



2021 AICPA SEC & PCAOB Conference Highlights

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Consistent with prior years, the annual AICPA and CIMA Conference on Current SEC and PCAOB Developments was held in Washington D.C. on December 6-8, 2021, where representatives from the Securities and Exchange Commission and the Public Company Accounting Oversight Board shared their views on various accounting, reporting and auditing issues.

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Overview

The regulatory landscape for public companies and the economic environment in which we all operate continue to change rapidly and evolve. Consequently, it was no surprise to hear the SEC staff emphasize the need for high quality financial reporting which includes high-quality standard setting, high-quality application of those standards, and high-quality audits throughout the Conference. While accounting and reporting issues related to the COVID-19 pandemic dominated last year's conversations, this year's conversations were dominated by topics at the forefront of Chair Gensler's Regulatory Agenda, including environmental, social and governance (ESG) reporting matters and special purpose acquisition companies (SPACs). Conference panelists highlighted some of the key accounting and reporting matters related to these areas and others, including:

- ▶ **SEC Reporting Matters** - reminders for registrants to consider the 2010 interpretive guidance on climate change disclosure, and more specifically, whether disclosures made in corporate social responsibility or sustainability reports have been appropriately considered for disclosure in SEC filings. Separately, the SEC staff discussed error assessments and evaluations of materiality, highlighting the importance of objective, unbiased analyses when concluding whether an error is a "little r" revision or a "Big R" restatement. Other disclosure topics included the transition away from the London Interbank Offered Rate (LIBOR) as a key reference rate, segment reporting, non-GAAP financial measures and metrics, and the Holding Foreign Companies Accountable Act (HFCAA).
- ▶ **Accounting Matters** - frequent topics of consultation with the Office of the Chief Accountant (OCA) related to revenue recognition matters, including principal vs. agent determinations, identification of performance obligations, and consideration payable to a customer. The SEC staff also discussed the accounting for SPAC warrants and redeemable shares, digital assets, and "spring-loaded" equity awards.
- ▶ **Auditing Matters** - compliance with the SEC's auditor independence requirements, particularly the general standard of auditor independence. The PCAOB staff also shared inspection findings and areas of focus for the coming year.

This publication provides insight into these matters and other accounting and reporting issues addressed at the Conference. Our companion publication, [2021 SEC Reporting Insights](#), may be referenced for a more comprehensive discussion of SEC rulemaking, developments and related staff activities, many of which were highlighted at the Conference. Additionally, Acting Chief Accountant Paul Munter's [statement](#) that was released in connection with his remarks at the Conference highlights OCA's priorities and perspectives on many of the topics included in this publication.

SEC Reporting Matters

ESG AND CLIMATE RISK DISCLOSURES

Investor demand for environmental, social, and governance information continues to evolve. The SEC staff discussed rulemaking activities related to climate risk, human capital, board diversity and inclusion, and cybersecurity disclosures. While waiting for new rulemaking, the SEC staff will review registrant climate change disclosures in light of its previously issued 2010 interpretative guidance (which was emphasized in the SEC staff's [sample comment letter](#) sent to registrants on climate change disclosure). The SEC staff is particularly focused on whether ESG disclosures appearing on a registrant's website or in a separate sustainability report are properly considered for disclosure in SEC filings.

With respect to climate change and other ESG disclosures, the SEC staff is also monitoring the activities of the newly created International Sustainability Standards Board (ISSB), which was established to develop global sustainability reporting standards. However, in order to meet investor demands for decision useful ESG information, the SEC intends to move forward with their own rulemaking initiatives rather than wait for the issuance of ISSB standards.

MATERIALITY AND ERROR CORRECTIONS

The materiality of an error in previously issued financial statements determines how a registrant must correct the error. A material error requires a restatement and reissuance of previously issued financial statements (i.e., a "Big R" restatement). When an error is not material to the historical financial statements, a registrant should evaluate whether the error may be corrected in the current period. If the error correction would result in a material misstatement to the current period, the registrant would instead correct the comparative prior period information within the current period financial statements (i.e., a "little r" revision). The SEC staff observed an increase in "little r" revisions as a percentage of all restatements and has, in certain circumstances, requested a registrant's analysis of the error to support such a conclusion.

Registrants should assess errors in previously issued financial statements with an unprejudiced perspective when evaluating the total mix of qualitative and quantitative factors. The existing guidance in [Staff Accounting Bulletin Topic 1.M](#) (SAB 1.M) continues to apply to these materiality judgments and should not be used as a checklist when evaluating an error. The SEC staff emphasized that, while all relevant facts and circumstances must be considered, a quantitatively material error usually results in a "Big R" restatement as it is challenging to overcome quantitative significance based on qualitative factors.

The SEC staff also provided insights into "passage of time" considerations, wherein a registrant concludes that a quantitatively material error is not qualitatively material due to the availability of more recent financial statements. Based on discussions with investors, the SEC staff indicated that investors often consider both current and historical financial statements as well as a registrant's history of identifying and correcting errors. Therefore, the SEC staff does not believe that the passage of time is a compelling factor when evaluating the materiality of an error.

Additionally, the SEC staff provided examples of situations when they objected to a registrant's "little r" conclusion. In the first scenario, the registrant misstated its historical financial statements by a quantitatively material amount (e.g., 20% of net income and greater than 50% of the loss on sale from discontinued operations). The analysis concluded that qualitative factors, namely that the error was isolated to discontinued operations and was corrected in the current financial statements (i.e., the "passage of time"), outweighed the fact that the amount was quantitatively material and therefore the error was corrected in the current period financial statements. The SEC staff was not persuaded by these qualitative factors, resulting in a "Big R" restatement.

In another example, a SPAC incorrectly classified a portion of its redeemable common shares within permanent equity. Quantitatively, the error represented 100% of permanent equity and changed EPS by greater than 50%. The SPAC's qualitative assessment asserted that its financial statements were not relevant to investors as investors primarily focus on the SPAC's merger target(s) financial statements and such shares would be presented in permanent equity upon

closing of a merger. The SEC staff objected to the registrant’s relevance conclusion based on the specific facts and circumstances, resulting in a “Big R” restatement.

The SEC staff reminded registrants to also evaluate the impact of errors on internal controls over financial reporting (ICFR). In that regard, the SEC staff referenced speeches from the [2014](#) and [2018](#) Conferences, noting the possibility that a material misstatement would not have been prevented or detected on a timely basis (i.e., the “could” factor) must be considered when assessing the ICFR impact of an immaterial error. Additionally, the SEC staff commented that material errors likely signify that a material weakness exists.

Furthermore, the SEC staff has observed boilerplate risk factor disclosures related to accounting errors. When risk factor disclosures include disclaimers about the accuracy of the accounting or the likelihood that a future auditor would agree with the accounting, the SEC staff may question management’s ability to certify, and the current auditor’s ability to opine, that the financial statements were prepared in accordance with GAAP.

REGULATION S-K AMENDMENTS

The SEC staff reminded issuers that the adoption of the recent amendments to Regulation S-K should not result in the elimination of material information. For example, while the amended rules eliminated the requirement to provide a contractual obligations table, registrants are still required to discuss material cash requirements and other obligations within management’s discussion and analysis, such as in liquidity and capital resource disclosures. Registrants may voluntarily provide a contractual obligations table if they believe it conveys information about future cash requirements in an effective manner.

Additionally, the amended rules eliminated the requirement to present a selected quarterly financial data table pursuant to S-K 302(a), unless there has been a material retrospective change applied in the last two fiscal years. The SEC staff has received inquiries related to the presentation of selected quarterly financial data when emerging growth company (“EGC”) status is lost during the year and specifically, whether the adoption of new accounting principles upon the loss of EGC status is considered a retrospective change. The SEC staff referred to an example in the [final rule](#) which states that not all changes in accounting principles would result in a retrospective change, such as when a calendar year-end EGC elected to take advantage of the extended transition period and adopts an accounting standard for the full year in its Form 10-K and interim periods thereafter. In contrast, a registrant that loses EGC status as of December 31 would be required to adopt the accounting standard in the Form 10-K for both the full fiscal year and interim periods within that fiscal year. The registrant must evaluate the materiality of such retrospective change to determine whether the selected quarterly financial data table is required under S-K 302(a).

HOLDING FOREIGN COMPANIES ACCOUNTABLE ACT

In December 2021, the SEC adopted [rule amendments](#) associated with the submission and disclosure requirements in the HFCAA. The PCAOB’s ability to fully inspect or investigate audit firms has been limited in certain foreign jurisdictions. Under the amended rules, the SEC will identify registrants audited by accounting firms in those foreign jurisdictions. The rules require additional disclosures for these “Commission-Identified Issuers,” including the addition of a new Item 9C to Form 10-K. Additionally, the SEC is required to suspend trading of the registrant’s securities if the PCAOB is unable to inspect the registrant’s audit firm for three consecutive years. During a trading suspension, the SEC staff emphasized that the issuer’s SEC reporting obligations would continue. The SEC staff also explained that 2021 is the first reporting year covered by the HFCAA.

SEC COMMENT LETTER TOPICS

NON-GAAP FINANCIAL MEASURES

The SEC staff continues to comment on non-GAAP financial measures presented in registrant filings. The SEC staff shared reminders about the prominence and labeling of non-GAAP measures. GAAP measures are the foundation of the SEC financial disclosure requirements. Therefore, a discussion of non-GAAP measures should not precede or

overshadow a similar discussion of GAAP measures. The SEC staff will comment on, and object to, the presentation of a full non-GAAP income statement and non-GAAP reconciliations that do not begin with the most directly comparable GAAP measure.

In addition, the SEC staff highlighted the importance of appropriate labelling, including clear detailed descriptions of non-GAAP adjustments. For example, the SEC staff noted that it would be inappropriate to label a contribution margin or other non-GAAP gross margin measure as “net revenue.”

The SEC staff also acknowledged that the distinction between non-GAAP measures and key performance metrics may be confusing. As such, the SEC staff encouraged registrants to review the Commission’s [existing guidance](#) on the disclosure of key performance indicators and metrics. The SEC staff also highlighted the importance of effective disclosure controls and procedures and ICFR, where applicable, over these non-GAAP measures and key performance metrics.

SEGMENTS

Segment disclosures provide insight into a company through the eyes of management and drive a registrant’s MD&A disclosures. As a result, the SEC staff focuses on such disclosures during the filing review process. When reviewing segment disclosures, the SEC staff may compare such disclosures to information presented inside and outside of SEC filings, including earnings calls, earnings releases and the registrant’s website.

The SEC staff may also inquire when a registrant discloses a single reportable segment. Additionally, registrants should consider the potential impact on segment reporting caused by changes in management and the business. The SEC staff also reminded registrants that all criteria under ASC 280 must be satisfied in order to aggregate two or more operating segments.

Furthermore, the SEC staff continues to see more than one measure of segment profit or loss presented in financial statements. When a registrant presents multiple measures of segment profit or loss which are not calculated in accordance with GAAP, the SEC staff will question the rationale for, and ultimately object to, such disclosures.

INCOME STATEMENT PRESENTATION

Registrants often present income statement line items on a more disaggregated basis than required by Regulation S-X. The SEC staff indicated that further disaggregation is acceptable as long as the presentation of revenues and expenses is consistent with GAAP. However, they may inquire about the classification of certain costs to understand whether the line item relates to revenues (i.e., cost of sales) or represents another operating expense. Registrants must also comply with SAB 11.B if depreciation and amortization (D&A) has not been allocated to cost of sales (which requires clear disclosure that D&A has not been allocated and prohibits the presentation of gross profit in the income statement).

FINANCIAL DISCLOSURES ABOUT ACQUIRED AND DISPOSED BUSINESSES

SIGNIFICANCE TEST CONSIDERATIONS

Consistent with views shared at the 2020 Conference, the SEC staff reiterated that a registrant’s average aggregate worldwide market value (WWMV) consists solely of the value of the registrant’s common stock traded on a market. The SEC staff has denied requests for alternative calculations of WWMV related to multiple classes of stock. When it is available, the WWMV must be used in the denominator of the investment test when calculating the significance of an acquisition, including in the year of an IPO.

Additionally, questions may arise related to the financial statements that should be used for the calculation of significance when a registrant completes an acquisition after its fiscal year end but prior to filing its annual report on Form 10-K. If the Form 10-K for the most recent fiscal year is filed prior to the due date of the target’s financial statements in Form 8-K, a registrant may choose to update its asset and income tests using the registrant’s most recent

financial statements included in the subsequently filed Form 10-K. In that circumstance, the registrant would not be required to obtain more recent financial statements of the acquired business.

For purposes of S-X Rules 3-09 and 4-08(g), the SEC staff discussed the application of the income test to an equity method investment accounted for under the fair value option. The SEC staff explained that a registrant should use the change in fair value of the equity method investment as reflected in the registrant's income statement as the numerator in the income test. Also, the registrant should use its proportionate share of the investee's revenues when calculating the revenue component of the income test.

PRO FORMA ADJUSTMENTS

The SEC staff addressed autonomous entity and management adjustments presented in pro forma financial information for a spin-off transaction. Autonomous entity adjustments are required to be presented in a separate column within the pro forma financial information for a spin-off transaction. Management adjustments are not required, but they may be presented in a footnote to the pro forma financial information. The SEC staff remarked that autonomous entity adjustments generally require a contractual agreement to support such adjustments, and, without such supporting evidence, adjustments are likely management adjustments.

OTHER REPORTING MATTERS

LIBOR

The SEC staff is focused on the transition away from LIBOR and expects increasingly detailed disclosures of the facts and circumstances specific to each registrant. These disclosures should offer insight into the registrant's actions to date as well as any additional expected measures necessary to mitigate the transition risk. The SEC staff also released a [statement](#) highlighting key disclosure considerations as the transition away from LIBOR is now certain.

MD&A DISCLOSURES AND RISK FACTORS

The SEC staff reminded registrants to consider the impact of the current economic environment (e.g., inflation, supply chain issues, labor shortages, etc.) when drafting MD&A and risk factor disclosures. Additionally, the cash flow impact of return-to-work costs such as additional employee benefits and hiring costs should be disclosed, if material.

Consistent with Chair Gensler's July [statement](#), the SEC staff also emphasized the importance of disclosures associated with investments in China-based variable interest entity structures. Registrants should sufficiently disclose:

- Investors are not buying shares of a China-based operating company, but instead they are buying shares of a shell company that has contractual arrangements with the operating company;
- The nature of the relationship between the registrant and the China-based operating company;
- Risks and uncertainties about the enforceability of contracts and future actions by the government of China which could impact financial performance; and
- Detailed financial information.

Accounting Matters

SPAC ACCOUNTING CONSIDERATIONS

SPAC IPOs and mergers have increased significantly in recent years. The SEC staff mentioned that it has worked through several common SPAC accounting challenges with registrants and their auditors over the past year, including:

- ▶ temporary versus permanent equity classification;
- ▶ warrants;

- ▶ earnings per share;
- ▶ compensation;
- ▶ business combination considerations;
- ▶ derivatives; and
- ▶ the adoption of new accounting standards.

The SEC staff discussed its April [statement](#), which resulted in a change of classification for certain warrants from equity-classified instruments to liability-classified instruments. The SEC staff reiterated that accounting conclusions are derived from the specific facts and circumstances of a registrant and its warrant agreements.

The SEC staff also summarized a consultation related to the classification of redeemable SPAC shares. In this fact pattern, the SPAC classified a portion of its redeemable shares within permanent equity due to a provision in its charter which limited redemptions that would cause its net tangible assets to decline below a minimum threshold. As the SEC staff considers each redeemable share to be a freestanding financial instrument, the SEC staff objected to the permanent equity classification for the SPAC's redeemable shares despite the charter provisions.

SPRING-LOADED COMPENSATION AWARDS

In late November, the SEC staff issued [SAB 120](#), which includes accounting and disclosure guidance for share-based compensation awards granted when a registrant possesses material non-public information. Registrants must consider the impact of an anticipated announcement of material non-public information on the fair value of these "spring-loaded awards," including any necessary adjustments to inputs in the valuation model such as expected volatility. While non-routine grants of share-based awards require extra scrutiny, the SEC staff reminded registrants to use reasonable judgment when granting awards in the normal course of business as well.

REVENUE RECOGNITION

The SEC staff continues to receive a steady volume of consultations on revenue recognition matters, including identification of performance obligations, principal versus agent considerations, identification of a customer and consideration payable to a customer. Well-reasoned judgments grounded in facts and the relevant accounting principles will be respected by the SEC staff. Registrants should also ensure that revenue recognition disclosures provide the appropriate context to investors.

Identifying Performance Obligations and Principal Versus Agent Considerations - The identification of performance obligations may be more complex when a contract includes a promise to provide a good or service upfront and a related service over time. For instance, a registrant may sell a smart device with ongoing cloud service and related maintenance or support services. In addition to determining whether those promised goods or services are distinct from each other (i.e., separate performance obligations), a registrant must also assess whether it is a principal or an agent in the transaction. The SEC staff reminded registrants that the indicators of control in a principal versus agent analysis should not replace an assessment of control. Rather, registrants should consider how, and to what extent, the facts around an indicator support the control assessment. For example, if a registrant integrates a good or service obtained from a third party into its own good or service, the registrant should assess whether it controls the third party good or service and the integration process as well as the nature and significance of the integration service.

Identification of a Customer and Consideration Payable to a Customer - The SEC staff discussed various matters when accounting for consideration payable to a customer. In one example, a registrant offered incentives to one or more parties in an arrangement (i.e., the seller and the end-user). Based on the specific facts and circumstances, the registrant concluded that it had one customer (i.e., the seller) and acted as the seller's agent when providing goods or services to the end-user. The SEC staff did not object to the recognition of incentives paid to the end-user as a marketing expense, rather than as a reduction of revenue.

However, the SEC staff noted that a registrant providing an agency service to the seller should also consider whether it explicitly or implicitly promised to provide incentives to the end-user on the seller's behalf or made an in-substance price concession to the seller.

DIGITAL ASSETS

Digital asset accounting consultations, including the accounting for digital asset holdings and revenue recognition considerations, increased in frequency during the year. As not all digital assets are the same, the SEC staff reminded registrants to consider the specific characteristics, rights and obligations associated with their digital assets to determine the appropriate accounting model to apply. When digital assets are not deemed securities or subject to specialized guidance, the SEC staff observed that digital assets will likely be accounted for as intangible assets under the existing GAAP framework.

Audit Matters

The PCAOB staff outlined their current standard setting and research project agendas, including projects related to audit firms' quality control systems, the supervision of audits involving other auditors, data and technology and audit evidence. Areas of focus also include observations from PCAOB inspections and the increased use of technology in audits. Furthermore, the SEC staff discussed the application of auditor independence standards.

AUDITOR INDEPENDENCE

Auditor independence plays a critical role in the financial reporting system and is viewed as a shared responsibility between registrants, audit committees and auditors. The SEC staff regularly receives independence consultations which depend on specific facts and circumstances, similar to other consultations. Under the recently amended independence rules, auditors must comply with S-X Rule 2-01 in its entirety in the current period presented in an initial registration statement, whereas compliance with local independence standards (e.g., AICPA standards) and the general independence standard within S-X Rule 2-01 is required in "lookback" periods.

The general independence standard provides guiding principles as to whether a relationship or a provision of a service:

- ▶ Creates a mutual or conflicting interest between the accountant and the audit client;
- ▶ Places the accountant in the position of auditing his or her own work;
- ▶ Results in the accountant acting as management or an employee of the audit client; or
- ▶ Places the accountant in a position of being an advocate for the audit client.

The SEC staff reiterated its view that it would be a high hurdle to conclude that an auditor was objective and impartial under the general standard when the auditor provided services that contradict these guiding principles during an audit period.

The SEC staff shared an example to illustrate these views. In the example, the financial statements of a private company merging with a SPAC were required in a merger proxy/registration statement for fiscal years 2021 and 2020. The private company's auditor prepared the 2020 tax provision during 2021. The SEC staff noted that the auditor violated the independence standards in both periods by acting as management in 2021, the year the tax provision preparation services were performed, and by auditing its own work for the 2020 audit.

PCAOB INSPECTIONS

The PCAOB staff noted recurring audit deficiencies found in 2021 inspections in the areas of business combinations, inventory, revenue, ICFR, and the allowance for loan losses. During the 2022 inspection cycle, the PCAOB staff plans to continue its focus on those audit areas in addition to audit risk factors driven by the current economic environment, such as:

- ▶ The volume of IPOs, mergers and acquisitions, and SPAC and de-SPAC transactions;
- ▶ Disruptions in supply chains; and

- ▶ Negative ongoing impacts of COVID-19 on certain industries.

Additionally, the PCAOB staff highlighted the importance of an audit firm's quality control system to the firm's ability to perform quality audits. Quality control systems should focus on firmwide risks such as:

- ▶ Auditor independence, including audit committee pre-approval and lead partner service periods;
- ▶ Processes and procedures around client acceptance;
- ▶ Knowledge and experience of personnel on audit engagements;
- ▶ Increased staff turnover; and
- ▶ External confirmation procedures.

Key takeaways from the PCAOB staff also included reminders related to professional skepticism, continuous risk assessment, and fraud procedures.

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