JANUARY 2017
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THE NEWSLETTER FROM BDO'S NATIONAL ASSURANCE PRACTICE

BDO KNOWS: SEC

CONTENTS

SEC YEAR IN REVIEW

SIGNIFICANT 2016 DEVELOPMENTS

Much like last year, in 2016 the SEC's agenda related to financial reporting focused on Congressionally-mandated rulemaking (e.g., rulemaking required by the Dodd-Frank Act of 2010 and the Fixing America's Surface Transportation Act of 2015) and activities related to its Disclosure Effectiveness Initiative, a broad-based review of the SEC's disclosure rules designed to improve the disclosure regime for both companies and investors. The Commission completed all rulemaking required by the FAST Act in 2016, which included rules that permit emerging growth companies to omit certain historical periods from initial registration statements, allow smaller reporting companies to forward incorporate information by reference into Form S-1, and explicitly permit registrants to include a summary page in Form 10-K. In June, the Commission completed a final rule requiring resource extraction issuers to disclose payments made to the U.S. and foreign governments. Other than a proposal to amend the definition of a smaller reporting company, the majority of the other rulemaking and Commission activities related to the Disclosure Effectiveness Initiative. In addition to rule proposals which would eliminate outdated and redundant disclosure requirements, modernize mining company disclosures and require the use of hyperlinks in exhibits, the Commission issued a Concept Release on Regulation S-K and a Request for Comment on management, certain security holders and corporate governance disclosures. Furthermore, while not directly related to the Disclosure Effectiveness Initiative, the Commission issued a report to Congress in November which was required by

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the FAST Act on how to modernize and simplify Regulation S-K.[1] The report includes recommendations that focus on both narrow procedural matters and more general matters, such as changing management's discussion and analysis to elicit a discussion that focuses more on trends and less on line-by-line comparisons.

There were several notable changes in key staff positions in 2016. Following a serious injury in 2016, the SEC's Chief Accountant, James Schnurr, announced his intent to retire from the agency in November. Wes Bricker, a Deputy Chief Accountant in the Office of the Chief Accountant (OCA) since 2015 and Interim Chief Accountant since July 2016, was appointed Chief Accountant in November. Also in November, Marc Panucci replaced Brian Croteau as the Deputy Chief Accountant in OCA who will lead the activities of the office's professional practice group. In December, the Director of Enforcement, Andrew Ceresney, and the Director of the Division of Corporation Finance, Keith Higgins, also announced their plans to depart the agency. Their announcements followed Chair White's similar announcement in November that she plans to leave the Commission at the end of the Obama administration in January after nearly four years of service. As 2016 came to a close, President-elect Trump has yet to nominate her replacement or other individuals to fill the two empty Commission seats, which were open for all of 2016. The two people President Obama nominated to fill the Commission seats in 2015 (Lisa Fairfax and Hester Peirce) were never confirmed by the Senate. As changes in the SEC Chair position, Commission seats, and key staff members typically accompany a change in Presidents, the turnover is not surprising. Moreover, these changes may also result in a change of the PCAOB Chair, as the term of the current Chair, James Doty, expired in October 2015. Chair White has expressed her belief that the appointment or reappointment of the PCAOB Chair should be left to a full Commission. This Commission will also need to appoint a replacement for Jay Hanson, who resigned from the PCAOB in December.

With respect to the focus areas of the Commission and staff in 2016, the use of non-GAAP financial measures has certainly been at the top of the list. In late 2015, Chair White and the Commission staff began highlighting non-GAAP measures as an area of focus given the extensive use of such measures and the overarching concern that these measures have served to supplant, not supplement, U.S. GAAP. Due to these concerns, the staff issued new non-GAAP Compliance and Disclosure Interpretations (C&DIs) in May and encouraged companies to "self-correct" their reporting of such information. The C&DIs address measures and adjustments which may be considered misleading, as well as examples of what it means to give "undue prominence" to non-GAAP measures.

The staff's other major focus area has been the implementation of and reporting issues associated with the new revenue accounting standard and other pending standards on leases, classification and measurement of financial instruments, and credit losses. In addition to the concern that many companies are not as far along as they should be in their implementation efforts (particularly as it relates to the new revenue standard), the staff is concerned that the disclosures related to the expected effects of adopting these significant new pending accounting standards have been inadequate. In light of these concerns, the staff made an announcement at the September meeting of the Emerging Issues Task Force (EITF) about its expectation for additional qualitative disclosures in registrants' upcoming 10-K filings. The staff also updated the Financial Reporting Manual (FRM) to answer various SEC-reporting questions that arise from the adoption of these new standards.

Both non-GAAP measures and implementing new accounting standards were key themes of the AICPA Conference on SEC and PCAOB Developments (the Conference) held in December. The other key theme of the Conference was the importance of effective internal control over financial reporting, as ICFR is such a critical element of financial reporting (especially in light of the significant changes in internal controls that may be required in order to implement the major new accounting standards). The staff continued to stress the importance of maintaining an open dialogue about these key focus areas among management, the auditor, and the audit committee.

The staff also issued guidance throughout the year to assist registrants and others with interpreting and complying with the SEC's rules and regulations. The staff also updated its C&DIs and the FRM for reporting matters unrelated to non-GAAP measures and new accounting standards.

Much of the Commission's rulemaking activity over the past few years has focused on adopting rules mandated by Congress. With the change in the administration and Congress, there may be mandates to revise or eliminate some of these rules. At the Conference in December, Keith Higgins suggested that proposals included in the Financial CHOICE Act[2] may be a good starting point when speculating about future SEC rulemaking. The Financial CHOICE Act calls for a repeal of certain Dodd-Frank-related disclosure rules (including those related to conflict minerals, resource extraction, mine safety, and pay ratios, among others), a narrowing of company personnel subject to the compensation clawback rules, and an expansion in the exemptions from audits of internal control over financial reporting. With Chair White's pending departure in January and two other open Commission seats, it is difficult to predict what activities will shape the Commission's agenda. We expect the staff to continue its scrutiny of non-GAAP measures and implementation and disclosure issues related to the significant new accounting standards and to continue to work on the Disclosure Effectiveness Initiative. How quickly the staff's work on the Disclosure Effectiveness Initiative will progress remains to be seen.

1 The report is available **here**.

2 The Financial CHOICE Act has been passed by the House Financial Services Committee. The Executive Summary of the Act is available **here**, while the text of the Act can be found **here**.

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This publication summarizes 2016 Commission rulemaking and activities, staff activities and guidance, and other practice issues covered at the Conference that affect financial reporting.[3] We discuss rulemaking, other activities and staff guidance first, followed by practice issues. While not the focus of this newsletter, we also discuss the relevant PCAOB 2016 standard-setting, related activities and common inspection findings.

SEC RULEMAKING

THE DODD-FRANK ACT

Disclosure of Payments by Resource Extraction Issuers (Release No. 34-78167)

In June, the SEC adopted amendments to Exchange Act Rule 13q-1 and Form SD. The rule and form require resource extraction issuers to disclose information about certain payments made to United States and foreign governments for the commercial development of oil, natural gas, and minerals. The requirements were originally adopted in 2012 pursuant to the Dodd-Frank Act but were vacated after they were challenged in a federal court. In response, the SEC rewrote the requirements. The SEC's press release announcing this rulemaking can be accessed **here**, and the final rule can be accessed **here**. The rule applies to "resource extraction issuers," defined as domestic and foreign issuers that are engaged in the commercial development of oil, natural gas, or minerals and required to file an annual report under the Exchange Act. The activities that constitute "commercial development of oil, natural gas, or minerals" include exploration, extraction, processing, export, or the acquisition of a license for any such activity.

Issuers are required to disclose on Form SD any payment (or series of related payments) to the U.S. government or foreign governments, including majority-owned entities of a foreign government, that is not de minimis (which the rule defines as equaling or exceeding $100,000 during a fiscal year) and has been made to further the commercial development of oil, natural gas, or minerals. The disclosures must be reported on a cash basis, do not need to be audited[4] and are not subject to officer certifications. Issuers must comply with the final rule for fiscal years ending on or after September 30, 2018. The disclosures will be filed annually in an XBRL-formatted exhibit to Form SD. The report will be due 150 days after the end of an issuer's fiscal year. Alternatively, issuers may use a report prepared for foreign regulatory purposes if the SEC deems the requirements of the foreign regime to be substantially similar to the Commission's requirements. An issuer may generally follow the due dates of the alternative regime.

The final rule is substantially consistent with the rule the SEC proposed in December 2015.[5] The most significant changes reflected in the final rule are:

- The final rule provides a transition period for reporting payments by recently acquired entities that were not previously subject to reporting and a one year delay in reporting payments related to exploratory activities.
- In a separate **order**, the Commission recognized two EU Directives, Canada's Extractive Sector Transparency Measures Act (ESTMA) and the U.S. Extractive Industries Transparency Initiative (USEITI), in their current forms as substantially similar disclosure regimes.
- Community and social responsibility payments required by law or contract were added to the comprehensive list of payments covered by the disclosure requirements.

THE FAST ACT

(Release Nos. 33-10003 and 34-77969)

In January, the SEC issued interim final rules to implement certain securities law amendments which were part of the Fixing America's Surface Transportation (FAST) Act.[6] The adopting release is available **here** on the SEC's website.

These rules:

- Revised the general instructions to Form S-1 and Form F-1 to reflect one of the FAST Act's self-executing changes which permits an emerging growth company conducting an initial public offering to omit historical periods from its financial statements if it reasonably expects that such periods will not be required at the time of the offering.[7] The preliminary prospectus distributed to investors must contain all financial information required by Regulation S-X.

3 We have historically published two separate reports – an *SEC Year in Review* (covering Commission rulemaking, activities, and staff guidance) and an *SEC Conference Report* (covering insights and practice issues addressed at the AICPA Conference on SEC and PCAOB Developments held annually in December). These publications were combined this year to provide a broader resource covering activities and focus areas of the Commission and staff.

4 Moreover, since Form SD does not include audited financial statements, auditors do not need to read the disclosures and consider whether they are materially inconsistent with the audited financial statements.

5 For further information about the rule proposed in 2015, refer to our SEC Year in Review newsletter on significant 2015 developments (available **here**).

6 For further information about the FAST Act, refer to our SEC Year in Review newsletter on significant 2015 developments (available **here**).

7 This applies to both confidentially submitted and filed registration statements.

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- Revised Item 12 of Form S-1 (and make a conforming change to Item 512(a) of Regulation SK) to permit a smaller reporting company to forward incorporate information by reference. Only smaller reporting companies that are not blank check companies, shell companies (other than business combination related shell companies) or issuers in offerings of penny stock are eligible to take advantage of this provision. This rule became effective on January 25, 2016.

As part of its rulemaking, the SEC solicited feedback on whether the amendments should be extended to other registrants or other forms.[8] However, no further rulemaking to expand these amendments to other registrants or forms was conducted in 2016.

In June, the SEC issued another interim final rule to implement a FAST Act provision. The rule added Item 16 to Form 10-K and specifically permits issuers to voluntarily include a summary in Form 10-K. The adopting release is available **here** on the SEC's website. If an issuer elects to provide a summary, each item within the summary must include a cross-reference via hyperlink to the related, more detailed disclosure in Form 10K. Registrants have historically been permitted to voluntarily provide information, such as a summary, but the FAST Act required SEC rulemaking to specifically permit the summary and require the use of cross-referencing. Item 16 provides registrants with flexibility in preparing the summary and does not specify the summary's length (other than to say it should be brief), location, or disclosure items that should be covered. The summary may only cross-reference information or exhibits that are included in Form 10-K at the time the form is filed.

The rule became effective on June 9, 2016. The SEC also solicited feedback on whether it should provide further guidance on the preparation and content of the summary, limit its length or dictate its location (among other topics). However, no further rulemaking was conducted on this topic in 2016.

DISCLOSURE EFFECTIVENESS INITIATIVE

In 2016, the SEC made notable progress on its Disclosure Effectiveness Initiative, a broad-based review of the SEC's disclosure rules designed to improve the disclosure regime for both companies and investors. The progress made in 2016 follows the SEC's Request for Comment on the effectiveness of certain financial disclosure requirements of Regulation S-X, which was published in September 2015.[9] Activity in 2016 was in the form of rulemaking, a concept release, and a request for comment. Proposed rulemaking is discussed below, while other forms of activities related to the Disclosure Effectiveness Initiative are discussed in Other Commission Activities below.

Proposed Modernization of Disclosures for Mining Registrants (Release No. 33-10098)

In June, the SEC proposed rules to modernize property disclosures made by mining registrants. The revisions would amend Item 102 of Regulation S-K, rescind Industry Guide 7 and include mining property disclosure requirements in a new subpart of Regulation S-K.

The proposed rules would:

- Provide one standard requiring registrants to disclose mining operations that are material to the company's business or financial condition.
- Require a registrant to disclose mineral resources and material exploration results in addition to its mineral reserves.
- Permit disclosure of mineral reserves to be based on a preliminary feasibility study or a final feasibility study.
- Provide updated definitions of mineral reserves and mineral resources.
- Require, in tabular format, summary disclosure for a registrant's mining operations as a whole as well as more detailed disclosure for material individual properties.
- Require that every disclosure of mineral resources, mineral reserves and material exploration results reported in a registrant's filed registration statements and reports be based on, and accurately reflect information and supporting documentation prepared by, a "qualified person."
- Require a registrant to obtain a technical report summary from the qualified person, which identifies and summarizes for each material property the information reviewed and conclusions reached by the qualified person about the registrant's exploration results, mineral resources or mineral reserves.

The proposal can be found **here** on the SEC's website. Comments were due in September.

Proposed Elimination of Outdated and Redundant Disclosure Requirements (Release No. 33-10110)

In July, the SEC proposed amendments to eliminate redundant and outdated disclosure requirements. While the proposal is consistent with the goal of the Disclosure Effectiveness Initiative, the amendments were also proposed in response to a FAST Act mandate

8 At the March meeting of the Center for Audit Quality's SEC Regulations Committee (which can be found **here** on the CAQ's website), the SEC staff noted that it is unable to extend the reporting relief described above to registrants other than emerging growth companies and to forms other than Form S-1 or Form F-1.

9 Further information regarding the Request for Comment can be found in our SEC Year in Review newsletter on significant 2015 developments (available **here**). Our comment letter can be found **here**.

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which requires the SEC to eliminate provisions of Regulation S-K that are duplicative, outdated, or unnecessary disclosures.

The proposal acknowledges that certain disclosure requirements in Regulations S-K and S-X have become outdated, redundant, overlapping or superseded in light of developments in U.S. GAAP, IFRS, other SEC disclosure requirements, and changes in the information environment. The changes are intended to simplify the overall compliance process but not change the mix of information provided to investors. For example, some of these proposed changes include:

- Eliminating the income tax rate reconciliation disclosure requirement in S-X 4-08(h)(2) as such disclosure is required by ASC 740-10-50-12.
- Eliminating the requirement to provide a computation of earnings per share in S-K 601(b)(11) as such disclosure is required by ASC 260-10-50-1a.
- Deleting S-K 101(b) which requires disclosure of segment financial information, restatement of prior periods when reportable segments change, and discussion of segment performance that may not be indicative of current or future operations. Such disclosures are similar to those required by Topic 280 and S-K 303(b).
- Deleting S-K 201(d) which requires disclosure of the securities authorized for issuance under equity compensation plans. Although the U.S. GAAP requirements are not identical to those contained in S-K 201(d), they provide disclosures about the nature and terms of equity compensation arrangements which results in reasonably similar disclosures.
- Eliminating the requirement in S-K 503(d) and related forms to provide a ratio of earnings to fixed charges when an offering of debt securities is registered. The Commission believes this requirement is no longer relevant and useful.

The proposal also solicits comments on:

- Certain disclosure requirements which may overlap with U.S. GAAP but provide incremental information. The SEC plans to use the feedback received on these areas to determine whether to retain, modify, eliminate, or refer them to the FASB for potential incorporation into U.S. GAAP.
- Where disclosures appear in an SEC filing. The proposal would result in the relocation of certain disclosures within a filing. The SEC is seeking feedback on how the relocations may affect the prominence or context of certain disclosures.

The proposal can be found here on the SEC's website. Comments were due in October.

BDO OBSERVATIONS:

We support the Commission's efforts to update its disclosure requirements, particularly its efforts to eliminate requirements that may be outdated, overlapping or superseded. With respect to requirements that may be redundant or duplicative, we believe it is important for the Commission to update them to ensure that any inconsistencies between these requirements and similar requirements in GAAP are intentional and not inadvertent. Moving forward, we encourage the Commission to establish a formal process for reviewing and updating its disclosure requirements in light of developments in U.S. GAAP, IFRS, and Commission guidance. Our specific recommendations as it relates to the proposal can be found in our comment letter (available here).

Proposed Requirement to use Hyperlinks (Release No. 33-10201)

In August, the SEC proposed a rule and form amendments that would require registrants to include a hyperlink to each exhibit listed in the exhibit index of their periodic and transactional filings. The intent is to facilitate easier access to these exhibits for investors and other stakeholders.

The proposal can be found here on the SEC's website. Comments were due in October.

OTHER RULEMAKING

Proposed Amendments to Smaller Reporting Company Definition (Release No. 33-10107)

In June, the Commission proposed rules which would increase the financial thresholds in the smaller reporting company[10] (SRC) definition. The proposal would expand the number of companies eligible for the scaled disclosures permitted by Regulation S-K and Regulation S-X. The financial thresholds in the definition of accelerated and large accelerated filer and the related filing requirements would remain unchanged.

Under the proposal, a company with less than $250 million of public float (or less than $100 million in annual revenues, if the company has no public float) would qualify as a SRC. The proposed financial threshold for re-entering SRC status is less than $200 million of public float (or less than $80 million in annual revenues, if the company has no public float). The following table summarizes the

10 The smaller reporting company definition excludes investment companies, asset-backed issuers and majority-owned subsidiaries of a parent that is not a smaller reporting company.

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proposed amendments to the SRC definition, as compared to the current definition:

Registrant Category	Current Definition	Proposed Definition
Reporting Registrant	Less than $75 million of public float at end of second fiscal quarter	Less than $250 million of public float at end of second fiscal quarter
Registrant Filing Initial Registration Statement	Less than $75 million of public float within 30 days of filing	Less than $250 million of public float within 30 days of filing
Registrant with No Public Float	Less than $50 million of revenues in most recent fiscal year	Less than $100 million of revenues in most recent fiscal year
Re-entering SRC Status Based on Public Float	Less than $50 million of public float at end of second fiscal quarter	Less than $200 million of public float at end of second fiscal quarter
Re-entering SRC Status Based on Revenues (No Public Float)	Less than $40 million of revenues in most recent fiscal year	Less than $80 million of revenues in most recent fiscal year

The current definitions of accelerated and large accelerated filer contain a provision that excludes registrants that qualify as SRCs. The proposal would eliminate that provision, while maintaining the financial thresholds in the definitions of accelerated filer (i.e. $75 million of public float) and large accelerated filer (i.e. $700 million of public float). Therefore, companies with public floats of $75 million or more, but less than $250 million,[11] that qualify as SRCs under the amended definition, would still be subject to the accelerated filing requirements, including the accelerated timing of filing periodic reports and the requirement to provide the auditor's attestation on management's assessment of internal control over reporting required by Section 404(b) of the Sarbanes-Oxley Act of 2002. However, those companies would be allowed to take advantage of the scaled disclosure system available to SRCs.

Rule 3-05 of Regulation S-X requires financial statements of businesses acquired or to be acquired. Rule 3-05(b)(2)(iv) allows registrants to omit such financial statements for the earliest of three fiscal years required if the net revenues of the business acquired or to be acquired are less than $50 million. The Commission has not proposed to amend this threshold.

11 Or less than $200 million of public float, if re-entering the SRC status.

The proposal can be found **here** on the SEC's website. Comments were due in September.

BDO OBSERVATIONS:

Overall, we support expanding the number of registrants that qualify as smaller reporting companies and thereby benefit from scaled disclosure requirements. We believe that doing so is consistent with the Commission's goals of promoting capital formation and reducing compliance costs for smaller registrants while maintaining investor protections. We also believe that the proposed public float and revenue thresholds are reasonable. However, while we agree with the Commission that the threshold for requiring audits of internal control over financial reporting should not be changed, we would like to see the Commission go further by providing more time for these same smaller registrants to file their periodic reports. Our comment letter on the proposal which includes these observations, among others, is available **here**.

OTHER COMMISSION ACTIVITIES

DISCLOSURE EFFECTIVENESS INITIATIVE

Concept Release on Regulation S-K (Release No. 33-10064)

In April, the SEC published a concept release on Regulation S-K. The release is part of the Disclosure Effectiveness Initiative described above. The release focuses on the business and financial disclosures that Regulation S-K requires in companies' periodic reports, many of which have not changed since they were first adopted over 30 years ago. The release seeks input from investors and registrants in the following areas:

- The overall disclosure framework (e.g., the concept of materiality)
- Information intended for investment and voting decisions, including:
  - Core company business information (e.g., narrative description of business)
  - Company performance, financial information, and future prospects (e.g., selected financial data and management's discussion and analysis)
  - Risk and risk management (e.g., risk factors)
  - Securities of the registrant (e.g., description of capital stock)
  - Industry guides (e.g., Guide 3 for bank holding companies)

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- Public policy and sustainability matters (e.g., environmental, social and governance concerns)
- Exhibits (e.g., material contracts)
- Scaled requirements for certain registrants (e.g., smaller reporting company and emerging growth company reporting relief)

- Presentation and delivery of important information (e.g., the use of hyperlinks or cross-referencing)

The concept release can be found here on the SEC's website. Comments were due in July.

BDO OBSERVATIONS:

We support the Commission's efforts to analyze the disclosure regime of Regulation S-K and consider ways to improve the requirements for the benefit of investors. From a broad perspective, we support a principles-based approach to disclosure outside the financial statements. We believe that using a principles-based approach would promote disclosure of information that is most meaningful and relevant. To implement this approach, we believe Regulation S-K should (a) clearly articulate disclosure objectives, (b) provide a list of related topics a registrant should consider discussing and (c) make it clear that the disclosure is only required to the extent necessary to achieve the disclosure objectives. We believe this objectives-based approach is likely to result in more useful disclosure than the line item or "check the box" type approach we observe many registrants taking in response to the current S-K disclosure regime. Our comments and recommendations related to specific S-K disclosure items can be found in our comment letter (available here).

Request for Comment – Management, Certain Security Holders, and Corporate Governance Disclosure Requirements (Release No. 33-10198)

In August, the SEC published a request for comment on the disclosure requirements of Subpart 400 of Regulation S-K, which relate to management, certain security holders and corporate governance matters. This request is a part of the Disclosure Effectiveness Initiative, though it is also intended to inform the Commission's study on Regulation S-K, which is required by the FAST Act.

The request for comment can be found here on the SEC's website. Comments were due in October.

SEC ORDER PERMITTING THE USE OF INLINE XBRL

(Release No. 34-78041)

In June, the SEC issued an order permitting issuers to voluntarily embed XBRL data directly in their financial statements using a format known as Inline XBRL in lieu of providing tagged data in a separate exhibit. The order is available here on the SEC's website.

Issuers have been required to provide XBRL data in an exhibit to their filings. Consequently, issuers copy their financial statement information into a separate document and tag it in XBRL. By allowing issuers to instead embed tags directly into the financial statements, this voluntary program is intended to reduce preparation costs and increase the quality of the data, thereby increasing its use by investors and other market participants.

The order permits issuers to voluntarily use Inline XBRL in their periodic and current reports through March 2020.

STAFF GUIDANCE

FINANCIAL REPORTING MANUAL

The staff of the SEC's Division of Corporation Finance published two updates to the Financial Reporting Manual (FRM) in 2016.[12] As updates are published, the staff includes a summary immediately following the FRM cover that describes the nature of the changes and lists the paragraphs that were updated. The staff also annotates the FRM to communicate the date a paragraph was most recently updated.

The staff added Topic 11 to the FRM in 2016 to address reporting issues related to the adoption of certain significant new accounting standards. The guidance summarizes the available adoption dates, transition methods for public and nonpublic business entities and other reporting guidance for the following standards:

- **The New Revenue Standard (Topic 606)** – Section 11100 was added to address reporting issues related to the adoption of the new revenue standard. The March and November updates addressed the following specific matters:
  - *Selected Financial Data* - When reporting selected financial data, a registrant adopting the new revenue standard using a full retrospective approach need not apply the new standard to periods prior to those presented in its retroactively-adjusted financial statements (refer to FRM paragraph 11100.1).

12 The FRM is an internal SEC staff reference document that provides general guidance covering several SEC reporting topics. While the FRM is not authoritative, it is often a helpful source of guidance for evaluating SEC reporting issues. The FRM, along with other helpful guidance, can be accessed from the Division of Corporation Finance home page, which is located here.

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However, companies are reminded to provide the information required by Instruction 2 to S-K Item 301 regarding comparability of the data presented, if applicable and material.

- o *Emerging Growth Companies* - Paragraph 11100.2 was added to communicate that a calendar year-end EGC that elects to adopt the new revenue standard for the annual period beginning on January 1, 2019 and for interim periods beginning on January 1, 2020 (i.e., the effective date for nonpublic entities) is not required to accelerate application of the standard to interim periods presented in the 2019 Form 10-K (i.e., pursuant to Item 302 of Regulation S-K). The staff noted that the EGC could provide disclosures it deems appropriate to explain why the sum of the 4 quarterly figures for 2019 presented in the annual report do not agree to the corresponding annual amount.
- o *Pro Forma Financial Statements* - Paragraph 11120.4 addresses the presentation of pro forma financial information associated with a significant acquired business in the year of adoption. If a registrant adopts Topic 606 on a full retrospective basis on January 1, 2018 and acquires a significant business in 2018, it is not required to apply the new revenue standard to pro forma financial information for periods prior to adoption (e.g., the pro forma income statement for the year ending December 31, 2017).

- **The New Leasing Standard (Topic 842)** – Section 11200 was added to address reporting issues related to the adoption of the new leasing standard. A calendar year-end registrant is required to adopt the standard on a modified retrospective basis on January 1, 2019, with an initial application date of January 1, 2017. Paragraph 11210.1 specifies that companies are not required to also retrospectively revise their 2016 financial statements if they file a registration statement on Form S-3 in 2019.[13] The guidance indicates that the reissuance of the financial statements in the Form S-3 only accelerates the requirement to recast the 2017 and 2018 financial statements, but it does not change the initial date of the standard's application.
- **The New Disclosures about Short-Duration Contracts for Insurance Entities Standard (Topic 944)** – Section 11300 was added to address reporting issues related to the adoption of ASU No. 2015-09, *Disclosures about Short-Duration Contracts*. Similar to the sections on other new standards above, the guidance summarizes the adoption dates and transition methods. Paragraph 11310.1 was added to address the disclosure requirements related to claims development tables. ASU 2015-09 requires disclosure of disaggregated claims development tables for each reportable segment which reflect re-estimates of claims by accident year for up to ten years. Consequently, the guidance indicates that Property and Casualty insurers are no longer required to separately present the consolidated ten-year loss reserve development table required by Securities Act Industry Guide 6 and Exchange Act Industry Guide 4 in their filings.

The March update amended paragraph 2410.8, which provides guidance on measuring significance of equity method investees under Rules 3-09 and 4-08(g). Previously, when a registrant retrospectively applied a new accounting principle, it was required to recompute the significance of equity method investees in prior years and redetermine the reporting requirements under Rules 3-09 and 4-08(g) when filing its next Form 10-K. This could trigger the need for investee financial statements and/or summarized financial data for prior years that had not previously been required. Under the revised guidance, registrants are no longer required to recompute significance after a change in accounting principle. Registrants should continue to recompute significance under Rules 3-09 and 4-08(g) for prior periods after a discontinued operation.

The staff also updated Topic 10 (Emerging Growth Companies) to the FRM in March to conform it to the FAST Act, which amended securities laws that impact emerging growth companies.[14]

The November update amended paragraph 10220.5, which addresses an emerging growth company's reporting requirements associated with financial statements of entities other than the registrant and pro forma financial information. An EGC is permitted to present only two years of financial statements for entities other than the registrant in its initial registration statement even if the application of the significance tests otherwise results in a requirement to present three years. Paragraph 10220.5(a) explicitly extends this relief to an EGC's acquired real estate operations under Rule 3-14. (The FRM had previously extended this relief to acquired businesses under Rule 3-05 and equity method investees under Rule 3-09.) Additionally, paragraph 10220.5(c) was amended to explicitly permit an EGC to omit pro forma financial information from its initial registration statement if it reasonably expects that such periods will not be required at the time of the offering. The guidance is consistent with securities law amendments included in the FAST Act which permit an EGC to omit historical periods from its financial statements if it reasonably expects that such periods will not be included in its effective registration statement.

The FRM is available **here** on the SEC's website.

13 Item 11(b)(ii) of Form S-3 requires companies to file restated financial statements if there has been a change in accounting principle and the change requires a material retroactive restatement of the financial statements.

14 For further information about the FAST Act, refer to our SEC Year in Review newsletter on significant 2015 developments (available **here**).

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COMPLIANCE AND DISCLOSURE INTERPRETATIONS

The SEC staff updated its C&DIs several times during the year. Many of these updates were legal in nature and provide guidance on tender offers, Regulation A, Regulation AB, Regulation D, pay ratio disclosure and various Securities Act and Exchange Act rules and forms, among others. One notable interpretation relates to the financial statement requirements in a Regulation A offering. As noted above, securities law amendments included in the FAST Act permit an emerging growth company to omit historical periods from its financial statements if it reasonably expects such periods will not be included in its effective registration statement. One of the new C&DIs formally extends this reporting relief to Regulation A filers. An issuer conducting a Regulation A offering is permitted to omit financial information for historical periods (including financial information of other entities that may be otherwise required) if it reasonably expects those periods will not be required at the time Form 1-A is qualified by the SEC.

In May, the staff updated its C&DIs on non-GAAP financial measures. These updates and other staff communications related to non-GAAP measures are discussed below under Practice Issues.

PRACTICE ISSUES

In addition to the guidance discussed above, the SEC staff addressed various practice issues throughout the year. This section discusses those issues, including observations the staff made at the Conference.

NON-GAAP FINANCIAL MEASURES

As discussed in our overview, over the past year non-GAAP measures have been highlighted as an area of concern by Chair White and the SEC staff, given registrants' extensive use of them and the potential for confusion they may cause. The updates to the C&DIs referred to above primarily address the nature and presentation of adjustments or measures that may be considered misleading and therefore violate Regulation G or Item 10(e) of Regulation S-K. Specifically, the updates communicate that:

- Certain adjustments to GAAP measures may be misleading even if they are not expressly prohibited by the SEC's rules. For example, the exclusion of cash operating expenses that are normal and recurring items could be misleading.
- Non-GAAP measures can be misleading if they are presented inconsistently between periods. While a change between periods is not prohibited, the reason for any change should be clearly described and disclosed. Additionally, registrants may need to consider recasting historical non-GAAP measures to conform to the current period presentation.
- Non-GAAP measures that exclude non-recurring charges but do not exclude non-recurring gains may be misleading.
- Revenue measures that are calculated using revenue recognition and measurement methods that are different from those required by GAAP are generally not permitted. The same concept may also apply to other financial statement line items measured using tailored accounting principles. A registrant's non-GAAP adjustments and measures generally should not tailor GAAP or apply accounting methods/principles for which the registrant does not otherwise qualify under GAAP.
- While registrants may present non-GAAP performance measures on a per share basis, registrants are prohibited from presenting non-GAAP liquidity measures on a per share basis. Whether per share data is permitted depends on whether the non-GAAP measure can be used as a liquidity measure, even if management presents it solely as a performance measure. For this reason, non-GAAP measures such as EBIT and EBITDA may not be presented on a per share basis. Also, registrants should focus on the substance of the non-GAAP measure and not management's characterization of the measure to determine whether presenting the measure on a per share basis is permissible.
- If a company presents EBIT or EBITDA as a performance measure, the measure should be reconciled to net income (not operating income). Operating income is not the most directly comparable GAAP financial measure because EBIT and EBITDA make adjustments for items that are not included in operating income.
- Registrants are permitted to present a non-GAAP measure such as "free cash flow,"[15] though they should clearly describe how the measure was determined as it does not have a uniform definition across companies. Companies should not imply that the measure represents cash available to fund discretionary expenditures as the definition typically excludes debt-service and other expenditure requirements. Since it is a liquidity measure, free cash flow should not be presented on a per share basis.
- When reconciling between GAAP measures and non-GAAP measures, the income tax effects of non-GAAP measures should be reflected separately and clearly explained. Reconciling items should not be presented net of tax.

The updates also provide several examples that illustrate placing undue prominence on non-GAAP measures (which is prohibited by Item 10(e) of Regulation S-K).

15 Free cash flow is typically calculated as operating cash flows less capital expenditures.

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These examples include, among others:

- Omitting comparable GAAP measures from an earnings release headline that includes non-GAAP measures;
- Presenting non-GAAP measures before the directly comparable GAAP measures;
- Describing a non-GAAP measure as "record performance" without an equally prominent description of the comparable GAAP measure; and
- Providing a discussion and analysis of the non-GAAP measures without a comparable discussion of the GAAP measures.

Furthermore, for registrants that present "funds from operations" (FFO), as defined by the National Association of Real Estate Investment Trusts (NAREIT), the staff clarified that it accepts NAREIT's definition of FFO in effect as of May 17, 2016 as a performance measure and does not object to its presentation on a per share basis. Additionally, registrants are permitted to present FFO on a basis other than as defined by NAREIT as long as the measure complies with Regulation G or Item 10(e) of Regulation S-K.

The C&DIs are available **here** on the SEC's website.

Building on staff speeches throughout the year, non-GAAP measures were a prominent theme at the Conference. The staff acknowledged the substantial progress registrants made after the issuance of the C&DIs, particularly in the prominence with which they present them. However, the staff is still concerned about the appropriateness of measures that seem to eliminate normal recurring expenses and the effectiveness of the related disclosure controls and procedures.

The staff emphasized the following:

- When providing the required reconciliation of the differences between a non-GAAP measure and the most directly comparable GAAP measure, begin the reconciliation with the GAAP amount. Presenting the non-GAAP amount first gives it undue prominence.
- The C&DIs prohibit individually tailored accounting principles, such as acceleration of revenue recognition and proportionate consolidation. However, the staff may allow certain revenue adjustments in limited circumstances (e.g. adjustments to reflect the expected impact of adopting Topic 606). In those situations, registrants should discuss the presentation with the staff in advance.
- When a registrant presents non-GAAP information in an earnings release, it should consider also including non-GAAP disclosures in MD&A, given the perceived importance of the measure to investors.
- Audit committees should understand the non-GAAP measures being utilized as well as the procedures and controls in place around those measures.

NEW ACCOUNTING STANDARDS

Staff Announcement - Disclosures Related to the Adoption of New Accounting Standards

In 2016, reporting issues related to the adoption of new, significant accounting standards have been a significant SEC staff focus area. One of these reporting issues relates to Staff Accounting Bulletin 74 disclosures (which has been codified into SAB Topic 11.M). SAB 74 addresses disclosure of the impact that recently issued accounting standards will have on the financial statements of the registrant when adopted in a future period. Since the new revenue standard was issued, the SEC staff has communicated its expectation for these disclosures to evolve over time as registrants better understand the effects that the new standard will have on their financial statements.

At the September 22, 2016 EITF meeting, the staff made an **announcement** regarding its views about SAB 74 disclosures related to:

- ASU No. 2014-09, *Revenue from Contracts with Customers* (Topic 606);
- ASU No. 2016-02, *Leases* (Topic 842); and
- ASU No. 2016-13, *Financial Instruments Credit Losses* (Topic 326): *Measurement of Credit Losses on Financial Instruments*.

The staff expects registrants that are not yet in a position to disclose the quantitative effects of these standards on their financial statements will make additional qualitative disclosures including:

1. The effect of the accounting policies that the registrant expects to apply (if determined) and a comparison to the registrant's current accounting policies and
2. The status of its process to implement the new standards and the significant implementation matters yet to be addressed

Registrants should also consider making any additional qualitative disclosures necessary to help financial statement users under the impact of these new standards. At the Conference, the staff indicated that it will be looking for these disclosures in registrants' upcoming 10-K filings and if they do not appear, companies should anticipate receiving a staff comment letter on the topic.

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BDO OBSERVATIONS:

As the adoption date of the new revenue standard has drawn nearer, the staff has also expressed its concern about a perceived lack of preparedness among registrants due to lackluster SAB Topic 74 disclosures – e.g., continued disclosure that states, "We are currently evaluating the effect of the standard on our financial statements." We believe the staff announcement in September requesting additional qualitative disclosure is intended, at least in part, to get the ball rolling for registrants who have not otherwise devoted significant time and attention to the impact that the standard will have on their financial statements. Examples of such qualitative disclosures for the new revenue standard may be as follows:

- **For a software company that has begun its assessment:** "We have formed a committee to evaluate the standard's effect on our financial statements. We have historically deferred revenue for certain deliverables in our multiple-element arrangements due to a lack of vendor specific objective evidence (VSOE) for those deliverables. Our preliminary analysis indicates that we will recognize revenue for these arrangements earlier under Topic 606 than under Topic 605 due to the elimination of the VSOE requirement."
- **For a company that has historically elected to expense all contract costs under SAB 104:** "Our historical accounting policy for contract costs is to expense all costs as incurred, as permitted under SAB 104. Under Topic 606, we will be required to capitalize certain contract costs for all contracts greater than one year and amortize them as we transfer goods or services to our customers. Accordingly, we expect to recognize a deferred charge for such costs on in-process contracts upon adoption."
- **For a company that is just getting started on its evaluation:** "We are in the initial stages of evaluating the effect of the standard on our financial statements and continue to evaluate the available transition methods.

Form S-3 Considerations

Item 11(b) of Form S-3 requires a registrant to recast its annual financial statements in a new or amended registration statement after retrospective adoption of a new accounting principle, if the change is material. Consequently, a registrant that elects to adopt the new revenue standard on a full retrospective basis may be required to recast its financial statements for an additional year if it files a new or amended registration statement in 2018. For example, a registrant with a calendar year end that adopts the revenue standard on a full retrospective basis on January 1, 2018 and does not file a registration statement in 2018 would be required to recast its 2017 and 2016 financial statements for purposes of its 2018 Form 10-K. However, if the registrant files a registration statement on Form S-3 in 2018 after it has filed its first quarter Form 10-Q, it would be required to restate its 2017, 2016 *and* 2015 financial statements. However, the staff communicated[16] that registrants may consider the impracticability exception included in ASC 250-10-45-9 if, for example, a company is unable to apply the requirement to recast all periods presented in its financial statements after making every reasonable effort to do so. While not required, the staff has indicated that a registrant may wish to consult with OCA if it has concluded it would be impracticable to present one or more comparative periods.

With respect to shelf takedowns (i.e., offers made using an already effective registration statement) in 2018, the staff indicated at the Conference that it would not expect registrants to conclude that the adoption of a new accounting standard qualifies as a "fundamental change," which would trigger the need to file a post-effective amendment to the registration statement and the recasting of the financial statements for the additional year as described above.

Adoption Dates for Equity Method Investees

The FASB's definition of a public business entity (PBE) includes entities whose financial information or financial statements are included in a filing with the SEC. Consequently, entities that are otherwise privately-held may be considered PBEs solely because their financial information / statements appear in an SEC filing (e.g., financial statements of an acquired business under Rule 3-05 or an equity method investee under Rule 3-09, and financial information of equity method investees under Rule 4-08(g)).[17] The determination of whether an entity qualifies as a PBE is important, particularly because many accounting standards, including the major new accounting standards discussed in this letter, have different adoption dates for PBEs (which are typically one year earlier than non-PBEs). The staff discussed the application of the PBE definition to an insignificant equity method investee whose financial information is not included in the filing, but is used only for purposes of recording the registrant's share of the investee's earnings or losses. The staff indicated that this type of equity method investee would not be considered a PBE and therefore, would not be required to adopt the new accounting standards using the PBE adoption dates.

Revenue Recognition Standard

At the Conference, Chief Accountant Wes Bricker emphasized that revenue is "one of the single most important measures used by investors in assessing a company's performance and prospects" and

16 Refer to Wes Bricker's remarks at the 2016 Baruch College of Financial Reporting Conference here.

17 Paragraph BC12 in ASU 2013-12 specifically states that an entity whose summarized financial information is provided to comply with Rule 4-08(g) of Regulation S-X is considered a PBE.

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"companies cannot afford to get the accounting wrong." Bricker's statements illustrate the importance of sufficient preparation, by all companies, to ensure successful implementation of the new principles-based revenue recognition standard. To date, the SEC staff has observed progress in readiness efforts. However, many registrants remain in the initial assessment phase. The staff encouraged registrants to discuss their current Topic 606 implementation status and ongoing activities with investors, audit committees, and auditors (while being mindful of auditor independence requirements).

While registrants prepare for the new standard, the staff is executing its own revenue implementation strategy. The staff actively monitors implementation efforts in order to understand areas of potential diversity and the types of judgments being made. Additionally, as registrants work through applying the standard, the staff continues to be available for consultations.

Bricker also provided insight into how the staff forms its views on specific transactions. The staff considers the nature, design and economic substance of the transaction by starting with the terms of the contract itself. The language in Topic 606 and the related basis for conclusions, implementation discussions such as those at the Transition Resource Group, and the objective of consistency and comparability are also contemplated. Prior to a consultation, the staff believes a registrant should fully understand their arrangements and be able to clearly articulate their basis for accounting under the new standard.

Based upon Topic 606 implementation consultations to date, the staff shared the following observations:

Definition of a contract – Certain companies may employ a loss leader pricing strategy, where they price one good or service at a discount in order to stimulate future sales of more profitable goods or services. While future sales may appear likely for economic or other reasons, the staff believes future contracts should not be accounted for as part of the existing revenue arrangement since a contract with enforceable rights and obligations does not exist.

Contract combinations –A company may enter two or more contracts at or near the same time with the same customer (or related parties of the customer). Under Topic 606, those contracts may be accounted for as a single contract, provided at least one of the following criteria is met:

- The contracts are negotiated as a package with a single commercial objective.
- The amount of consideration in one contract depends on the price or performance of the other contract.
- The goods or services that are promised in the contracts represent a single performance obligation.

The staff emphasized that the contract combination guidance should not be extended beyond the customer. For example, two interdependently priced contracts negotiated as a package at the same time would not meet the contract combination guidance unless the contracts were with the same customer.

Payments to customers – The staff noted that companies make payments to customers for a variety of reasons. To assess the accounting for such payments, a company must understand the economic reason(s) for the payments, the relevant terms of the contract, and how the payments are described to investors and other stakeholders. After gaining this understanding, the payment should be accounted for on a basis that is consistent with the substance of the transaction and the relevant accounting literature. The staff stated that the concept of "matching is not a determinative factor." Furthermore, classification of customer incentives in the income statement, particularly if a customer is not in the standard supply chain, requires judgment. The staff expects quantitative disclosures for material amounts reflected outside of revenues.

Gross versus net presentation – The control-based nature of the new revenue recognition standard may result in a change in the presentation of revenues. The staff urged registrants to take a fresh look at existing principal (gross) and agent (net) conclusions, stressing that no default or safe harbor exists under Topic 606. Rather, the specific facts and circumstances should drive the accounting conclusion.

Disaggregated disclosures – Topic 606 requires certain disclosures of revenues on a disaggregated basis (e.g. by geography, type of good/service, etc.), similar to segment disclosures. While an impracticability exception exists for segment reporting, no such exception is available in the new revenue standard. The staff indicated they will review other investor communications, such as earnings releases and company websites, in order to assess whether a company makes appropriately disaggregated disclosures. This is consistent with the staff's approach for segment disclosures.

SAB Topic 13 – The staff noted that SAB Topic 13, Revenue Recognition, applies prior to the adoption of the new revenue recognition standard. Thereafter, registrants should evaluate revenue arrangements under Topic 606. The staff will assess any implementation related consultations under Topic 606 similarly, i.e., without regard to SAB Topic 13.

Disclosing the effects of adoption – The staff also indicated a registrant that adopts the new revenue standard on a modified retrospective basis may present as supplemental pro forma information in MD&A the amounts it would have reported if full retrospective adoption had been elected. This supplemental pro forma information would be considered non-GAAP financial information subject to the applicable requirements, including a prohibition on presenting a full supplemental pro forma income

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statement. In addition to supplemental pro forma revenues disclosures, registrants should also disclose the impact on other financial statement line items, such as costs of sales.

Credit Losses Standard

The SEC staff commented that "virtually every registrant will be affected" due to the range of financial assets scoped into the new credit losses standard, including loans, debt securities and trade receivables. Furthermore, the staff noted that management must determine an estimate of expected credit losses that is most reflective of the company's expectations. Since Topic 326 does not require a specific method to estimate expected credit losses, each company must develop accounting principles and methodologies that can be applied consistently from one period to another. A systematic methodology consistent with the principles of the new standard should support management's expected credit loss estimates each period. The staff emphasized that detailed documentation of policies, procedures, methodologies and decisions will continue to be necessary. SAB 102, *Selected Loan Loss Allowance Methodology and Documentation Issues*, and Financial Reporting Release No. 28, *Accounting for Loan Losses by Registrants Engaged in Lending Activities* will continue to be relevant given the need to use reasonable and supportable forecasts in the new standard.

OTHER ACCOUNTING AND DISCLOSURE TOPICS

Share-Based Awards: Grant Dates

Topic 718, Compensation – Stock Compensation, defines a grant date as the date when a mutual understanding of the key terms and conditions of a share-based payment award is reached between the employer and employee. For an equity-classified service award, a company recognizes the grant date fair value of the award over the requisite service period. Compensation cost for services provided prior to the grant date is recorded based upon the fair value of the award at each reporting date, resulting in multiple valuation dates. The SEC staff highlighted the need for careful consideration with respect to the establishment of a grant date (i.e., whether a mutual understanding has been reached) when an award includes a key discretionary condition, such as a clawback provision. A company should consider its past practices and how they have evolved over time as part of the assessment. The staff also noted that appropriate ICFR is necessary to monitor past company practices used to support grant date judgments.

Defined Benefit Plan Considerations

The following approaches for developing pension benefit obligations (PBO) and the related interest costs for single employer defined benefit pension plans have been accepted by the SEC staff:

Approach	PBO	Interest Cost
Single weighted average	The plan sponsor determines the PBO at the measurement date by discounting the projected future benefit payments at the individual duration-specific rates forecast for the time of the projected payments. The single weighted average discount rate calculated by the plan sponsor represents the rate that discounts the projected benefits payments to a present value amount that equals the PBO.	The plan sponsors use this weighted average discount rate to determine the annual interest costs for defined benefit plan reporting.
"Spot rate" or yield curve	The plan sponsor determines the PBO in the same manner as in the single weighted average approach.	The plan sponsor uses the individual, duration-specific ("spot") rates from the yield curve to calculate annual interest costs.
Hypothetical bond portfolio	The plan sponsor determines the PBO by developing a hypothetical portfolio of actual bonds with cash flows that match the projected future benefit plan payments.	The plan sponsor uses the hypothetical bond portfolio to calculate the weighted average rate, and uses this rate to calculate annual interest costs.

The single weighted-average and the spot rate approaches result in the same PBO based on the use of an identical yield curve, but the annual interest costs differ. The hypothetical bond portfolio approach results in a different PBO. The staff stressed that the same approach must be used to calculate both the PBO and interest costs as the two calculations are integrated. Consequently, if a company utilizes the hypothetical bond portfolio matching approach to develop the PBO, the spot rate approach cannot be used to calculate the interest cost.

Insurance Company Disclosures: Short Duration Contracts

Topic 944, Financial Services – *Insurance*, requires presentation of a claims development table in the footnotes to the financial statements. The SEC staff noted that retrospective restatement of

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the claims development tables to capture the effects of acquisitions and dispositions would be consistent with the objectives of Topic 944. Alternatively, separate prospective presentation of the claims information for the existing business as well as the liabilities of an acquired business might also meet the objectives of the standard. The staff believes a company may capture the impact of foreign currency exchange rates by using the current-period exchange rates for all years in the claims development tables or by including a separate claims development table for each functional currency.

Fair Value Option for Financial Instruments

For financial liabilities for which a fair value option has been elected under Topic 825, Financial Instruments, as amended by ASU No. 2016-01, *Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, an entity must present separately, in other comprehensive income (OCI), the portion of the total change in the liability's fair value that results from a change in instrument-specific credit risk. The fair value option can also be elected under Topic 815, *Derivatives and Hedging*, for a hybrid financial liability (e.g., a debt obligation with an embedded derivative) for which the embedded feature otherwise would have been required to be bifurcated and accounted separately.

Under the new presentation guidance in ASU 2016-01, the SEC staff believes that similar to a fair value election under Topic 825, changes due to instrument-specific credit risk should be recorded in OCI even when an entity elects the fair value option under Topic 815. There is no requirement under GAAP to first evaluate whether an entity can elect a fair value option under the derivatives guidance in Topic 815, prior to electing a fair value option under Topic 825. Accordingly, an entity that elects a fair value option under either guidance for an eligible hybrid financial liability should follow the new presentation requirements in ASU 2016-01 regarding changes in instrument-specific credit risk.

Under the updated guidance, an entity may consider the portion of the total change in fair value that excludes amounts related to a base market risk (e.g., risk-free rate or benchmark interest rate) to be the result of a change in instrument-specific credit risk, which the staff referred to as the "base rate method." Alternatively, a company may use another method if it faithfully represents the portion of the total change in fair value resulting from a change in instrument-specific credit risk. The staff provided hypothetical examples to illustrate the judgment involved in the measurement of instrument-specific credit risk. In one scenario, payment of a nonrecourse financial liability, for which a company has elected the fair value option, is tied solely to the cash flows of the asset pledged as collateral. The staff believes that none of the change in fair value would relate to instrument-specific credit risk since the fair value is derived from the risks inherent in the collateral asset. Therefore, the entire change in the financial liability's fair value would be reflected in earnings. Under another scenario, the staff observed that the base rate method may not be appropriate for a company electing the fair value option for a debt obligation that is indexed to the price of gold and requires cash settlement since the price of gold impacts the change in fair value.

Segment Reporting

Many of the principles and objectives within the segment reporting guidance highlighted in prior years were once again discussed at the Conference. The following segment reporting issues continue to receive a substantial amount of attention from the SEC staff.

- **Operating segments** – The staff views the availability of gross margins for a component as sufficient to conclude that discrete financial information is available. The allocation of shared operating costs is not required.
- **Aggregation of operating segments** – When considering aggregation of two or more operating segments, a registrant must consider whether: (a) aggregation is consistent with the objective and basic principles in the standard, (b) operating segments have similar quantitative economic characteristics, and (c) operating segments have similar qualitative characteristics. The staff reminded registrants that economic similarity (e.g., similar margins) does not matter if operating segments are qualitatively different. Economic similarities may be coincidental. As such, a registrant should also consider qualitative factors, including the nature of the entity's activities, when contemplating aggregation.
- **Entity-wide disclosures and other general information** – The staff cautioned registrants not to overlook other disclosure requirements in their segment reporting, such as enterprise-wide disclosures and the factors used to identify reportable segments (e.g., by geography, by product, regulatory environment, etc.).

Additionally, the SEC's rules prohibit the presentation of non-GAAP information within financial statements, except for the required disclosure of the segment financial measure used by the chief operating decision maker. The staff stated that registrants should not voluntarily disclose additional segment financial measures. GAAP does not require such additional disclosures, making them non-GAAP measures. For the same reason, a registrant with one reportable segment should not present segment financial measures.

Income Taxes

The SEC staff has historically stressed the need for continued improvement in income tax disclosures in both the footnotes to the financial statements and in MD&A. At the Conference, the staff specifically mentioned that additional comment letters will be issued this year if disclosures are not enhanced. Income tax

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disclosures should help a reader understand a company's complete tax situation.

Undistributed foreign earnings - Topic 740, *Income Taxes,* creates a general presumption that undistributed foreign earnings will be repatriated, resulting in a tax liability when transferred to the parent entity. A registrant may overcome the general presumption if certain criteria are met and assert that foreign earnings are indefinitely reinvested. The staff has observed disclosures outside of the financial statements, such as in MD&A, which "call into question (or potentially contradict) assumptions relied upon in accounting for undistributed earnings." Consistent use of assumptions when making complex income tax accounting judgments requires coordination among multiple business functions within a company's global organization.

MD&A disclosures – The staff also expects registrants to explain reasons for changes in effective tax rates, the extent to which historical effective tax rates are an indicator of future rates (and why or why not), the effect of uncertain tax benefits, the amount of cash in foreign jurisdictions for which deferred income taxes have not been provided, and the liquidity impact of tax obligations. Furthermore, the staff emphasized that valuation allowance related disclosures must be relevant and specific, including the sources and amounts of taxable income that the registrant relies on to avoid a valuation allowance, while avoiding "boilerplate" language.

Accounting Policy Considerations

In accordance with Topic 250, *Accounting Changes and Error Corrections*, accounting principles should be applied consistently from period to period unless a company can justify that a change is preferable. The SEC staff reminded registrants that changes in accounting principles resulting from new accounting standards do not require an evaluation of preferability. Additionally, changes due to events or transactions that are clearly different in substance from past events or transaction do not necessitate an evaluation of preferability. The staff cautioned that "identifiable differences between certain transactions or events does not necessarily equate to a clear difference in substance." A company should consider the nature of the events or transactions that lead to the current documented accounting policy as part of the assessment.

Measurement Period Adjustments

Topic 805, *Business Combinations*, requires disclosure of provisional amounts when the initial accounting for a business combination is incomplete at the end of a reporting period. A company adjusts the provisional amounts based upon new information obtained during the measurement period about facts and circumstances that existed at the acquisition date. The SEC staff reiterated that the measurement period is not one year from the acquisition date. Rather, the measurement period ends "as soon as the acquirer receives the information it was seeking about facts and circumstances that existed as of the acquisition date or learns that more information is not obtainable" and cannot exceed one year. The staff also emphasized the difference between the timing of recognition of a measurement period adjustment (during the current reporting period) and a material error correction (restatement of prior periods) as well as the need for sufficient ICFR to identify and account for adjustments and errors separately.

Loss Contingencies

The staff continues to focus on loss contingency disclosures, specifically when "surprises" occur. The staff cited timely disclosure of accruals for loss contingencies and the reasonably possible range of loss, when applicable, as commonly omitted disclosures. When a company settles a loss contingency shortly after a reporting period, the staff may inquire about the absence of related disclosures in previous filings.

Joint Ventures, Strategic Alliances, and Other Collaborative-Type Arrangements

The growing prevalence of various types of strategic alliances and the increasing complexity of these arrangements may create issues across a number of accounting topics (e.g., consolidation, gain recognition, revenue recognition, derivatives, leases, etc.). As a result, careful consideration of the facts and circumstances surrounding an arrangement is essential.

Registrants should first determine whether the activities of the strategic alliance are conducted wholly or partially within a legal entity and, if so, whether that legal entity should be consolidated. The variable interest entity (VIE) and voting interest consolidation models require a thoughtful analysis regarding decision-making authority, including the determination of which activities most significantly impact the economic performance of a VIE. The SEC staff noted that conclusions on decision-making authority should be consistent with the substance of the arrangement as well as the consolidation guidance.

When a registrant conducts activities outside of a legal entity or does not consolidate a legal entity, a company must contemplate the applicability of other accounting guidance (e.g. joint ventures and collaborative arrangements). Additionally, certain arrangements where another party receives the outputs of an entity's ordinary activities may meet the definition of a contract with a customer within Topic 606.

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INTERNAL CONTROL OVER FINANCIAL REPORTING

ICFR was a pervasive topic throughout the prepared remarks of many SEC representatives at the Conference, consistent with last year. Chief Accountant Wes Bricker echoed Chair White's comments from her 2015 keynote address stating, "It is hard to think of an area more important than ICFR to our mission of providing high-quality financial information that investors can rely on." Unidentified or unaddressed deficiencies can lead to lower-quality financial reporting and restatements. Bricker also relayed investor sentiment about the significance of strong and effective controls, including audits of such controls, in establishing the credibility necessary to raise capital.

The staff relayed key takeaways from an SEC enforcement action during the year, noting that management should 1) evaluate the severity of control deficiencies, report any material weaknesses promptly, and disclose the cause of any material weakness and its potential impact on the financial statements, 2) maintain competent and adequate accounting staff, complementing them with qualified external resources where necessary, and 3) take responsibility for its ICFR assessment, as it cannot be outsourced to third parties.

As a sign of improvement, the SEC staff observed that identification of material weaknesses in advance of restatements has improved at an increasing rate. Nevertheless, frequent identification of deficiencies in ICFR audits by the PCAOB indicate issues still exist. The staff reminded registrants that those findings may also indicate deficiencies in management's controls and assessments. Placing unwarranted reliance on controls that are not designed at a level of precision to address the risk of material misstatement or controls that are dependent on the effectiveness of other controls and obtaining evidence to support conclusions on the design and effectiveness of ICFR require the attention of registrants. The staff reiterated the importance of regular ongoing dialogue among registrants, auditors and audit committees about ICFR assessments, specifically when there are changes to previous risk assessments.

The staff stressed that effective design and operation of ICFR is necessary to support the inherent judgments needed for complex accounting matters, such as consolidations and identification of operating segments, as well as when implementing new accounting standards and policies. Existing controls may no longer be appropriate. Registrants may need to implement new or re-designed controls prior to the adoption of the new accounting standards for revenue recognition, leases, and credit losses.

IFRS FOR U.S. ISSUERS

In his Conference remarks, Chief Accountant Wes Bricker touched on the use of IFRS in the United States. While he believes that the FASB's independent standard setting process and GAAP will continue to serve the needs of investors for at least the foreseeable future, he expressed support for continued collaboration between the FASB and IASB to eliminate differences between their standards. He also indicated that the staff will continue to evaluate his predecessor's idea to permit domestic issuers to voluntarily provide IFRS-based information as a supplement to their GAAP financial statements without requiring a reconciliation of that information to GAAP.

SEC STAFF CONSULTATIONS AND COMMUNICATIONS

Registrants may wish to request a waiver, accommodation, or interpretation of SEC reporting requirements from the SEC staff (i.e., review of a pre-filing letter). The staff encourages such consultations, particularly for complex reporting matters. The staff reminded registrants that pre-filing letters should focus on the relevant facts and provide support for the proposed positions. Registrants should also ensure that the pre-filing letters are provided to their auditors for feedback and review prior to their submission.

In addition, the staff reminded registrants that the SEC comment letter process is intended to create a dialogue between the registrant and the staff. When the staff asks a question, registrants should not assume that a change in the filing is necessary. Furthermore, registrants should communicate whether a staff comment relates to an immaterial matter early in the comment letter process. The staff also cautioned registrants about analogizing to fact patterns in other companies' comment letters as each staff comment and its corresponding resolution are based on facts and circumstances which may not be apparent in the publicly-available letters.

PCAOB DEVELOPMENTS

FINAL AUDTING STANDARD AND AMENDMENTS

Disclosure of Certain Audit Participants on a New PCAOB Form AP and Related Amendments to Auditing Standards

In May, the SEC approved the PCAOB's adopted Rules 3210 and 3211 that require audit firms, beginning in 2017, to file a new PCAOB Form AP, *Auditor Reporting of Certain Audit Participants*, within a specified number of days after the first time an audit report for each of the firm's issuer clients is included in a document filed with the SEC. The following information is required to be disclosed on Form AP:

Effective for auditor's reports issued on or after January 31, 2017:

- The name of the engagement partner, along with a unique 10 digit identifier for that partner.

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Effective for auditor's reports issued on or after June 30, 2017:

- The names, locations, and extent of participation of other accounting firms that took part in the audit, if their work constituted five percent or more of the total audit hours; and
- The number and aggregate extent of participation of all other accounting firms that took part in the audit and that individually contributed less than 5 percent of the total audit hours.

A Form AP is required for each audit report issued for an issuer, employee benefit plan subject to PCAOB auditing standards (Form 11-K), and registered investment company. Form AP is not required by a registered public accounting firm that is referred to in an auditor's report by the principal auditor in accordance with AS 1205, *Part of an Audit Performed by Other Independent Auditors*.

The information on Form AP will be available in a searchable database on the PCAOB's website and will include unique ID numbers for both engagement partners and firms. Investors and other financial statement users will have access, in one location, to the names of engagement partners on all issuer audits. This will allow interested parties to compile information about the engagement partner, such as whether the partner is associated with restatements of financial statements or has been the subject of public disciplinary proceedings, as well as whether he or she has experience as an engagement partner auditing issuers of a particular size or in a particular industry.

Information provided on Form AP is also intended to help investors understand how much of the audit was performed by the accounting firm signing the auditor's report and how much was performed by other accounting firms. This information is expected to allow the public to determine other information about the firms identified in the form, such as whether a participating firm is registered with the PCAOB, whether it has been inspected and, if so, what the results were and whether it has any publicly available disciplinary history.

The SEC also approved the Board's adopted amendments to AS 3101, Reports on Audited Financial Statements, and AS 1205, that permit auditors to voluntarily disclose in the auditor's report the name of the engagement partner, information regarding other accounting firms, or both.

The rules and amendments are available **here**. Additionally the PCAOB recently published staff guidance, which is available **here**, to help firms comply with the requirements for filing reports on Form AP.

OTHER STANDARD-SETTING ACTIVITIES

Supervision of Audits Involving Other Auditors, and Proposed Auditing Standard, Dividing Responsibility for the Audit with Another Accounting Firm

In April, the PCAOB proposed for public comment a new auditing standard, along with related amendments, to strengthen the requirements that apply to audits that involve accounting firms and individual accountants outside the accounting firm that issues the audit report. Among other things, the proposed new standard and amendments would apply a risk-based supervisory approach, and would require more explicit procedures regarding the lead auditor's involvement in the work of other auditors through enhanced communication and more robust evaluation of the other auditors' qualifications and work.

The proposed new standard, AS 1206, *Dividing Responsibility for the Audit with Another Accounting Firm*, would supersede AS 1205. Proposed AS 1206 would retain, with modifications, many of the requirements of AS 1205, including the requirement that a lead auditor disclose in its audit report which portion of the financial statements was audited by each other auditor. However, proposed AS 1206 would also require the lead auditor to:

- Obtain a representation from each referred to auditor that they are licensed to practice under the applicable laws of the relevant country or jurisdiction.
- Determine whether each of the referred to auditors that play a substantial role in the preparation or furnishing of the lead auditor's report is registered with the PCAOB.
- Disclose the name of the other auditor in the lead auditor's report.

The proposal would also modify existing PCAOB auditing standards as follows:

- Amend AS 1215, *Audit Documentation*, to require that the lead auditor document which specific working papers of other auditors the lead auditor has reviewed, but not retained.
- Amend AS 1220, *Engagement Quality Review*, to explicitly require the engagement quality reviewer to evaluate the engagement partner's determination of his or her firm's sufficiency of participation in the audit.

Read more

- Amend AS 2101, *Audit Planning*, to incorporate and update requirements of AS 1205 to specify that they be performed by the lead auditor. For example, the proposal would incorporate and revise requirements for determining the firm's sufficiency of participation in an audit that involves other auditors.

- Amend AS 1201, *Supervision of the Audit Engagement*, to provide additional direction to a lead auditor on how to apply AS 1201's requirements to supervising other auditors. Specifically, the proposed amendments would require certain procedures to be performed by the lead auditor in supervising the work of other auditors.

The proposed auditing standard and amendments can be accessed **here**. The comment period closed in July. The PCAOB staff is currently analyzing the comments received to determine its next steps.

BDO OBSERVATIONS:

In our comment letter, we supported the PCAOB's efforts to strengthen the auditing standards relating to audits in which other auditors participate. We also encouraged the PCAOB to monitor the activities of the IAASB relating to a similar project and align with the IAASB's standards when possible to minimize unnecessary differences. Additionally, our comment letter indicated that while we support enhancing guidance in situations in which other auditors participate in an audit, we believe such enhancements should incorporate a risk-based approach in order to allow the lead auditor to apply professional judgment in developing an audit strategy. Our comment letter is available **here**.

The Auditor's Report on an Audit of Financial Statements when the Auditor Expressses an Unqualified Opinion, and Related Amendments

In May, the PCAOB reproposed for public comment the standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, and related amendments. The reproposed standard revises the PCAOB's initial proposal issued in 2013. Similar to the 2013 proposal, the reproposed standard would retain the existing "pass/fail" model in the auditor's report, but would provide additional information in the report, such as the communication of critical audit matters and new elements related to auditor independence and auditor tenure.

A "critical audit matter" (CAM), as defined in the reproposed standard, is any matter that is communicated or required to be communicated to the audit committee and that (1) relates to accounts or disclosures that are material to the financial statements, and (2) involves especially challenging, subjective, or complex auditor judgment. The auditor's report would identify the critical audit matter, describe the considerations that led the auditor to conclude that such matter is a critical audit matter, describe how it was addressed in the audit, and refer to the relevant financial statement accounts and disclosures.

The reproposed standard refines a number of aspects in the 2013 proposal, including:

- Limiting the source of potential CAMs to matters communicated or required to be communicated to the audit committee
- Adding a materiality component to the definition of a critical audit matter
- Narrowing the definition of a critical audit matter to only those matters that involved particularly challenging, subjective, or complex auditor judgment
- Revising the related documentation requirement to be consistent with the definition of a critical audit matter
- Requiring the auditor to describe in the audit report how the critical audit matter was addressed during the audit

The reproposed standard would also result in the following changes to the existing auditor's report:

- The auditor's report would include a statement regarding the requirement for the auditor to be independent.
- The phrase "whether due to error or fraud," would be added to the auditor's report when describing the auditor's responsibilities under PCAOB standards to obtain reasonable assurance about whether the financial statements are free of material misstatements.
- A statement would be included in the auditor's report regarding the number of years the auditor has served as the company's auditor
- The opinion would be required to be the first section of the auditor's report
- Section titles would be required in the auditor's report, to help guide the reader

The 2013 proposal also included another new auditing standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*, regarding the auditor's responsibilities for other information outside the financial statements. The Board has not reproposed this auditing standard but plans to determine next steps at a later date.

The reproposed standard would generally apply to audits conducted under PCAOB standards. Unlike the 2013 proposal, however, the requirements regarding CAMs would not apply to audits of brokers and dealers reporting under the Securities Exchange Act of 1934 Rule 17a-5; investment companies other than business development companies; and employee stock purchase, savings, and similar plans.

The reproposal is available **here**. The comment period closed in August. The PCAOB staff has evaluated the comments on the reproposal, and is currently drafting a final standard and an adopting release for the Board's consideration.

BDO OBSERVATIONS:

In our comment letter, we supported the PCAOB's efforts to modernize the auditor reporting model by enhancing the usefulness and informational value of the auditor's report. We also encouraged the PCAOB to align its proposed standard with the IAASB's revised suite of auditor reporting standards because of the interconnected nature of the global economy and the needs of investors for a consistent reporting framework. Additionally, we stated in our comment letter that we do not support disclosure of auditor tenure within the auditor's report, nor do we believe there is support for a regulatory requirement for such disclosure. Our comment letter is available **here**.

INSPECTIONS

The PCAOB staff noted several recurring inspection findings, especially with respect to ICFR (management review controls, reliance on controls that lack precision or controls that rely on other controls). Other audit areas that require improvement include the assessments of, and responses to, risks of material misstatement, accounting for estimates, including fair value measurements, and the implementation of AS 18 (related parties).

The staff indicated that the 2017 inspections will likely focus on the recurring audit deficiencies noted above, audit firm efforts related to the implementation of new accounting standards, including how independence is being maintained and monitored, audit areas impacted by economic trends and higher financial reporting risk (e.g., fluctuations in oil and gas prices), going concern evaluations, and multi-national audits, including mandatory auditor rotation, among other areas. Additionally, the staff indicated they will be gathering information related to auditor consideration of a registrant's non-GAAP measures.

Read more

CONTACT US

CHRISTOPHER TOWER
National Managing Partner -
Audit Quality and Professional Practice
714-668-7320 / ctower@bdo.com

JEFF LENZ
National Director - SEC Practice
312-616-3944 / jlenz@bdo.com

BRANDON LANDAS
National Assurance Partner
312-233-1887 / blandas@bdo.com

PAULA HAMRIC
National Assurance Partner
312-616-3947 / phamric@bdo.com

FIRST NAME

LAST NAME

EMAIL

PHONE

SUBJECT

MESSAGE

SUBMIT

People who know, know BDO.[SM]