registrants, including foreign private issuers.

### Foreign private issuers and cross-border reporting challenges

Craig Olinger, Senior Advisor to the Chief Accountant of DCF, said that, as of 31 December 2017, about 60% of the 850 foreign private issuers (FPIs) registered with the SEC prepared their financial statements in accordance with IFRS as issued by the IASB and about 40% prepared their financial statements in accordance with US GAAP. The number of FPIs using home-country GAAP reconciled to US GAAP is de minimis.

Mr. Olinger noted that during 2018, Argentina's economy became highly inflationary under both IFRS and US GAAP. Mr. Olinger said this change affects both domestic filers and FPIs that have significant operations in Argentina, not just Argentinian registrants. Mr. Olinger noted that registrants with significant operations in Argentina should disclose business and financial risks as well as any related trends and uncertainties in their Management Discussion and Analysis. Disaggregated disclosure related specifically to their Argentinian operations may also be appropriate.

Mr. Olinger also said the staff would consider requests for relief under Rule 3-13 of Regulation S-X for cross-border transactions. Specifically, in the context of Rules 3-05 and 3-09 of Regulation S-X, the SEC staff will consider allowing a domestic or foreign registrant to provide financial statements prepared in accordance with IFRS as issued by the IASB when the investee or target "almost" qualifies as a foreign business, such as when it is 50% owned by a US entity and 50% owned by a foreign entity, he said.

## New auditing standards

### Critical audit matters

Staff members from both the PCAOB and the SEC discussed the implementation of the PCAOB's requirement that auditors discuss CAMs in their auditor's reports. The requirement is effective for audits of large accelerated filers for fiscal years ending on or after 30 June 2019 and represents the most significant change in auditor reporting in over 70 years.

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### ***Current implementation activities***

In their remarks, PCAOB and SEC staffs praised audit firms' implementation efforts, including dry run programs that are taking place in advance of the effective date. They said these efforts are helping audit firms, audit committees and companies prepare for changes in the audit process and reports and helping companies determine whether they need to make any changes in their disclosures and financial reporting process in advance of auditor reporting of CAMs.

Staff members from both the PCAOB and SEC said they are observing what audit firms are doing to implement the new requirements and working with them to understand their experiences in performing the dry runs. They also encouraged stakeholders to raise any implementation questions and other observations with the PCAOB staff and the SEC staff.

In addition, they discussed the PCAOB's plans to assess the effectiveness of CAM implementation and reevaluate the costs and benefits of the standard. In its evaluation, the PCAOB will address the initial implementation at large accelerated filers before the requirement applies to audits of smaller filers in 2020, they said. The PCAOB will then perform a more comprehensive review after the implementation is fully completed.

### ***Early observations from implementation activities***

Both the PCAOB and SEC staff discussed early observations from firm dry run programs, which included the following:

- ▶ *Number of CAMs* – While PCAOB staff did not express any expectations about the number of CAMs that should be identified, Jennifer Rand, Deputy Chief Auditor at the PCAOB, emphasized that the standard contains a presumption that at least one matter would be identified as a CAM in each audit, even in audits of companies with limited operations.
- ▶ *Relationship with critical accounting estimates* – Mr. Panucci noted that the SEC staff does not expect all critical accounting estimates to be CAMs, due to differences in the underlying definitions and requirements. He emphasized that the requirement to report CAMs was not designed to have auditors duplicate management's disclosures.
- ▶ *Concerns that CAMs will be boilerplate* – One of main concerns raised by investors is that CAMs might become "boilerplate" and thus not serve their intended purpose of providing entity-specific and useful information. Ms. Rand said CAMs should be audit-specific. Therefore, she does not expect CAMs to contain boilerplate language about why a matter is a CAM or what procedures were performed in that particular audit to address the CAM.
- ▶ *Concerns about disclosing original information* – Mr. Panucci said the PCAOB standard and the SEC's order approving the standard each state that auditors are not expected to be the source of original information about the company. Nevertheless, he noted that CAMs were intended to provide original information about the audit.
- ▶ *Expectations for consistency in CAMs within industries* – Ms. Rand acknowledged that similar matters may be identified as CAMs for companies operating in the same industry (e.g., banks' allowance for loan losses). However, she noted that despite such commonality in the source of a CAM, the description of a CAM is intended to be specific to each audit. Further, she emphasized that CAMs were intended to be identified based on the facts and circumstances underlying each audit and that comparability of CAMs between audits was not an objective of the PCAOB standard.

### **How we see it**

Management should use the dry run process to consider the company's existing disclosures about critical accounting estimates and their interaction with matters the auditor identifies as CAMs.

In a panel discussion, two officials from large accelerated filers noted that the matters identified thus far by their auditors as part of their dry run activities were in areas that the registrants had expected, including complex areas on which management spends a significant amount of effort and on which their audit committees focus. The panelists also noted that one of the benefits of their participation in the dry run program was that it provided an opportunity to take a fresh look at their historical disclosures about matters their auditors identified as CAMs.

## ICFR and audit standard setting

### Internal control over financial reporting

The SEC staff said management's assessment of ICFR is more important than usual this year due to the higher risk that controls may fail to timely detect or prevent a material misstatement of the financial statements following the adoption of new accounting standards.

#### *Evaluating the operating effectiveness of ICFR*

Emily Fitts, a professional accounting fellow in OCA, said that both the design of controls and the evaluation of their operating effectiveness require management's well-reasoned and supported judgment, which is grounded in the assessment of the risk of control failure and the risk of material misstatement, considering changes in risks. As these risks increase, more persuasive evidence is generally needed, she said.

To determine whether controls operated effectively and as designed, Ms. Fitts shared some questions for management to consider:

- ▶ Did the assessment include an evaluation of how the operation of the control mitigated the identified risks?
- ▶ If a control is designed to address multiple financial reporting risks or if the control is multifaceted, did the assessment include an evaluation of the operating effectiveness of each aspect of the control?
- ▶ For controls that operate more than once per annual period, was the consistency of the execution of the control considered?
- ▶ When the control was designed with a threshold, was the threshold applied consistently and was further evaluation of items exceeding the threshold conducted when necessary?
- ▶ Were the competency and authority of the personnel who performed the control, or monitored its performance, evaluated and considered?
- ▶ In considering the competency and authority of the responsible personnel, did the assessment consider whether there had been any changes in the personnel who either perform the control or monitor its performance?

To determine whether management has a reasonable basis for its assessment of the operating effectiveness of controls, Ms. Fitts shared the following questions for management to consider:

- ▶ Is the sample size to evaluate the effectiveness of the control sufficient, considering the number of instances in which the control operated during the assessment period?
- ▶ Were the risks associated with the control considered in determining the appropriate level of persuasiveness needed for the evidence to be obtained?
- ▶ For controls related to financial reporting elements with a higher risk of material misstatement (e.g., susceptibility to fraud, need for significant judgment, complexity), did the nature, timing and extent of the evaluation procedures appropriately reflect the level of risk?

As risks of material misstatement increase, more persuasive evidence is generally needed to evaluate operating effectiveness of the related controls.

- ▶ Was the type of control (i.e., manual or automated) considered in determining the nature, timing and extent of the evaluation procedures?
- ▶ Did the control rely on the completeness and accuracy of the information produced by the company? If so, were the controls over that information evaluated and found to be effective?

### ***Evaluating control deficiencies***

Tom Collens, a professional accounting fellow in OCA, shared observations related to management's evaluation of the severity of a control deficiency, including whether a deficiency, either alone or in combination with other identified control deficiencies, rises to the level of a material weakness. To assist management in evaluating control deficiencies, Mr. Collens shared the following observations and reminders.

Mr. Collens said the evaluation of deficiencies too often focuses on the actual misstatement that occurred. For example, management may assume that a control deficiency is limited to the area in which a misstatement occurred and may fail to perform a root cause evaluation that would help management determine whether it is reasonably possible that other financial statement areas could be affected.

Mr. Collens also reminded preparers that it is important to perform a fulsome analysis of the magnitude of a reasonably possible misstatement when there is a control deficiency. For example, if a deficiency resulted in offsetting misstatements in a financial statement line item or disclosure, management may need to consider those misstatements in the aggregate without netting as a starting point for evaluating the potential magnitude of misstatements resulting from the control deficiency.

Finally, Mr. Collens observed that compensating controls should (1) operate at a level of precision that would prevent or detect a misstatement that could be material and (2) be designed to achieve the same objective as the control identified as deficient in order to reduce the severity of that control deficiency to below a material weakness. The existence of a material misstatement would likely indicate that the compensating control was not sufficient.

### ***Improving disclosures about material weaknesses***

Despite improvements the SEC staff generally has noted in disclosures of material weaknesses, Ms. Fitts said companies could do more to make these disclosures more informative for investors. For example, management should help investors understand the cause of the material weakness, its effect on the financial statements (e.g., whether the material weakness is pervasive or isolated to specific accounts or disclosures) and management's remediation plans, she said.

### **PCAOB audit standards**

Barbara Vanich, Acting Chief Auditor and Director of Professional Standards at the PCAOB, said that the PCAOB plans to consider final standards on auditing accounting estimates, including fair value measurements and the use of specialists, at a public meeting on 20 December 2018. Ms. Vanich noted that the proposed standards are designed to strengthen audit requirements in areas that are significant in the audit by establishing a more uniform, scalable and risk-based approach that provides appropriate supervision and the application of professional skepticism.

Ms. Vanich also said the PCAOB is focusing on understanding how emerging technology is being used in the audit and how it affects audit quality. The PCAOB is performing research to determine whether auditing standards potentially impede the use of new technology that may improve audit quality and whether rulemaking or guidance from the PCAOB staff is needed.

## SEC enforcement and PCAOB inspection matters

### Remarks of SEC enforcement staff

Ms. Avakian and Matthew Jacques, Chief Accountant in the Division of Enforcement, discussed the SEC's enforcement actions over the past fiscal year.

Ms. Avakian said the Division's priorities, which are executed by six specialized units, focus on:

- ▶ Protection of retail investors
- ▶ Conduct of registrants
- ▶ Cyber-related misconduct, including violations involving initial coin offerings and distributed ledger technology (blockchain)
- ▶ Financial fraud
- ▶ Insider trading

Ms. Avakian said that, during the last fiscal year, the SEC awarded 13 individuals who participated in the whistle-blower program approximately \$170 million. More than 5,000 whistle-blower tips were received by the SEC during that period, an increase of 20% from the year before.

Ms. Avakian said, during the last fiscal year, the SEC brought enforcement actions against individuals involved in a wide range of accounting frauds, such as matters involving revenue recognition (e.g., fictitious sales, inappropriate acceleration of revenue), understatement of expenses and accrued liabilities, misleading disclosures (e.g., about backlogs) and misleading the independent auditors.

One of the root causes identified by the SEC in enforcement actions involving revenue recognition relates to the improper flow of information within the organization or to the independent auditors, such as undisclosed side agreements with terms and conditions that would preclude or delay a registrant from recognizing revenue under US GAAP. Mr. Jacques emphasized that adopting ASC 606 in 2018 gave registrants an opportunity to strength their processes and internal controls over revenue recognition, including improving the flow of information between key personnel within the organization.

Mr. Jacques said the SEC also has brought more enforcement actions against auditors for violations of auditing standards and independence rules. He described several instances of audit failures, emphasizing that the root cause usually relates to a lack of supervision and review, a lack of professional skepticism, an overreliance on management representations or a failure to obtain sufficient audit evidence.

### PCAOB inspections

George Botic, Director of Registration and Inspections at the PCAOB, discussed the focus areas for inspections in 2019 and the state of audit quality.

#### *Activities at the PCAOB*

Mr. Botic said the PCAOB is changing how inspectors assess a firm's overall system of quality control and its control environment. That is, inspectors will perform additional procedures and analyses to facilitate a deeper understanding of a firm's key controls and predictors of audit quality. Inspectors will also consider whether a firm's culture underpins a strong system of quality control that drives audit quality and responds to risks such as those related to client acceptance and retention. The initial focus will be on the large annually inspected US firms.

PCAOB inspections will consider whether a firm's culture supports a strong system of quality control that drives audit quality.

Mr. Botic discussed the PCOAB's plan to deploy a dedicated team of inspectors who will focus on performing targeted inspection procedures across a number of firms. The PCAOB will share the results of these targeted reviews as part of its outreach initiatives, he said. The topics to be covered in these targeted reviews may include emerging audit risks. Mr. Botic confirmed that beginning in 2019, the PCAOB intends to increase its engagement with audit committee chairs of US companies selected for inspection.

Other planned changes noted by Mr. Botic include:

- ▶ Improving reporting on inspection findings by making them more timely, relevant, transparent and easier to understand (i.e., written in plain English)
- ▶ Identifying and sharing practices employed by audit firms that promote or enhance the quality of audits
- ▶ Making greater use of data analysis and technology to strengthen the inspection process

#### ***The state of audit quality***

Mr. Botic said audit firm leaders should identify and use audit quality indicators, such as the portion of audit procedures performed before year end, to drive quality at the engagement, local, regional and national levels.

Mr. Botic observed that frequent findings in 2018 inspections continue to include deficiencies related to ICFR, accounting estimates, revenue and accounts receivable. Mr. Botic also discussed the benefits of a robust root cause analysis. He noted that improvements in audit quality have generally been observed at firms that have established an effective root cause analysis program. He said firms should perform a root cause analysis of both negative and positive quality events, which will help them design more effective remediation responses to a negative event.

#### ***Outlook for 2019***

In addition to increasing their focus on the design and operating effectiveness of firms' systems of quality control and areas of recurring inspection findings, PCAOB inspectors will continue to perform procedures to understand how firms consider risks related to cybersecurity incidents and digital assets (e.g., cryptocurrencies), Mr. Botic said.

Inspectors will also continue to monitor the use and development of digital audit tools that firms have developed, including considering whether audit teams are effectively using these tools and applying due care.

Finally, Mr. Botic said the PCAOB is monitoring how audit firms are implementing the new requirement that they report CAMs. The PCAOB staff is talking with the firms about the methodologies they developed and their experiences identifying CAMs and drafting descriptions of CAMs during their dry run programs. In late 2019, inspectors will begin to assess compliance once the requirement that auditors communicate CAMs in the auditor's reports becomes effective for audits of large accelerated filers for fiscal years ending on or after 30 June 2019.

## Endnotes

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- <sup>1</sup> [Statement on the Vital Role of Audit Quality and Regulatory Access to Audit and Other Information Internationally—Discussion of Current Information Access Challenges with Respect to U.S.-listed Companies with Significant Operations in China.](#)
- <sup>2</sup> ASC 326-20-35-8.
- <sup>3</sup> ASU 2018-16, *Derivatives and Hedging (Topic 815): Inclusion of the Secured Overnight Financing Rate (SOFR) Overnight Index Swap (OIS) Rate as a Benchmark Interest Rate for Hedge Accounting Purposes.*
- <sup>4</sup> [Commission Statement and Guidance on Public Company Cybersecurity Disclosures.](#)
- <sup>5</sup> [Report of Investigation Pursuant to Section 21\(a\) of the Securities Exchange Act of 1934 Regarding Certain Cyber-Related Frauds Perpetrated Against Public Companies and Related Internal Accounting Controls Requirements.](#)
- <sup>6</sup> A release seeking input on the frequency of interim reporting is scheduled for 19 December 2018.
- <sup>7</sup> The JOBS Act includes scaled disclosure relief for EGCs enabling a deferral to follow private company effective dates of new or revised accounting standards (i.e., to adopt new or any revised accounting standards on the same date as nonpublic business entities).
- <sup>8</sup> Regulation S-K Item 10(e)(2).
- <sup>9</sup> IASB Meeting July 2018 – Disclosure Initiative: Definition of Material (Amendments to IAS 1 *Presentation of Financial Statements* and IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*).

### About EY

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## Appendix – Conference speeches

	Speech and link to source
SEC Chief Accountant Wesley Bricker	▶ <a href="#">Statement in Connection with the 2018 AICPA Conference on Current SEC and PCAOB Developments</a>
SEC Senior Associate Chief Accountant Kevin L. Vaughn	▶ <a href="#">Speech by SEC Senior Associate Chief Accountant: Remarks before the 2018 AICPA Conference on Current SEC and PCAOB Developments</a>
SEC Associate Chief Accountant Sarah N. Esquivel	▶ <a href="#">Speech by SEC Associate Chief Accountant: Remarks before the 2018 AICPA Conference on Current SEC and PCAOB Developments</a>
SEC Professional Accounting Fellow Andrew W. Pidgeon	▶ <a href="#">Speech by SEC Professional Accounting Fellow: Remarks before the 2018 AICPA Conference on Current SEC and PCAOB Developments</a>
SEC Professional Accounting Fellow Emily L. Fitts	▶ <a href="#">Speech by SEC Professional Accounting Fellow: Remarks before the 2018 AICPA Conference on Current SEC and PCAOB Developments</a>
SEC Professional Accounting Fellow Rahim M. Ismail	▶ <a href="#">Speech by SEC Professional Accounting Fellow: Remarks before the 2018 AICPA Conference on Current SEC and PCAOB Developments</a>
SEC Professional Accounting Fellow Sheri L. York	▶ <a href="#">Speech by SEC Professional Accounting Fellow: Remarks before the 2018 AICPA Conference on Current SEC and PCAOB Developments</a>
SEC Professional Accounting Fellow Tom W. Collens	▶ <a href="#">Speech by SEC Professional Accounting Fellow: Remarks before the 2018 AICPA Conference on Current SEC and PCAOB Developments</a>
PCAOB Director George Botic	▶ <a href="#">Speech by PCAOB Director of Registration and Inspections: Protecting Investors through Change</a>
FASB Chairman Russell G. Golden	▶ <a href="#">Speech by FASB Chairman: Remarks before the 2018 AICPA Conference on Current SEC and PCAOB Developments</a>
IASB Chair Hans Hoogervorst	▶ <a href="#">Speech by IASB Chair: Are we ready for the next crisis?</a>
CAQ Executive Director Cindy Fornelli	▶ <a href="#">Speech by CAQ Executive Director: Center for Audit Quality Update</a>