

SEC YEAR IN REVIEW

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Significant 2018 Developments

One way to understand the focus and activities of the Securities and Exchange Commission in 2018 would be to quickly peruse the SEC's near-term [Regulatory Flexibility Act](#) agenda published in the Fall of 2017. With Chairman Clayton's deliberate intention to streamline the agenda and provide greater transparency about where the SEC's efforts will be concentrated, the Commission advanced 23 out of the 26 rules on the agenda in the past year. Many of the rules and activities that affect financial reporting continued to center on matters related to capital formation, cybersecurity, and the SEC staff's Disclosure Effectiveness Initiative. More specifically, these rules and activities included:

- ▶ Interpretive guidance on cybersecurity to further emphasize the importance of cybersecurity policies, procedures, and disclosures. In October, the Commission also released an [investigative report](#) about cyber-related frauds perpetrated against public companies and the related internal control requirements.
- ▶ Amendments that eliminate certain redundant and outdated disclosure requirements of Regulations S-X and S-K.
- ▶ Amendments to the definition of a smaller reporting company that increase the number of registrants eligible to apply scaled disclosures in their filings.
- ▶ New rules that will require the use of "Inline XBRL" in financial statements, which are intended to improve the accuracy of tagged data and reduce costs over time.
- ▶ Proposed amendments to Rules 3-10 and 3-16 of Regulation S-X to streamline disclosures associated with registered debt securities.
- ▶ A Request for Comment on earnings releases and quarterly reports. The Request followed a tweet from President Trump earlier in the year, who instructed the SEC to study the frequency of reporting in the U.S.

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Though it was not on Chairman Clayton's rulemaking agenda, the Commission and staff also devoted significant time and attention to issues related to initial coin offerings and cryptocurrency-related matters in 2018. In a June [speech](#), Bill Hinman, the Director of the Division of Corporation Finance, provided additional insight into whether digital assets are securities and therefore, subject to securities laws and regulations. Given the prevalence of digital asset transactions, this area will likely continue to require the attention of the Commission and staff.

While there were changes in commissioners in 2018, Chairman Clayton's agenda was largely carried out by a full Commission. In January, Hester Peirce (R) and Robert Jackson (D) were sworn in, filling two empty Commission seats. In September, Elad Roisman (R) filled the seat vacated by Michael Piwowar (R) who left the Commission in July. Kara Stein's (D) term expired in June, though she stayed through the end of 2018 as permitted by SEC rules on term limits. Another Democratic nominee to fill Commissioner Stein's seat is expected in the months to come. At the staff level, Kyle Moffatt replaced Mark Kronforst as Chief Accountant within the Division of Corporation Finance.

Outside of the Commission's rulemaking efforts, the staff remains heavily focused on implementation and disclosure issues related to significant new accounting standards. Comment letters on revenue recognition accounting and disclosure have increased and are expected to increase for the foreseeable future as the staff continues to review filings that reflect the adoption of ASC 606, the new revenue standard. Moreover, with the pending adoption of the new leasing standard on January 1, 2019 for calendar year-end registrants, the staff continues to stress the importance of "SAB 74"¹ disclosures about the impact these standards will have on registrants and their financial statements when adopted. As expected, the implementation of these new standards was a key topic of the AICPA Conference on SEC and PCAOB Developments (the Conference) held December 10-12 in Washington, D.C. The staff offered several [observations](#) and insights about the implementation and application of these standards that registrants should keep in mind going forward.

More broadly speaking, Conference attendees were reminded that a high-quality financial reporting system is a shared responsibility among all stakeholders including management, audit committees, auditors, regulators and standard setters.²

Collaboration among all participants in the financial reporting process is especially critical in times of significant change. That said, "change" was a prevalent theme of the 2018 Conference. In addition to the significant new and changing accounting standards, rapidly changing technologies and the current geopolitical environment have created new and emerging areas of focus for all public company stakeholders to address. The staff highlighted the need to focus on disclosures related to cyber risks and breaches, the business and financial risks from "Brexit" (the United Kingdom's pending exit from the European Union) and the anticipated phase-out of the London Interbank Offered Rate (i.e., LIBOR, the widely-used benchmark interest rate).

The new auditor's reporting model (ARM) was also a prevalent topic at the Conference. While certain aspects of ARM such as format and tenure were already implemented in 2018, the new requirement to disclose Critical Audit Matters³ will become effective for audit opinions on the financial statements of the largest companies issued after June 30, 2019. These changes to the audit report come at a time of transformation for the Public Company Accounting Oversight Board. The PCAOB's activities in 2018, which included a new standard on auditing accounting estimates and staff guidance on ARM, among others, were advanced by an entirely new board appointed by the SEC at the end of 2017. Following a period in which it solicited public input on the overall direction of the PCAOB, the board just released its [five year strategic plan](#) in December. Among other focus areas, the plan includes driving improvements to audit quality, anticipating and responding to the changing environment (including new technologies), and improving communication with all stakeholders. There were also significant changes in the senior staff of the PCAOB. The PCAOB's new Chief Auditor and Director of Professional Standards, Megan Zietsman, was appointed in December and will be key to advancing the Board's standard-setting activities going forward. Other open positions have yet to be filled.

The SEC staff issued other guidance throughout the year to assist registrants and others with interpreting and complying with the SEC's rules and regulations. The staff updated its Compliance and Disclosure Interpretations and released a web-based version of its Financial Reporting Manual that is easier to access and navigate than the traditional PDF format. In 2018, the staff also remained diligent in responding to Rule 3-13⁴ of Regulation S-X waiver requests received from registrants on a timely basis.

1 Staff Accounting Bulletin No. 74, *Disclosure Of The Impact That Recently Issued Accounting Standards Will Have On The Financial Statements Of The Registrant*. Codified in Topic 11-M.

2 Refer to Commissioner Peirce's [speech](#) for additional insights into this topic.

3 Further information on the identification and disclosure of "critical audit matters" can be found in our [BDO Flash Report](#) on the auditor's reporting model.

4 Under Rule 3-13, issuers can request modifications to their financial reporting requirements particularly when the disclosures may not be material to the total mix of information available to investors.

At the Conference, the staff provided numerous examples in which it granted relief from strict compliance with Regulation S-X.

If the SEC's track record during Chairman Clayton's first full year is an indicator of the future, the latest near term agenda provides excellent insight into the Commission's activities over the coming year. From a financial reporting perspective, some of the most anticipated items include proposed amendments or changes to:

- ▶ The accelerated filer definition, to potentially lower the number of registrants required to obtain an audit of internal control over financial reporting.
- ▶ Rule 3-05 of Regulation S-X, to potentially change the circumstances in which acquired business financial statements are required. The staff has indicated that the proposal will also consider changes to Rule 3-14 (real estate operations to be acquired) and Article 11, *Pro Forma Financial Information*.
- ▶ Guide 3, *Statistical Disclosure by Bank Holding Company Companies*, to revise and update the disclosure requirements applicable to banks.
- ▶ Regulation S-K, to modernize and simplify certain disclosure requirements in Regulation S-K.
- ▶ Disclosure of payments made by resource extraction issuers.

As highlighted above, the staff's focus on the implementation of the new significant accounting standards and disclosures related to cybersecurity, Brexit, and the phase-out of LIBOR will continue. We also expect conforming changes to the staff's FRM to reflect rulemaking in 2018 and other staff guidance.

This publication summarizes 2018 Commission rulemaking and activities, staff activities and guidance, and practice issues covered at the Conference that affect financial reporting. 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 2018 PCAOB standard-setting and related activities.



Commission Activities

CAPITAL FORMATION

AMENDMENTS TO THE DEFINITION OF A SMALLER REPORTING COMPANY (Release No. 33-10513)

In June, the SEC adopted [amendments](#) to the definition of a smaller reporting company⁵ (SRC). The amendments increase the financial thresholds in the SRC definition, thereby expanding the number of companies eligible for the scaled disclosures permitted by Regulation S-K and Regulation S-X. The SEC's press release stated that the Commission staff estimated that almost 1,000 additional companies would be eligible for SRC status in the first year based on the new definition. The financial thresholds in the definitions of accelerated and large accelerated filer and the related filing requirements (including those related to obtaining audits of internal control over financial reporting) remain unchanged.

Under the amended initial qualification thresholds, a company with less than \$250 million of public float qualifies as a SRC. In addition, a company with less than \$100 million in annual revenues qualifies if it has either no public float or a public float of less than \$700 million.

The following table summarizes the new initial qualification thresholds, as compared to the prior thresholds:

SRC Criteria	Prior Definition	New Definition
Public Float	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
Revenues	Less than \$50 million of revenues in most recent fiscal year and no public float at the end of the second fiscal quarter	Less than \$100 million of revenues in most recent fiscal year and no public float or less than \$700 million in public float at the end of the second fiscal quarter

The amendments also increase the financial thresholds for a company that is not a SRC to enter SRC status, which are set at 80% of the initial qualification thresholds outlined above. For example, a company may enter SRC status when its public float falls below \$200 million at the measurement date. In addition, a company that is not a SRC because it exceeded either or both of the \$100 million annual revenue and \$700 million public float thresholds may enter SRC status when it meets 80% of the criteria on which it previously failed to qualify (\$80 million of annual revenue and \$560 million of public float) and continues to meet any threshold it previously satisfied (\$100 million of annual revenue and \$700 million of public float). The following table summarizes the subsequent qualification thresholds:

SRC Criteria	Prior Definition	New Definition
Subsequent Qualification 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
Subsequent Qualification Based on Revenues	Less than \$40 million of revenues in most recent fiscal year and no public float	Less than \$80 million of revenues in most recent fiscal year, if it previously had \$100 million or more of annual revenues;** and Less than \$560 million of public float, if it previously had \$700 million or more of public float**

A registrant must satisfy a lower threshold only with respect to the threshold it previously exceeded. For example, if a registrant with less than \$700 million of public float lost SRC status because its annual revenues exceeded \$100 million, it can re-enter SRC status if its revenues drop below \$80 million (i.e., public float does **not also need to be below \$560 million for the registrant to re-enter SRC status).

5 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.

The prior definitions of accelerated and large accelerated filer contained a provision that automatically excluded registrants that qualified as SRCs. The final rule eliminates 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 float of \$75 million or more, but less than \$250 million,⁶ 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, Chairman Clayton has directed the staff to develop recommendations for the Commission to consider which would amend the accelerated filer definition and potentially reduce the number of companies that qualify as accelerated filers.

The Commission also made conforming changes to Rule 3-05. Rule 3-05 requires financial statements of businesses acquired or to be acquired. Rule 3-05(b)(2)(iv) previously allowed 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 were less than \$50 million. The Commission increased this revenue threshold in Rule 3-05 to \$100 million in line with the amendments to the SRC definition.

The amendments became effective on September 10, 2018. Further information on the amendments, transition guidance, and a list of scaled disclosures available to SRCs can be found in the staff's [Small Entity Compliance Guide](#) available on the SEC's website.

DISCLOSURE EFFECTIVENESS INITIATIVE

The staff discussed its progress on the Disclosure Effectiveness Initiative at the Conference and highlighted that additional rulemaking related to the Initiative is expected in the next year. The staff continues to consider potential amendments to the rules, including amendments to Regulation S-X requirements for financial statements of entities other than the registrant, as well as industry-specific disclosures relevant to banking registrants. Rulemaking and other activities related to the initiative during 2018 are discussed further below.

DISCLOSURE UPDATE AND SIMPLIFICATION (Release No. 33-10532)

The SEC adopted rule amendments to eliminate redundant and outdated disclosure requirements of Regulations S-X and S-K in August. 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 made are intended to simplify the overall compliance process, but not change the mix of information provided to investors.

The [adopting release](#) and the [demonstration version](#) of the amendments are available on the SEC's website. While the rulemaking is part of the SEC's Disclosure Effectiveness Initiative, the amendments also aim to fulfill the Commission's responsibility under the FAST Act⁷ to eliminate provisions of Regulation S-K that are duplicative, outdated, or unnecessary for all filers. The amendments became effective on November 5, 2018.

⁶ Or less than \$700 million of public float if the company has less than \$100 million in annual revenues.

⁷ The Fixing America's Surface Transportation (FAST) Act was passed in 2015 and contained amendments to securities laws and Congressional mandates for the Commission. Further information can be found in our [BDO Flash Report](#).

While the changes are voluminous, many of them are not substantive. Some changes merely update the terminology used in the rules. For example, Rule 3-02 of Regulation S-X was modified to reference the statements of **comprehensive** income instead of the statements of income. Other changes remove requirements that are duplicative with other SEC or GAAP disclosure requirements. For example, Item 101(b) of Regulation S-K was deleted as it required 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 ASC 280 and Item 303(b) of Regulation S-K. The requirement to provide a computation of earnings per share in Item 601(b)(11) of Regulation S-K was also deleted because such disclosure is already required by ASC 260.

Other amendments remove requirements that are simply outdated. For example, the requirement in Item 503(d) of Regulation S-K and related forms to provide a ratio of earnings to fixed charges when an offering of debt securities is registered was eliminated. The Commission believes this requirement is no longer relevant or useful. Additionally, the requirement in Item 201 of Regulation S-K to disclose the high and low stock prices for each quarter over the last two fiscal years was eliminated because such information is widely available.

The amendments contain a notable new requirement to present changes in shareholders' equity in interim financial statements within Form 10-Q filings. The disclosure of changes in shareholders' equity within a registrant's Form 10-Q filing is required on a quarter-to-date and year-to-date basis for both the current year and prior year comparative periods. We understand that a registrant may disclose the changes in one of two ways:

1. Reconcile the changes in two separate schedules detailing the quarter-to-date changes and the year-to-date changes; or
2. Reconcile the changes in one schedule, detailing the changes in each quarter within the fiscal year.

In light of the effective date of the amendments, some questioned when a registrant would be first required to disclose the changes in shareholders' equity in its Form 10-Q filing. The staff issued [Compliance and Disclosure Interpretation 105.09](#), which communicates that the staff would not object if a registrant first discloses the changes in shareholders' equity in its Form 10-Q for the quarter that begins after November 5, 2018, the effective date of the amendments.

The following table summarizes the effective dates for various fiscal year-ends:

Fiscal Year-End	Disclosure required in the Form 10-Q for the quarter ending:
December 31	March 31, 2019
March 31	June 30, 2019
June 30	March 31, 2019
September 30	March 31, 2019

In connection with this rulemaking, the Commission also referred certain disclosure requirements which overlap with U.S. GAAP but provide incremental information to the FASB for potential incorporation into U.S. GAAP. Examples include:

- ▶ Incremental income tax disclosures required by Rule 4-08(h) of Regulation S-X – e.g., disclosing the amount of domestic and foreign pre-tax income and income tax expense.
- ▶ Information about major customers required by Item 101 of Regulation S-K – e.g., disclosing a customer's name in certain instances and removing the bright-line threshold (10%) for disclosure.

The FASB has 18 months from the date the amendments were published in the Federal Register (June 2020) to complete its consideration of whether the referred items will be added to its agenda for potential standard setting.

INLINE XBRL FILING OF TAGGED DATA (RELEASE NO. 33-10514)

In June, the SEC amended its XBRL reporting requirements to require the use of "Inline XBRL," which will allow the financial statements to be both human-readable and machine-readable. Historically, 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. The [amendments](#) require issuers to embed XBRL tags directly in their financial statements using a format known as Inline XBRL in lieu of providing tagged data in a separate exhibit. The intent of the amendments is to reduce the preparation costs over time and improve the quality, timeliness and usefulness of the data, which benefits investors and other market participants.

The Inline XBRL requirements take effect based on filing status as follows:

- ▶ June 15, 2019 – large accelerated filers that prepare their financial statements in accordance with U.S. GAAP
- ▶ June 15, 2020 – accelerated filers that prepare their financial statements in accordance with U.S. GAAP
- ▶ June 15, 2021 – all other filers

Form 10-Q filers will commence Inline XBRL reporting in their Form 10-Q for the first quarter ending on or after these dates.

Filers will be permitted to file using Inline XBRL prior to their compliance date once the SEC modifies its EDGAR system to accept submissions in Inline format. The SEC expects this to occur in March 2019.⁸

The requirement for companies to post XBRL data on their websites is eliminated upon the applicable effective date.

Currently, the information in XBRL files is excluded from the officer certification requirements, and issuers are not required to obtain assurance on such information from third parties, such as auditors. In the adopting release, the Commission noted that the change in format to Inline XBRL does not change this.

MODERNIZATION OF PROPERTY DISCLOSURES FOR MINING REGISTRANTS (RELEASE NO. 33-10570)

In October, the SEC adopted [amendments](#) to modernize property disclosures for mining registrants. The amendments aim to improve the quality and reliability of information provided to the investors by closely aligning the disclosure requirements and policies for mining properties with current industry and global regulatory practices and standards.

Key aspects of the amendments:

- ▶ Require a registrant with material mining operations to disclose certain information concerning its mineral resources in addition to its mineral reserves.
- ▶ Require a registrant's disclosure of exploration results, mineral resources, or mineral reserves in SEC filings to be based on, and accurately reflect, information and supporting documentation prepared by a "qualified person" (i.e., a mining expert).
- ▶ Require a registrant to obtain a dated and signed technical report summary from the qualified person. This technical report summary will also be filed as an exhibit to the relevant SEC filings in certain circumstances.
- ▶ Require certain registrants with material mining operations to provide investors with an overview of its properties and mining operations, including summary and individual property disclosure provisions in either a narrative or tabular format.
- ▶ Provide updated definitions of mineral reserves and mineral resources.

The final rules reflect numerous changes to the proposed rules issued in June 2016 based on feedback received by the SEC on the proposal. The SEC's [press release](#) on the amendments contains further details about these changes.

Registrants are required to comply with the new rules in their first fiscal year beginning on or after January 1, 2021. Registrants may voluntarily apply the new disclosure requirements at an earlier date. The existing disclosure requirements contained in Guide 7 remain effective until all registrants are required to comply with the final rules, at which time they will be rescinded.

⁸ The SEC terminated its voluntary program which permitted, but did not require, issuers to use Inline XBRL. Companies may continue to voluntarily file in Inline XBRL until that time.



FINANCIAL DISCLOSURES REQUIRED BY RULES 3-10 AND 3-16 OF REGULATION S-X (RELEASE NO. 33-10526)

The SEC proposed rule [amendments](#) to simplify and streamline the financial disclosures required in and subsequent to registered debt offerings in late July. The proposal would amend Rule 3-10 applicable to guarantors and issuers of guaranteed securities and Rule 3-16 applicable to affiliates whose securities collateralize a registrant's securities. The proposal follows the SEC's *Request for Comment on the Effectiveness of Financial Disclosures about Entities Other Than the Registrant*⁹ published in September 2015. The proposed changes are intended to better align the financial reporting requirements with the needs of investors by providing them with information that is material and easier to understand. They are also intended to reduce the costs and burdens to registrants, thereby encouraging them to conduct more offerings on a registered basis.

Background

Rules 3-10 and 3-16 affect disclosures made in connection with registered debt offerings and subsequent periodic reporting.

Rule 3-10(a) states the general rule that every issuer of a registered security that is guaranteed¹⁰ and every guarantor of a registered security must file the financial statements required for a registrant by Regulation S-X. The rule also sets forth five exceptions to this general rule. Each exception specifies conditions that must be met. If the conditions are met, separate financial statements of each qualifying subsidiary issuer and guarantor may be omitted, but the parent company must provide certain "Alternative Disclosures."

The form and content of the Alternative Disclosures are determined based on the facts and circumstances and can range from a brief narrative to highly-detailed condensed consolidating financial information.

Subsidiary issuers and guarantors that are permitted to omit their separate financial statements under Rule 3-10 are also automatically exempt from Exchange Act reporting under Exchange Act Rule 12h-5. The parent company, however, must continue to provide the Alternative Disclosures for as long as the guaranteed securities are outstanding.

Rule 3-16 requires a registrant to provide separate financial statements for each affiliate whose securities constitute a substantial portion of the collateral, based on a numerical threshold, for any class of registered securities as if the affiliate were a separate registrant. Although affiliates whose securities are pledged as collateral are not registrants with respect to the collateralized security and are not generally subject to the related reporting requirements, existing Rule 3-16 requires financial statements as if the affiliates were registrants.

⁹ Further information regarding the Request for Comment can be found [here](#) in our Flash Report. Our comment letter can be found [here](#).

¹⁰ A guarantee of a debt or debt-like security ("debt security") is a separate security under the Securities Act and, as a result, offers and sales of these guarantees must be either registered or exempt from registration. If the offer and sale is registered, the issuer of the debt security and the guarantor must each file its own audited annual and unaudited interim financial statements required by Regulation S-X. Additionally, the offer and sale of the securities pursuant to a Securities Act registration statement causes the issuer and guarantor to become subject to reporting under Section 15(d) of the Exchange Act. Reporting under Section 15(d) requires filing periodic reports that include audited annual and unaudited interim financial statements for at least the fiscal year in which the related Securities Act registration statement became effective.

Summary of Proposed Amendments

The following is a summary of the significant proposed changes.

Rule 3-10

The proposed amendments would continue to follow the approach of permitting issuers to omit separate financial statements of subsidiary issuers and guarantors when certain conditions are met. However the conditions and the required Alternative Disclosures would change. The proposed amendments would:

- ▶ Require disclosure of any quantitative or qualitative information that would be material to making an investment decision with respect to the guaranteed security.
- ▶ Amend the condition that each subsidiary issuer or guarantor must be 100% owned by the parent company to omit its separate financial statements. The proposed rule would require that the subsidiary issuer or guarantor be a consolidated subsidiary of the parent company pursuant to the relevant accounting standards.
- ▶ Require summarized financial information for the issuers and guarantors, which may be presented on a combined basis.¹¹ The summarized financial information would be required for only the latest year and subsequent interim period. This would replace the current requirement to provide condensed consolidating financial information for all periods presented in the consolidated financial statements.
- ▶ Require expanded qualitative disclosures about the guarantees and the issuers and guarantors.
- ▶ Permit the Alternative Disclosures to be provided outside the footnotes to the financial statements (such as in MD&A) in the registration statement covering the offer and sale of the subject securities and any related prospectus as well as in Exchange Act reports required to be filed shortly thereafter. Subsequently, the Alternative Disclosures would need to be provided in footnotes to the parent company's audited annual and unaudited interim consolidated financial statements.
- ▶ Permit a registrant to stop providing the Alternative Disclosures when the issuers and guarantors no longer have an Exchange Act reporting obligation with respect to the guaranteed securities, rather than requiring them for as long as the guaranteed securities are outstanding.

Rule 3-16

The proposed amendments would replace the existing requirement to provide separate financial statements for each affiliate whose securities are pledged as collateral with financial and non-financial disclosures about the affiliate(s) and the collateral arrangement. The financial disclosures would consist of summarized financial information similar to that to be provided by issuers and guarantors of guaranteed securities discussed above.

Comments on the proposal were due on December 3, 2018.

BDO OBSERVATIONS:

We support the Commission's initiative to improve the effectiveness of financial disclosures under Regulation S-X. In this regard, we agree with the direction of the proposed changes to Rules 3-10 and 3-16 and believe the proposed amendments largely address the Commission's stated objective to provide investors with material information that is easier to understand. Our observations about the proposed presentation and location of the disclosures as well as feedback on when disclosures are required (among other remarks) can be found in our [comment letter](#) on the proposal.

¹¹ The summarized financial information required would be that defined in Rule 1-02(bb) of Regulation S-X. This rule defines summarized financial information as "the presentation of summarized information as to the assets, liabilities and results of operations of the entity for which the information is required. Summarized financial information shall include the following disclosures:

i. Current assets, noncurrent assets, current liabilities, noncurrent liabilities, and, when applicable, redeemable preferred stocks and noncontrolling interests (for specialized industries in which classified balance sheets are normally not presented, information shall be provided as to the nature and amount of the majority components of assets and liabilities);

ii. Net sales or gross revenues, gross profit (or, alternatively, costs and expenses applicable to net sales or gross revenues), income or loss from continuing operations before extraordinary items and cumulative effect of a change in accounting principle, net income or loss, and net income or loss attributable to the entity (for specialized industries, other information may be substituted for sales and related costs and expenses if necessary for a more meaningful presentation)."



REQUEST FOR COMMENT ON EARNINGS RELEASES AND QUARTERLY REPORTS (RELEASE NO. 33-10588)

In late December, the SEC released a [Request for Comment](#) that solicits input on the nature, content, timing and frequency of earnings releases and quarterly reports. The request follows a tweet made by the President in August, who directed the SEC to study the frequency of reporting and consider a semi-annual system. However, this is not the first time the SEC has considered the issue. The Commission previously requested comment on the frequency of reporting in its [Concept Release](#) on the business and financial disclosure requirements of Regulation S-K in April 2016.

Broadly speaking, this latest request seeks input on how the SEC might simplify the process associated with the release of quarterly earnings and reports while maintaining the investor protection benefits of disclosure. The Commission also seeks input on how the periodic reporting process, earnings releases and earnings guidance affect corporate decision making and strategic decisions – i.e., does the process lead to an overemphasis on short-term thinking by registrants and other stakeholders?

The SEC's [press release](#) contains further details about the Request. Comments are due 90 days following the Request's publication in the Federal Register.

Many of the detailed questions in the release focus on the following categories:

- ▶ **The information content resulting from the quarterly reporting process**, including how companies determine whether to issue an earnings release, what information is included in that release, and how it impacts the usefulness of information included in Form 10-Q.
- ▶ **The timing of the quarterly earnings process**, including how the release of earnings in a Form 8-K relates to the issuance of the Form 10-Q.
- ▶ **The earnings release as the core quarterly disclosure**, including whether registrants should be given the option to follow a "Supplemental Approach" in which they can use their earnings releases (if issued) to satisfy certain core financial requirements of Form 10-Q.
- ▶ **The reporting frequency**, including whether the SEC should move to a semi-annual reporting model for all or certain categories of reporting companies.

CYBERSECURITY

Since taking office, Chairman Clayton has highlighted the importance of cybersecurity to the Commission and to all market participants. As explained in further detail below, the Commission issued an interpretive release in February that provides a framework for registrants to consider when evaluating whether to disclose information about cybersecurity risks and incidents. At the Conference, the staff reinforced the guidance within the release about disclosures and registrants' insider trading policies as they relate to cyber matters. The staff continued to emphasize the importance of disclosure controls and procedures related to cyber incidents to ensure the implications of cyber breaches are escalated internally and communicated externally on a timely basis. The staff also reminded registrants that disclosures should be company-specific (not boilerplate), especially in situations in which a material cyber breach has occurred. The staff noted that it will focus on cybersecurity disclosures and compliance with the interpretive guidance in their review of registrants' upcoming Form 10-K filings.

COMMISSION STATEMENT AND GUIDANCE ON PUBLIC COMPANY CYBERSECURITY DISCLOSURES (RELEASE NO. 33-10459)

In response to the increasing significance of cybersecurity incidents, the Commission issued an [interpretive release](#) in February, which outlines its views with respect to cybersecurity disclosure requirements under the federal securities laws as they apply to public operating companies.¹² The release reinforces and [expands the guidance on reporting and disclosing cybersecurity risks and incidents](#) that the Division of Corporation Finance (the Division) issued in 2011. In addition, the release addresses the importance of cybersecurity policies and procedures and the application of insider trading prohibitions in the cybersecurity context.

The Division's 2011 guidance reminded registrants that although existing disclosure requirements do not explicitly include cybersecurity risks or cyber incidents, registrants may nonetheless be obligated to make such disclosures. The specific disclosure obligations within the Division's 2011 guidance included:

- ▶ Risk factors
- ▶ Management's discussion and analysis of financial condition and results of operations ("MD&A")
- ▶ Description of business
- ▶ Legal proceedings
- ▶ Financial statement disclosures
- ▶ Disclosure controls and procedures

Each of those specific disclosure obligations was reinforced within the release. Additionally, the release expanded upon the Division's 2011 guidance by including a focus on the following new topics:

- ▶ **Stressing the importance of cybersecurity policies and procedures** – Companies were reminded that establishing and maintaining effective disclosure controls and procedures must include considerations for cybersecurity. The Commission also reminded companies to consider the materiality of cybersecurity risks and incidents when preparing their disclosures and included the relevant obligations companies have related to periodic reports, Securities Act and Exchange Act filings, and current reports.
- ▶ **Application of insider trading prohibitions in the cybersecurity context** – Cybersecurity risks and incidents may create material nonpublic information. The Commission encouraged companies to not only consider federal securities laws related to insider trading, but to also review their own insider trading policies and procedures already in place to prevent trading on the basis of material nonpublic information related to cybersecurity risks and incidents. In addition, the Commission expects companies to have policies and procedures to ensure that any disclosures of material nonpublic information related to cybersecurity risk and incidents are not made selectively, and that they comply with the Regulation FD disclosure requirements.
- ▶ **Board risk oversight disclosures** – Expanded to include cybersecurity risks when disclosing how the board of directors administers its risk oversight function.

¹² This release does not address the specific implications of cybersecurity to other regulated entities under the federal securities laws, such as registered investment companies, investment advisers, brokers, dealers, exchanges, and self-regulatory organizations.

Shortly after the release, Chairman Clayton issued a statement summarizing the new topics and encouraging companies to “*examine their controls and procedures, with not only their securities law disclosure obligations in mind, but also reputational considerations around sales of securities by executives.*”

Consistent with the Division's 2011 guidance, the Commission's release reinforced the notion that companies are not to provide a “roadmap” on how to compromise their systems. Instead, companies are to provide meaningful disclosures that would be material to an investor and to provide such disclosures in a timely fashion.

BDO OBSERVATIONS:

As noted above, the interpretive release highlights the need for disclosure about how a registrant's board administers its risk oversight function specifically as it relates to cybersecurity. In June, the Center for Audit Quality released a new tool, [Cybersecurity Risk Management Oversight: A Tool for Board Members](#), as a resource for board members in their oversight of data and cybersecurity risk. The CAQ tool provides suggested questions for boards to ask of management and the auditors in evaluating the mitigation of a company's cybersecurity risk.

OTHER COMMISSION ACTIVITIES

AMENDMENTS TO REGULATION A (RELEASE NO. 33-10591)

In response to a mandate of the Economic Growth, Regulatory Relief, and Consumer Protection Act, the SEC approved amendments to Regulation A in December that permit Exchange Act reporting companies to rely on the Regulation A exemption for their securities offerings. Prior to the amendments, Regulation A was not available to public companies.

Regulation A provides an exemption from registration for companies that raise up to \$50 million in a 12-month period.¹³ Larger Regulation A offerings require an offering process and ongoing reporting requirements that are essentially scaled down versions of the offering and ongoing reporting processes used during and after registered offerings. Based on the amendments, companies that meet their Exchange Act reporting obligations are considered to have met their ongoing Regulation A reporting requirements.

The SEC's [press release](#) and adopting release contain further information about the amendments. The amendments become effective upon publication in the Federal Register.

¹³ Further information about Regulation A can be found in our [Flash Report](#).



Staff Guidance

FINANCIAL REPORTING MANUAL

In 2018, the staff of the SEC's Division of Corporation Finance made its [Financial Reporting Manual \(FRM\)](#) available in a web-based format.¹⁴ Previously, the FRM was only accessible in a PDF format, which is still available on the SEC's website. At the Conference, the staff indicated that it is working on an update to the FRM, particularly to reflect changes from rulemaking activity in 2018 (e.g., amendments to the SRC rules) and guidance for emerging growth companies' adoption of new accounting standards.

OTHER STAFF GUIDANCE AND ACTIVITIES

FINANCIAL STATEMENT REQUIREMENTS IN A FORM S-4 OR MERGER PROXY FOR AN OPERATING COMPANY MERGING WITH A SPECIAL PURPOSE ACQUISITION ENTITY

At the July and September CAQ SEC Regulations Committee [meetings](#), the Committee and staff discussed the financial statement requirements for private operating companies in a Form S-4 or merger proxy filed by a public Special Purpose Acquisition Entity (SPAC). Public SPACs are like public shell companies except that they raise money from investors for the purpose of acquiring an existing private operating company (sometimes in a specific industry). It is common for a SPAC to file a Form S-4 or merger proxy which solicits shareholder approval for the merger transaction and contains the financial statements of the private company. The staff communicated that it views the acquisition of a private operating company by the SPAC as the private company's initial public offering (moreover, the private company is considered to be the predecessor of the registrant). Accordingly, the private company's financial statements included in the S-4/merger proxy should be audited in accordance with PCAOB standards and include all of the required public company disclosures (e.g., Regulation S-X, segments, and earnings per share disclosures, among others). Additionally, the private operating company should evaluate the need to provide financial statements for any probable or consummated business acquisitions in accordance with Rule 3-05. Registrants who are unable to provide an auditor's report reflecting the use of PCAOB auditing standards for the private company in the Form S-4/merger proxy should discuss their facts and circumstances with the staff prior to filing.

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 non-GAAP financial measures, Proxy Rules and Schedules, Regulation S-K, and Securities Act Forms, among others.

RELEASE OF SERIOUS DEFICIENCY LETTERS

In June, the staff [announced](#) that it would begin releasing serious deficiency letters through the EDGAR system. A serious deficiency letter (or "bedbug" letter, as it is sometimes referred to) is issued when a registration statement or offering document is so deficient that the staff defers its review until the deficiencies are corrected. Letters associated with publicly filed registration statements or offering documents are made available on EDGAR within 10 calendar days of issuance. Letters associated with confidential submissions would only be released on EDGAR with the rest of the SEC correspondence associated with the filing no sooner than 20 business days after completion of the review.

¹⁴ 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.

Practice Issues

In addition to the SEC rulemaking and other activities mentioned above, the SEC staff discussed various other topics throughout the year. This section addresses those practice issues, including observations from the staff at the Conference.

NEW ACCOUNTING STANDARDS

The implementation of new accounting standards was a prominent theme throughout the Conference, with various regulators offering their perspectives on accounting and disclosure issues, effects on internal control over financial reporting, and other topics related to the new standards.

REVENUE RECOGNITION

The SEC staff commended stakeholders' ASC 606 implementation efforts, particularly the collaboration and commitment of preparers, auditors, audit committees, professional organizations and others. During 2018, the initial year of adoption for most issuers, ASC 606 was the most frequent consultation topic, especially related to gross versus net presentation and identification of performance obligations. The staff acknowledged some diversity in practice may be acceptable as long as the conclusions are underpinned by thorough analyses and reasonable judgments.

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

Performance obligations – Understanding the nature of the promise within the context of the contract carries the utmost importance when evaluating performance obligations. A company must assess whether it has promised to transfer individual goods or services or a combined item for which the goods or services are merely inputs. Additionally, a company must consider whether two or more promised goods or services significantly affect each other.

For example, a company determined that the components of a security monitoring service (e.g., each piece of equipment, the installation, and the monitoring service) were capable of being distinct. However, the registrant provided a significant integration service to deliver a combined output: a comprehensive “smart” security solution. The staff did not object to the registrant’s reasonable conclusion that the nature of the promise was the provision of the combined commercial security solution with a greater benefit than could be received from each individual component.

In another consultation, a company sold off-the-shelf software that allowed the customer to prepare patent applications. Each software sale included a free, one-time service to submit an application electronically. The software could also print applications to submit by mail. The registrant believed the software and service were capable of being distinct, but also highly interdependent based on their combined utility (i.e., allowing customers to electronically submit completed patent applications). The staff objected to this conclusion since the electronic service was offered as a convenience to the customer. That is, the utility of the software was not affected by the delivery method (electronic vs. mail). Therefore, the software and service were not highly interdependent or highly interrelated.

Principal vs. agent – The staff emphasized the rigorous thought process required to apply the principal versus agent model. Registrants must consider the definition of control and any indicators of control, particularly when physical possession of a good does not occur. In one consultation, a manufacturer shipped certain specialized products directly to retailers. For those products, the distributor determined pricing, managed product fulfillment (e.g. delivery, quantity, and spoilage) based on the contract and marketing materials and the returns process in accordance with regulatory requirements and was the primary point of contact with the retailer. As such, the distributor concluded it was the principal for these product sales and the staff did not object.

Significant financing components – The staff also provided an example of a contract that provided a third party with the right to access the registrant's trademarks and brand over an extended period, thus conveying a symbolic license of intellectual property. As consideration, the registrant received a large up-front payment. The timing difference between the provision of the service and the receipt of payment led the registrant to question whether a significant financing component existed. The staff did not object to the conclusion that there was not a significant financing component for the following reasons:

- ▶ The up-front payment incentivized the third party to maximize value and profits for both parties, especially due to the registrant's negative experience with other parties when no up-front payment was received.
- ▶ The up-front payment reduced the risk related to the third-party's use of the registrant's brand.
- ▶ The up-front payment was not necessary to finance the registrant's operations, as favorable financing terms were available to the registrant in the marketplace.
- ▶ The registrant did not contemplate a structure of the transaction without a large up-front payment.

Consistent with the adoption of any new accounting standard, the staff indicated that filing reviews will focus on the adoption of ASC 606 and the robustness of the related disclosures. In that regard, the staff may inquire about significant judgments required by ASC 606, such as the identification of performance obligations, principal vs. agent considerations, timing of revenue recognition, disaggregation of revenues, and variable consideration.

For instance, the staff may ask a registrant to clarify whether a performance obligation is recognized at a point in time or over time. Additionally, for performance obligations measured over time, the staff may further request disclosure of the measures of progress and why such measures best depict the transfer of control of the performance obligations.

In addition, disclosures should clearly indicate which judgment applies to each revenue stream. The staff will also question when accounting conclusions appear incorrect or when material disclosures are omitted.

LEASES

As the effective date for the new leasing standard (ASC 842) draws near for many registrants, the SEC staff continues to monitor implementation efforts. The staff highlighted the importance for stakeholders (including registrants, auditors, audit committees, etc.) to discuss and resolve key implementation questions in the absence of a transition resource group. Additionally, regulators at the Conference reiterated that the effective date of ASC 842 would not be delayed. Consistent with previous reminders, the staff stated that SAB 74 disclosures should provide an understanding of the registrant's implementation status for a new accounting standard, such as ASC 842, as well as the estimated impact on financial reporting.

At the Conference, the SEC staff discussed the following observations from recent leasing consultations:

Minimum rental payments – The measurement of existing operating leases by lessees upon transition to ASC 842 is based upon the remaining minimum rental payments. At the 2017 Conference, the staff acknowledged the diversity in practice related to the inclusion or exclusion of executory costs in the presentation of minimum rental payments under ASC 840. As a result, the staff did not object to the consistent application of a registrant's historical accounting policy regarding the composition of minimum rental payments for purposes of establishing lease liabilities in transition.

A similar diversity in practice exists for future minimum rental payments based on an index or a rate. Given the lack of explicit guidance in ASC 840, some lessees apply the current index or rate in the calculation of future minimum lease payments, while others use the index or rate at lease inception. Accordingly, the staff also did not object to the consistent application of a registrant's historical accounting policy in transition to ASC 842.

During the transition to ASC 842, a registrant may re-evaluate its historical policies. For example, a registrant that previously excluded executory costs may wish to include such costs in its minimum rental payments when transitioning to ASC 842. Additionally, a registrant may adjust its policy for the use of an index or rate at lease inception to reflect the current index or rate when calculating future minimum rental payments used to measure lease liabilities in transition. In these scenarios, the staff did not object to the application of ASC 250, which permits a change in accounting principles if the change is preferable.

When evaluating preferability, the staff also noted it would be reasonable to consider whether the lease liability that results from using the current index or rate represents a better measurement of the registrant's current lease obligations.

Lessee and lessor costs – The staff also discussed two specific consultations on certain lessee and lessor costs. The first issue related to lessee accounting for costs incurred to place a leased asset into its intended use, such as shipping costs incurred from a party other than the lessor. The staff did not object to the capitalization of such costs, as an accounting policy election, based upon an analogy to the capitalization guidance in ASC 360.

CREDIT LOSSES

With the effective date of the new credit loss standard (CECL) on the horizon, the dialogue between the SEC staff and many registrants progressed from scoping questions to implementation consultations during 2018. At the Conference, the staff shared their views on various implementation topics associated with CECL.

Loan charge-offs – In one consultation, a registrant concluded that loans should be assessed at the individual loan level to determine when the loans should be charged off. The staff did not object to the conclusion that loans retain their individual characteristics for this purpose, even though CECL requires pooling of loans with similar risk characteristics for purposes of determining the loan allowance.

Since CECL does not include guidance on the assessment of collectability, the staff discussed another question relating to whether portfolio level information should be considered in determining collectability for accounting purposes. In this consultation, the registrant determined that all relevant information, including individual loan information and historical losses on similar loans, should be considered when deciding whether a loan is uncollectible. The staff did not object to this conclusion.

Similarly, a lessor may also incur transportation or other costs to fulfill its obligations under a lease. Rather than recognizing those costs in current period earnings, the staff did not object to the capitalization of such costs, as an accounting policy election, by analogy to the guidance in ASC 340-40 to the extent the specific lessor costs are not within the scope of other GAAP and the costs would qualify for deferral if the lease was within the scope of ASC 606.

Registrants should apply these accounting policy elections consistently and provide appropriate disclosures, if material.

Subsequent events – The staff also addressed the application of subsequent events guidance in ASC 855 to the forward-looking estimates required by CECL. When information received after the balance sheet date but before the financial statements are issued or available to be issued is significantly different from management's expectations, the staff expects a registrant to consider factual loan-specific information about conditions at the balance sheet date in its estimate of expected credit losses. Examples of such loan-specific information include servicer reports providing payment information (e.g., prepayments or delinquencies) that happened on or before the balance sheet date and appraisal reports indicating the fair value of loan collateral as of the balance sheet date.

Additionally, the staff would not object if a registrant either considers or does not consider information relating to forecasting assumptions that is not loan specific (e.g., announcement of unemployment rates by the U.S. government) when such information is received before completion of the estimation process. Information relating to forecasting assumptions received after the completion of the estimation process would not be recognized. However, in any case, if the information signifies a deficiency in the estimation process, then the information should be recognized.

The staff also communicated they are in the process of updating Staff Accounting Bulletin 102, *Selected loan Loss Allowance Methodology and Documentation Issues*, to conform with the concepts in CECL.



NON-GAAP FINANCIAL MEASURES

At the Conference, the SEC staff acknowledged that non-GAAP financial measures are an important element of financial reporting. As a consequence, the staff reminded registrants that non-GAAP information should not be presented merely to report more favorable information as compared to GAAP amounts. Given the weight placed on non-GAAP measures by investors, registrants need appropriate disclosure controls and procedures in place to ensure complete, accurate and consistent presentation of these measures. The staff further noted that registrant disclosure policies should address the presentation and communication of changes in calculations and the correction of errors to investors.

Additionally, the staff indicated that audit committees should understand a company's controls around non-GAAP measures as well as why such measures are meaningful. Non-GAAP measures should provide insight into how management views the business and how management evaluates the company's performance. To that point, the staff may inquire about the information presented to a registrant's board of directors to validate management's disclosures.

The staff continues to challenge non-GAAP financial measures that accelerate accounting recognition or adjust financial measures for timing and measurement differences. Such "individually tailored accounting principles" may be misleading in the eyes of the staff.

To assist in the identification of what constitutes an individually tailored accounting principle, the staff suggested registrants consider the following questions:

- ▶ Does the adjustment shift the measure from an accrual basis of accounting to a cash or modified basis of accounting, such as presenting revenues on a cash receipts or billings basis?
- ▶ Does the adjustment add in transactions that are also reflected in another company's financial statements, such as the consolidation of an equity method investee?
- ▶ Is an adjustment limited to only select parts, but not all, of an accounting concept?
- ▶ Is an adjustment inconsistent with the economics of a transaction or an agreement, such as reflecting sales-type leases as operating leases?

If so, the non-GAAP financial measure probably constitutes an individually tailored accounting principle.

In the year of adopting ASC 606 using the modified retrospective method, the staff reiterated that a registrant may adjust revenues to reflect the previous revenue recognition standard (ASC 605) to facilitate comparability in the year of adoption. In subsequent years, the staff would likely consider such measures to be individually tailored accounting principles.

STAFF COMMENT LETTERS - PROCESS AND FOCUS AREAS

As required by the Sarbanes-Oxley Act, the staff reviews registrant filings at least once every three years. The staff reviews may vary from a cover to cover review for compliance with the applicable rules and regulations to a targeted review focused on specific disclosures within the footnotes and MD&A for compliance with the relevant accounting standards and related disclosure requirements.

Events such as a material restatement, significant volatility in the registrant's stock price as compared to its peers, or significant business combinations may trigger more frequent reviews. During an ongoing comment letter process, the staff may issue verbal comments to expedite the process when only small points of clarification remain or to inquire about a registrant's disclosure plans for a recent news event.

While continuing to monitor recurring comment letter topics such as non-GAAP measures as discussed above, the staff has also turned its attention to revenue recognition and related disclosures under ASC 606 (as discussed above) as well as other emerging topics, including cybersecurity (as discussed above), Brexit and LIBOR disclosures. Chairman Clayton and the staff emphasized the importance of tailoring these disclosures to a registrant's specific circumstances. MD&A disclosures, including risk factors, should provide investors with an understanding of the potential impact on the registrant.

BREXIT

At the Conference, Chairman Clayton reiterated his concern that the potential adverse effects of Brexit may not be understood or may be underestimated. The staff commented that, if material, a registrant should disclose the implications of, and its plan to address, the uncertainties caused by Brexit. To date, Chairman Clayton and the staff have observed a broad range of Brexit disclosures. For example, despite expectations that two registrants will be impacted in similar ways, one registrant discussed the potential impact on the its supply chain and business prospects in detail while another simply provided a general statement that identified Brexit as potential business threat on the horizon.

LIBOR

The SEC staff is actively monitoring the efforts of the Alternative Reference Rates Committee, FASB and others related to the expected transition away from LIBOR. In that regard, the staff highlighted the FASB's recent expansion of its list of benchmark interest rates for hedge accounting to include the Overnight Index Swap Rate based on the Secured Overnight Financing Rate (SOFR).

The staff also acknowledged the potential implications on hedge accounting, specifically surrounding the probability and effectiveness of a hedged transaction. In a recent consultation, the staff did not object to a conclusion that hedge documentation implicitly considers a replacement rate, thus allowing the registrant to continue to assert the hedged item is probable of occurring. Similarly, the staff did not object to a view that the transition itself will not impact the effectiveness of a cash flow hedge of variable rate debt, based on an expectation that the anticipated changes to LIBOR will affect both the hedged item and the hedging instrument.

In anticipation of the phase out of LIBOR, the staff also reminded registrants to re-evaluate their MD&A disclosures (e.g. risk factors, liquidity and capital resources, etc.).

INTERNAL CONTROL OVER FINANCIAL REPORTING

Throughout the Conference, the staff highlighted the critical role ICFR plays in the financial reporting process. The staff also pointed out the risks surrounding the implementation of new accounting standards, increasing the importance of management's assessment of ICFR. The staff also discussed the evaluation of operating effectiveness and severity of control deficiencies as well as material weakness disclosures.

When evaluating the operating effectiveness of controls, the staff stressed that registrants should consider (a) whether a control is operating as designed and (b) whether the nature, timing, and extent of the management's evaluation procedures are appropriate in light of the assessed risks of control failure and material misstatement.

In this regard, the staff provided the following considerations to assist in planning an evaluation of operating effectiveness:

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

To help management determine whether its evaluation procedures sufficiently support the ICFR assessment, the staff also provided the following questions for consideration:

- ▶ Is the sample size to evaluate the effectiveness of the control sufficient in considering the number of instances in which the control operated during the assessment period?
- ▶ Were the risks considered in determining the appropriate level of persuasiveness needed for the evidence to be obtained?

- ▶ For controls related to financial reporting elements with a higher risk of material misstatement (resulting from the susceptibility to fraud, the significance of judgment, or the control's complexity), did the nature, timing, and extent of the evaluation procedures appropriately reflect the level of risk?
- ▶ Was the type of control (whether it is, manual or automated) considered in determining the nature, timing, and extent of the evaluation procedures?
- ▶ Did the control rely on the completeness and accuracy of the information produced by the company? If so, were the controls over that information evaluated and found to be effective?

The staff also emphasized the need for a holistic evaluation approach when assessing the severity of a control deficiency. The views of a "prudent official" should be considered when evaluating whether a deficiency rises to the level of a material weakness.

To critically evaluate the severity of a control deficiency, a registrant must accurately define the control deficiency and its impact on the financial statements. For instance, the staff noted that a root cause analysis of a deficiency related to the sufficiency or competence of accounting personnel identified because of a misstatement in a complex area of GAAP may identify other areas of possible misstatement. Furthermore, when estimating the potential magnitude of a misstatement, the staff reminded management to consider what might be reasonably possible based upon the information known. In the case of offsetting misstatements, management may need to consider those misstatements from an absolute value perspective. Additionally, the staff observed that some registrants continue to incorrectly focus on the actual misstatement caused by a deficiency, rather than whether a reasonable possibility exists that a material misstatement would not have been prevented or detected on a timely basis.

While compensating controls may reduce the severity of a control deficiency, the staff cautioned that the compensating control must be designed to accomplish the same objective of the deficient control and operate at an appropriate level of precision.

After identifying a material weakness, the staff reminded management to disclose meaningful information which provides investors with an understanding of the cause of the material weakness and its potential impact on the financial reporting. Additionally, a disclosure of management's plans to remediate the material weakness should be sufficiently clear.

RULE 3-13 WAIVERS

As permitted by Rule 3-13, the SEC staff may waive or modify certain financial statement requirements. In this regard, the staff encourages registrants to consult with them when financial statement requirements are not material to the total mix of information available to investors. The staff may grant relief to a registrant when such requests are consistent with investor protection. While each Rule 3-13 waiver depends on a registrant's specific facts and circumstances, the staff provided the following insights at the Conference.

ACQUIRED OR TO BE ACQUIRED BUSINESS MEETS ONLY ONE SIGNIFICANCE TEST

When an acquired or to be acquired business meets only one of the significance tests under Rule 1-02(w) of Regulation S-X, the staff may consider alternative measures of significance or an alternative financial statement presentation. For instance, when significance is triggered solely based on the income test, such as during a break-even period, the staff may look to other supplemental measures of significance used by the registrant, including revenues, operating income and/or other nonfinancial measures.

Similarly, the staff may allow a registrant to present abbreviated financial statements, such as an audited statement of assets acquired and liabilities assumed based on an allocation of the purchase price at fair value on the transaction date, in lieu of full financial statements when the acquisition is significant solely based on the investment test. In this scenario, the staff will generally want to understand why the registrant paid an apparent premium for the business.

OMISSION OF REQUIRED FINANCIAL STATEMENTS FOR AN ACQUIRED OR TO BE ACQUIRED BUSINESS

A registrant must present financial statements covering all related businesses when the related businesses are significant in the aggregate. However, one of the related businesses may not be significant to the overall acquisition. In that situation, the staff may agree to the omission of the financial statements of the individually insignificant business.

Additionally, the acquisition of a significant business during the earliest year presented in a company's initial registration statement may no longer be meaningful to an investor when the company experienced significant growth after the acquisition. As a result, the staff may allow the financial statements of the previously acquired business to be omitted.

In an initial Form 10 filing, a smaller reporting company may also request relief when the audited financial statements of a significant business acquired during the earliest year presented are difficult to obtain.

Lastly, the staff will consider requests for the omission of a significant acquired business' financial statements in a draft registration statement when the company's publicly filed financial statements will include the operations of the acquired business for at least a full year.

SUBSTITUTION OF FINANCIAL STATEMENTS

When an acquired business meets the definition of a foreign private issuer except for the ownership condition, the staff will consider a registrant's request to present financial statements prepared under IFRS, without reconciliation to U.S. GAAP, in lieu of U.S. GAAP financial statements. The staff may also consider similar requests for financial statements required under Rule 3-09 of Regulation S-X.

Furthermore, Rule 3-09 may require partial year financial statements of an investee during the year of acquisition or disposition. When such partial year financial statements are difficult to obtain, the staff may grant requests to present full year financial statements in lieu of the partial year financial statements.

The staff also encouraged registrants to propose appropriate alternative disclosures as part of their waiver requests. For example, a registrant may suggest an expanded version of the summarized financial information under Rule 4-08(g) of Regulation S-X in lieu of full investee financial statements.

Lastly, the staff continues to look for ways to improve transparency in the Rule 3-13 process. While the subject of a Rule 3-13 waiver request may contain confidential information, the staff acknowledged that the others may benefit from an understanding of the staff's approach to specific requests.

EMERGING GROWTH COMPANIES

An emerging growth company may elect to defer compliance with new or revised accounting standards until private company adoption dates. The staff clarified certain guidance with respect to the extended transition period for EGCs at the Conference.

ADOPTION AFTER EXTENDED TRANSITION PERIOD

Using the new revenue standard as an example,¹⁵ a calendar year-end EGC that elected to defer compliance must adopt the new revenue standard in its 2019 Form 10-K for the entire fiscal year ending December 31, 2019. An EGC need not accelerate application of the standard to interim periods for the sole purpose of reporting supplementary quarterly financial data required by S-K Item 302(a). As such, that same EGC will not be required to present quarterly information in its 2019 Form 10-K in accordance with the new revenue standard. However, the EGC should provide clear and transparent disclosure that the quarterly information is presented on a different basis than the annual financial statements. At the Conference, the staff expressed a preference for EGCs to reflect the adoption of the new revenue standard in the 2019 comparable periods presented in the 2020 Form 10-Q filings, but it continues to consider the issue.

ADOPTION AFTER LOSS OF EGC STATUS

Upon the loss of EGC status, a registrant must reflect the adoption of previously deferred standards in its next periodic filing as of the beginning of that year. On the other hand, if the registrant adopted the new standard before it lost EGC status, the staff would not expect the company to revise its financial statements for a new or different adoption date. The following scenarios illustrate this guidance based upon the adoption dates for the new revenue standard for a calendar year-end registrant:

Registrant loses its EGC status as of December 31, 2018

- ▶ The registrant should adopt the new revenue standard for the entire fiscal year 2018 in its 2018 Form 10-K and reflect the adoption for all quarterly information in that Form 10-K (i.e., no revision of the 2018 Form 10-Q filings would be required).
- ▶ The registrant should also provide clear and transparent disclosure indicating the quarterly information in the 2018 Form 10-K differs from the information in its 2018 Form 10-Q filings.
- ▶ A registrant's 2019 Form 10-Q filings should reflect the application of the new standard in the 2018 comparable periods.

Registrant deferred adoption of the new revenue standard and loses its EGC status as of December 31, 2019

- ▶ The staff would not object if the registrant adopts the new revenue standard only for the entire fiscal year 2019 including the quarterly information in its 2019 Form 10-K (i.e., no revision of the 2019 Form 10-Q filings would be required).
- ▶ The registrant should provide clear and transparent disclosure indicating the quarterly information in the 2019 Form 10-K differs from the information in its 2019 Form 10-Q filings.
- ▶ A registrant's 2020 Form 10-Q filings should reflect the application of the new standard in the 2019 comparable periods.

Registrant adopts the new revenue standard in its 2019 10-K and loses its EGC status in 2020 or later

- ▶ The staff would not expect the registrant to revise its January 1, 2019 adoption date of the new revenue standard.

Additionally, an initial registration statement for a company that does not qualify as an EGC should reflect the adoption of the new standard using the effective dates for public business entities (i.e., as of January 1, 2018).

¹⁵ Nonpublic business entities are required to adopt the new revenue standard in annual periods beginning after December 15, 2018 (e.g. on January 1, 2019 for calendar year-end companies) and in interim periods within annual periods beginning after December 31, 2019 (e.g. January 1, 2020 for calendar year-end companies).

OTHER ACCOUNTING AND REPORTING TOPICS

INCOME TAXES

The staff remarked that the issuance of SAB 118 in December 2017 enabled registrants to present useful estimates to investors as soon as possible, while also allowing them time to fully understand the Tax Cuts and Jobs Act (Tax Act). The staff also reaffirmed that the effects of the Tax Act must be finalized by the end of the measurement period on December 22, 2018. Registrants should follow the guidance in ASC 740 for any adjustments after that date.

ARGENTINA

At the Conference, the SEC staff reminded registrants that Argentina's economy is now classified as "highly-inflationary" for accounting purposes. Companies should provide disclosures based on their individual circumstances, including tailored risk factors discussing the business and financial risks of operating in a highly-inflationary environment and a discussion of the impact on trends and operating results within MD&A.

PCAOB Developments

THE NEW BOARD AND ITS STRATEGIC FOCUS

In December 2017, a complete overhaul of the PCAOB occurred as the SEC appointed the following five new members, who were sworn in between January and April 2018:

- ▶ Chairman William D. Duhnke III, former majority staff director and general counsel to the U.S. Senate Committee on Rules and Administration.
- ▶ J. Robert Brown, Jr., a former law professor and attorney.
- ▶ Duane M. DesParte, a former senior vice president and corporate controller as well as a former assurance partner.
- ▶ Kathleen M. Hamm, a former securities and cyber solutions adviser.
- ▶ James G. Kaiser, a former assurance partner focused on assurance methodology.

BDO OBSERVATIONS:

The new Board championed internal and external engagement by soliciting broad perspectives from PCAOB staff and a variety of stakeholders including audit committees, management, investors, and auditors in order to establish their Strategic Plan for the next five years. Most recently, during the Conference, the entire Board reflected on the past 15 years of the PCAOB and highlighted the transformation that the PCAOB is undertaking across all areas within their oversight of audit quality, including standard setting; inspections of audit firms; engagement with audit committees, investors, advisory groups and international standard setters; evolving technology and its impact on audit quality; audit firm quality controls and enforcement; and finally, the talent needed to drive systemic audit quality.



APPROVAL OF FIVE-YEAR STRATEGIC PLAN (2018 – 2022)

In November, the PCAOB approved its [strategic plan](#) for 2018 through 2022. The overall goal of the strategic plan is to drive continuous improvement in audit quality and improve communication with investors, audit committees, preparers, and other stakeholders, while transforming into a more “agile, innovative regulator.”

The five areas of focus in the strategic plan include:

1. Drive improvement in the quality of audit services through a combination of prevention, detection, deterrence, and remediation.
2. Anticipate and respond to the changing environment, including emerging technologies and related risks and opportunities.
3. Enhance transparency and accessibility through proactive stakeholder engagement.
4. Pursue operational excellence through efficient and effective use of the PCAOB's resources, information, and technology.
5. Develop, empower, and reward the people of the PCAOB to achieve their shared goals.

The PCAOB utilized outreach and surveys to develop the plan, and the draft was open for public comment prior to being finalized. The PCAOB also plans to conduct ongoing outreach with financial statement preparers and other stakeholders and seeks to be “more open with respect to our operations and with respect to the information that we collect and produce.”

Another significant emphasis in the PCAOB strategic plan includes a shift from an audit deficiency only focus to a more “forward-looking and balanced” approach that looks at prevention. The strategic plan also addresses a change in inspection reports, including improved clarity, timeliness, and relevance.

Finally, the strategic plan indicates that the PCAOB intends to better leverage economic and risk analysis of standards by incorporating data from their oversight activities and performing post-implementation reviews of new or amended auditing standards.

BDO OBSERVATIONS:

As an audit firm, we have noticed a significant shift toward a more “open door” policy with respect to the frequency and quality of conversations about audit quality drivers and indicators, which has increased communications and enforced a feedback loop within the audit profession. BDO also noted an acceleration of inspection timing and improved timeliness of reporting firm level findings. We anticipate this expedited timing will continue. We also expect a greater inspection focus on firm quality control processes and monitoring procedures, including the use, and supervision, of other audit firms within the scope of an audit. Another expected change resulting from the new plan is an increased focus on the use of technology (e.g., data analytics and artificial intelligence) by audit firms in the context of an audit as well as by the PCAOB in their own inspections.

Comments made by the Board during the Conference underscored each of these observations. Duane DesParte and fellow Board members specifically highlighted the PCAOB's standard setting agenda item related to quality control auditing standards as a preventative means to reduce audit deficiencies. In addition, the Board addressed the thematic reviews by PCAOB inspection teams during the 2019 inspection cycle, which will be followed by public a public discussion of their findings. As part of the overall inspection process, the PCAOB also intends to engage directly with the audit committee of each company subjected to PCAOB inspections. The Board also provided their thoughts on the communication of inspection reports and how to make such reports more useful, such as reflecting a more balanced approach to provide a better understanding of the severity of inspection findings and their linkage to audit quality.

Auditors, management, and audit committees should also be contemplating the increased pace of significant standard-setting and the strategic and operational impacts that these standards will have on the auditing process.

STANDARD SETTING AND RELATED GUIDANCE

ADOPTED AUDITING STANDARD, AUDITING ACCOUNTING ESTIMATES, INCLUDING FAIR VALUE MEASUREMENTS, AND RELATED AMENDMENTS

In December, the PCAOB adopted a new auditing standard, *Auditing Accounting Estimates, Including Fair Value Measurements*, along with related amendments to the risk assessment standards. The standard enhances the requirements applicable to auditing accounting estimates, including fair value measurements. Once approved by the SEC, this standard will replace three existing auditing standards: AS 2501, *Auditing Accounting Estimates*, AS 2502, *Auditing Fair Value Measurements and Disclosures*, and AS 2503, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*. A special topics appendix in the standard addresses auditing the fair value of financial instruments, including the use of information from pricing services.

The adopted standard and related amendments strengthen existing requirements by:

- ▶ Prompting auditors to devote more attention to potential management bias in accounting estimates, while emphasizing the importance of professional skepticism.
- ▶ Extending certain key requirements in the extant standard on auditing fair value measurements to all accounting estimates in significant accounts and disclosures, thereby reflecting a uniform approach to substantive testing.
- ▶ Prompting auditors to focus on estimates with a greater risk of material misstatement.
- ▶ Providing specific requirements to address unique aspects of auditing fair values of financial instruments, including the use of pricing sources (e.g., pricing services and brokers or dealers).
- ▶ Updating other requirements for auditing accounting estimates to provide clarity and specificity.

Subject to approval by the SEC, the final standard and amendments will become effective for audits of financial statements for fiscal years ending on or after December 15, 2020.

The PCAOB [release](#) adopting the standard and related amendments and a [fact sheet](#) that summarizes the main provisions of the standard and related amendments are available on the PCAOB's website.

ADOPTED AMENDMENTS TO AUDITING STANDARDS FOR AUDITOR'S USE OF THE WORK OF SPECIALISTS

Also, in December, the PCAOB adopted amendments to strengthen requirements regarding auditors' use of the work of specialists in an audit. These amendments apply a risk-based supervisory approach to both auditor-employed and auditor-engaged specialists and strengthen requirements for evaluating the work of a company's specialist. The amendments, once approved by the SEC, will add a new appendix to AS 1105, *Audit Evidence*. The appendix will address the use of the work of a company's specialist as audit evidence based on the risk-based approach of the risk assessment standards. AS 1201, *Supervision of the Audit Engagement*, will also be amended to add a new appendix on supervising the work of auditor-employed specialists. Further, the amendments will replace extant AS 1210, *Using the Work of a Specialist*, and retitle it to *Using the Work of an Auditor-Engaged Specialist*, to set forth requirements for using the work of auditor-engaged specialists.

Subject to approval by the SEC, the amendments will become effective for audits of financial statements for fiscal years ending on or after December 15, 2020.

The [amendments](#) and a [fact sheet](#) that summarizes the main provisions of the amendments are available on the PCAOB's website.

AUDITOR REPORTING MODEL - UPDATED STAFF GUIDANCE, CHANGES TO THE AUDITOR'S REPORT EFFECTIVE FOR AUDITS OF FISCAL YEARS ENDING ON OR AFTER DECEMBER 15, 2017

In August, the PCAOB updated its [staff guidance](#), *Changes to the Auditor's Report Effective for Audits of Fiscal Years Ending On or After December 15, 2017* (the Staff Guidance), to help firms implement changes to the auditor's report under AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*. The updates to the Staff Guidance include the following:

Determination of Auditor Tenure

The updated guidance clarifies the following:

- ▶ A company's benefit plan that files an annual report on Form 11-K is considered a separate issuer and has a separate tenure determination.
- ▶ Publicly available information to help determine auditor tenure includes annual reports on Form 10-K, current reports on Form 8-K reporting a change in the company's independent registered public accounting firm, or other company filings available on the SEC's EDGAR system.
- ▶ If there is uncertainty as to the year the auditor began serving consecutively as the company's auditor, language other than that described in the Staff Guidance may be used in the auditor's report to express uncertainty regarding tenure. The statement must effectively communicate the first year the firm knows that it served as the company's auditor and the uncertainty of the specific year when tenure began. However, the explanatory language should not state or imply that the auditor did not make a tenure determination.
- ▶ When the auditor's report is reissued by a predecessor auditor, the predecessor auditor may expand the tenure statement to indicate when its tenure ended.

Auditor Reporting Regarding ICFR

In certain circumstances, management is required to report on the company's ICFR, but such report is not required to be audited. In such cases, the auditor must include explanatory language to that effect in the Basis for Opinion section. However, if an audit of ICFR is performed, whether pursuant to SEC rules, the rules of another regulator, or otherwise, such explanatory language in the Basis for Opinion section would not be included.

Additionally, if the auditor issues separate reports on ICFR and the financial statements, the required paragraph referencing the separate report should appear in the Opinion on the Financial Statements section, immediately following the opinion paragraph. Auditor tenure is not required to be disclosed in the auditor's separate ICFR report.

Explanatory Paragraphs

If the auditor is required to include explanatory language in the auditor's report but the location is not specified in the PCAOB standards, the language may be placed where the auditor considers appropriate.

Emphasis Paragraphs

When an emphasis paragraph is included in the auditor's report, it is not appropriate for the auditor to use phrases such as "with the foregoing [following] explanation" in the opinion paragraph. The emphasis paragraph may be placed where the auditor considers appropriate, with an appropriate section title.

Information About Certain Audit Participants

If the auditor voluntarily decides to provide information about certain audit participants that is required to be reported on PCAOB Form AP, *Auditor Reporting of Certain Audit Participants*, the auditor may include information about the engagement partner, information about the other accounting firms, or both. If the auditor includes information about the other accounting firms in the auditor's report, all other accounting firms required to be disclosed on Form AP must be included in the auditor's report.

Other Reporting Situations

The Appendix in the updated guidance includes the following topics:

- ▶ Supplemental information. AS 2701, *Auditing Supplemental Information Accompanying Audited Financial Statements*, allows the auditor's report on supplemental information to be included in the auditor's report on the financial statements, but does not specify a location. Since there is no specified location, such report may be placed where the auditor considers appropriate, and an appropriate section title may be added to differentiate the auditor's report on supplemental information from the other sections of the auditor's report on the financial statements.
- ▶ Reviews of interim financial information. The reporting requirements in AS 4105, *Reviews of Interim Financial Information*, conform to the requirements of AS 3101. Further AS 4105.37C.e requires a statement on auditor independence to be included in the Basis for Review Results section of the auditor's report on the review of interim financial information.
- ▶ Special reports. AS 3305, *Special Reports*, provides reporting requirements for various types of special reports, such as reports on specified elements, accounts, or items of a financial statement. AS 3305.01 indicates that if a special report is filed with the SEC, the auditor's report is required to include the basic elements that would be required in an unqualified auditor's report under AS 3101. Additionally, for reports that are prepared in conformity with a comprehensive basis of accounting other than generally accepted accounting principles under AS 3305.01.a, the auditor is required to communicate critical audit matters, when applicable.

BDO OBSERVATIONS:

In addition to changes in basic elements of the auditor's report effective in 2017, AS 3101 requires the auditor to communicate any critical audit matters (CAMs) within the auditor's report for issuers beginning with large accelerated filers for audits of fiscal years ending on or after June 30, 2019, and for other issuers for audits of fiscal years ending on or after December 15, 2020. The PCAOB, along with the SEC, is particularly interested in monitoring the results from "dry run" programs for reporting CAMs that audit firms and their issuer clients are currently performing. Participation in dry runs by these stakeholders along with post-implementation sharing of knowledge will better inform the PCAOB on the need for additional implementation guidance as well as any unintended consequences of standard-setting. In addition, the Center for Audit Quality has released a tool "[Critical Audit Matters: Key Concepts and FAQs for Audit Committees, Investors, and Other Users of Financial Statements](#)" to assist users of financial statements in better understanding the identification and communication of CAMs. The tool provides some early considerations for the lessons learned from dry runs conducted to date as well as certain frequently asked questions to aid in implementation efforts by preparers, audit committees, and auditors.

INSPECTIONS OUTLOOK FOR 2019

According to the PCAOB's [Inspections Outlook for 2019](#) that was released in December and supplemented by the PCAOB staff at the Conference, the key areas of focus for 2019 inspections include:

- ▶ Audit firms' systems of quality control
- ▶ Independence
- ▶ Recurring inspection deficiencies (e.g., auditing ICFR, revenue recognition, allowance for loan losses, other accounting estimates, and assessing/responding to risks of material misstatement)
- ▶ External considerations (i.e., firms' responses to elevated risks of material misstatement due to factors external to the company, such as economic conditions)
- ▶ Cybersecurity risks
- ▶ Software audit tools
- ▶ Digital assets
- ▶ Audit quality indicators
- ▶ Changes in the auditor's report
- ▶ Implementation of new accounting standards

BDO OBSERVATIONS:

BDO's insights with respect to how our firm is addressing each of these significant areas are available in our [BDO Alert](#).

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