



# Bringing clarity to SEC Highlights of the 2014 AICPA Conference on current SEC and PCAOB Developments

**Please note** – The audio for today's presentation will be transmitted through your computer speakers

**December 18, 2014**



# Contents

- Executive summary
- Regulatory matters
- Accounting topics
- Auditing developments



## Important caveats

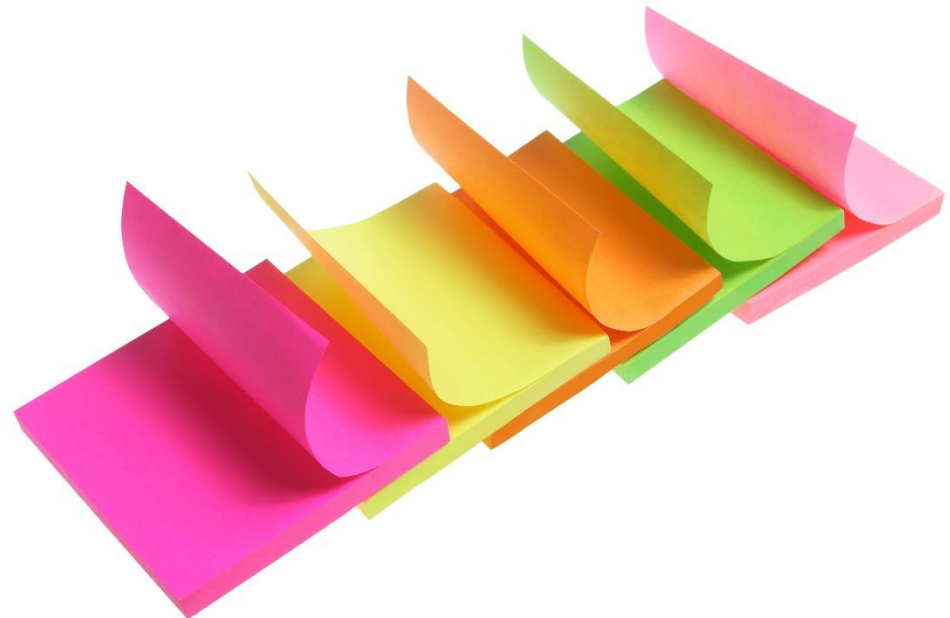
This webcast does not provide official Deloitte interpretive accounting guidance.

Consult your Deloitte advisor for additional support.



# Executive summary

- Rethinking financial disclosures and disclosure effectiveness
- SEC Staff Speeches
- Financial Reporting and Accounting Updates
- Auditor transparency and importance of conducting high-quality audit
- Incorporation of IFRSs into U.S. financial reporting system for domestic registrants



# Regulatory matters

# Regulatory matters

## Domestic registrants – Use of IFRS

- Alternatives considered to date
  1. Full adoption of IFRS
  2. Giving option for U.S. domestic registrants the ability to file IFRS FS
  3. Condoresment approach
  - 4. IFRS-based financial information**
- Comments from James Schnurr, Chief Accountant, regarding a fourth alternative — Voluntary supplementary use of IFRSs financial information
- More discussion in the near term

# Regulatory matters (cont'd)

## Materiality

### Disclosure effectiveness

- What is it?
  - Excessive disclosure that obscures relevant information
  - Assessing materiality for financial statement disclosures

### Materiality for MD&A

- Regulation S-K, Item 303, requires disclosure in MD&A of known trends and uncertainties with likely material impact on liquidity, capital resources, or results of operations
- Two-prong test for forward-looking information:

**MD&A disclosure required, unless registrant is able to conclude either:**

1. It is not reasonably likely that the trend or uncertainty will occur
2. That a material effect is not reasonably likely to result

# Regulatory matters (cont'd)

## Business combinations

### Definition of a business

- U.S. GAAP and Regulation S-X, Article 11, definitions differ
- Determine whether certain arrangements are part of an acquisition or are separate from the acquisition

### Blackline expense presentation

- Exclusion of certain expenses incurred in a business combination from the predecessor and successor income statement periods when pushdown financial statements are presented
- Registrants sometimes exclude expenses that are contingent on a change-in-control event from the predecessor and successor periods and record those expenses on the “blackline” separating the two periods
- Must provide transparent and disaggregated disclosure of the nature and amount of such expenses



# Regulatory matters (cont'd)

## Goodwill impairment

### Changes in annual goodwill impairment testing date

- Requirements
  - ASC 350 requires the annual goodwill impairment test to be performed on the same date each year
  - Does not impose a similar requirement for indefinite-lived intangible assets
- Preferability letter historically generally requested upon change in a registrant's annual goodwill impairment testing date
  - Would not hold true if goodwill was not material
  - Registrants may demonstrate that change in date is an immaterial change in accounting principle and a preferability letter would not be required
- Staff noted that FASB may amend this guidance

# Regulatory matters (cont'd)

## Segment reporting

### OCA offers thoughts on evolving view

- Segment reporting disclosures may be among the most important financial statement disclosures
- Notable points to consider
  - Identifying the entity's Chief Operating Decision Maker (CODM)
  - Identifying operating segments
  - Aggregation of operating segments
- Common topics of comment focus on areas of omission, including:
  - The basis of the segment presentation organization
  - Aggregation of operating segments
  - Revenue by products and services

# Regulatory matters (cont'd)

## Statement of cash flows

### OCA observations about recent restatements

- Number of restatements in this area has increased
- Errors often caused by less complex U.S. GAAP
- OCA actions for entities to prevent errors:
  - Ensure completeness and accuracy of underlying schedules
  - Standardize and automate reports and other data
  - Consider nonrecurring transactions
  - Allow adequate review time
  - Select employees with expertise and providing appropriate training
  - Incorporate risk assessment and monitoring controls, in addition to control activities

# Regulatory matters (cont'd)

## Statement of cash flows

### Current consultation topics

- Noncontrolling Interest (NCI) cash flows presented with financing activities
- Sale of NCI resulting in “loss of control” is an investing activity
- NCI transaction cost presentation based on initial measurement:
  - Expensed as incurred — Presented within operating activities
  - Recorded as contra-equity — Presented within financing activities
- Contingent consideration liability initial fair value presented within financing activities with changes in fair value presented as either:
  - Financing activities
  - Operating activities
- Restricted cash presented within investing activities
- Gross presentation unless all criteria in ASC 230-10-43-8 are met
- Capital equipment acquired but not paid (trade payable) disclosed as noncash investing activities

# Regulatory matters (cont'd)

## Other accounting and financial reporting matters

### IPO and spin-off transactions

- Accounting for spin-off transactions
  - Forward spin or reverse spin
  - Perform assessment using indicators in ASC 505-60
  - Consult with OCA (especially for reverse spin)
- Financial statements in IPO transactions
  - Determining what financial statements to include may be complex
  - Use of a Developments Section in IPO transactions
    - Consider disclosing other material additional information to ensure that the disclosures are not misleading
- Pre-IPO stock valuations for share-based compensation arrangements
  - Pre-IPO valuation significantly lower than prices observed in transactions shortly before an IPO — “Cheap stock”



# Regulatory matters (cont'd)

## Identification and reporting of material weaknesses in ICFR

- Questions on whether all material weaknesses in internal controls are being properly identified, evaluated and disclosed
- Why ?
  - Not identifying deficiencies initially
  - Not appropriately evaluating the severity of deficiencies
- Focus on what “could” happen rather than what did happen
- Reminder on COSO framework – Clear disclosure

# Accounting topics

# Accounting topics

## Consolidation

### Evaluating joint power

- Each party sharing power would be required to consent to all decisions related to the significant activities of the VIE
- Determining which activities most significantly affect the economic performance of a VIE is a crucial first step in the primary beneficiary analysis

### Power when decision maker is acting as an agent

- Whether the substance of the arrangement identifies a party other than the decision maker as the party with power

### Related-party tiebreaker test

- To determine whether stated power is substantive
- If no party in the common control group individually meets both characteristics of a primary beneficiary, consider tiebreaker guidance



# Accounting topics (cont'd)

## Equity

### Amendments to or exchanges of equity-classified preferred stock

- Office of the Chief Accountant (OCA) staff discussed:
  - Entity's evaluation of whether amendments to or exchanges of equity-classified preferred stock constitute an extinguishment or modification
  - Accounting for equity-classified preferred stock modifications
- The following approaches are available:
  - Qualitative approach
  - Fair value approach
  - Cash flow approach
  - Legal form approach

# Accounting topics (cont'd)

## Fair value

### Comment trends consistent with prior years

- Initial fair value measurements in business combinations
- Testing for impairments of many types of assets
- Inputs when impairment indicators (or other “red flags”) exist but no impairment charge has been recorded

### Other considerations

- Staff evaluates disclosures related to the classification of assets and liabilities within the fair value hierarchy
- Registrants are reminded to continue disclosing information related to recurring fair value measurements
- Registrants *should not* omit disclosures related to nonrecurring items

# Accounting topics (cont'd)

## Financial instruments

### Impact of derivative novations on hedge accounting

- When one counterparty is replaced by another, this typically would trigger discontinuation of the hedge (legal termination of the original derivative instrument)
- Certain circumstances in which the SEC staff would not object if entity continues its existing hedging relationship

### Hybrid financial instruments

- Allocation of proceeds when the fair value of a liability is greater than the proceeds from issuance
- Arm's-length and related-party considerations

# Accounting topics (cont'd)

## Income taxes

### Recent observations

- Division of Corporation Finance staff continues to issue comment letters related to disclosures about:
  - The potential tax and liquidity ramifications regarding the repatriation of foreign earnings
  - Valuation allowances
  - Rate reconciliation
  - Unrecognized tax benefits
- Discussed need for improvements in tax provision disclosures



# Accounting topics (cont'd)

## Pension and other postretirement benefits

### Mortality rates

- Key assumption in defined benefit obligation measurement
- Each individual assumption under ASC 715-30 and ASC 715-60 represents management's best estimate

### Views on Society of Actuaries updated mortality tables and improvements scale (released October 2014)

- OCA staff expects entities to disclose any significant effect on the benefit obligation resulting from change in mortality tables
- Updated mortality tables could result in significant increases in benefit obligation



# Accounting topics (cont'd)

## Revenue recognition

### **Principal vs. agent considerations — Current practice**

- Complexities have arisen in applying ASC 605-45 to emerging business models (e.g., online advertising)
- Determine “deliverables” and responsibility for fulfillment based on all available information

### **New Revenue Standard, ASU 2014-09 — “Looking ahead”**

- ASU will significantly increase judgment required of management (e.g., measuring and constraining variable consideration)
- Systems, processes, and controls may need to be modified to support judgments

### **Observations on new revenue recognition standard**

- Transition resource group (TRG) has received 28 submissions of questions — Many have been discussed or will be discussed in the future
- FASB staff currently focusing on questions relating to the application of the license implementation guidance and principal-agent analysis

# Accounting topics (cont'd)

## Other accounting and financial reporting matters

### Definition of a joint venture (JV)

- JV registrants recognize either:
  - Full or partial step-up in basis, or
  - Predecessor basis
- Consider whether purpose of transaction is consistent with the definition of a JV or business combination

### Software development costs

- Capitalization of costs for software developed for internal use versus sale can differ significantly
- Subsequent decision to sell software originally developed for internal use has accounting implications under ASC 350-40

# Accounting topics (cont'd)

## Other accounting and financial reporting matters

### Oil and gas industry observations

- Should consider the recent declines in prices because such changes may:
  - Represent a known trend or uncertainty that should be discussed in a registrant's MD&A
  - Represent a risk that should be discussed in a registrant's risk factor disclosures
  - Affect the determination of estimated proved reserves

**Note:** Regulation S-X, Rule 4-10(a), and Question 131.04 of the SEC's C&DI address the definition of proved undeveloped oil and gas reserves and the interaction of that definition with a registrant's development plan. A registrant's scheduled drilling activity should reconcile to its investment plans that have been approved by management.



# Accounting topics (cont'd)

## Other accounting and financial reporting matters

### FASB and IASB standard-setting discussion

- Russell Golden, FASB Chairman
  - FASB's priority is to improve U.S. GAAP; simplification initiative and reducing complexity
  - Continue to work toward converged standards
  - FASB is currently looking to address recognition issues raised by TRG
- Ian Mackintosh, IASB Vice-Chairman
  - Global success of IFRSs and increasing relevance
  - IASB and FASB convergence efforts
- FASB and IASB standard-setting update
  - Overview of IASB's standard-setting process
  - Research initiatives and major projects, including conceptual framework project

# Accounting topics (cont'd)

## Other accounting and financial reporting matters

### Dan Murdock view on consideration of staff speeches

- Intended to provide transparency on how the staff analyzes complex accounting matters
- Cautioned against overreliance of speeches and other nonauthoritative guidance in setting accounting policies
- Speeches tend to have approximate five-year shelf life due to evolving staff views and changes in U.S. GAAP



# Auditing developments

# Auditing developments

## Auditing and PCAOB developments

### PCAOB Chairman James Doty weighs in...

- Board remains focused on initiatives to enhance reliability and relevance of the audit and related auditor's report
- Explicitly incorporating economic analysis into its standard-setting activities to balance benefits to investors with the cost to the audit
- Continued engagement with audit committees to ensure they have relevant and timely information to enhance effective auditor oversight



# Auditing developments (cont'd)

## Increased global cooperation

### Progress and continued cooperation

- Tremendous progress made internationally with PCAOB inspections in many jurisdictions
  - One third of referred work reviewed in the prior-year inspection cycle had significant findings
  - Significant number of deficiencies in testing “revenue” and “inventory”
  - PCAOB will increasingly focus on controls in a global network
- PCAOB continues to work with its foreign counterparts to gain access to certain countries
  - Increase transparency
  - Increase investor protection

# Auditing developments (cont'd)

## Areas of common findings

Revenue recognition

---

Inventory

---

Goodwill and intangible assets

---

Business combinations

---

Management estimates — Including fair value measurements

---

Effectively responding to the assessed risk of material misstatement

---

Internal controls over financial reporting

---

# Auditing developments (cont'd)

## Looking ahead to 2015

### Areas of PCAOB focus

Environmental risk

- Environmental developments that will have a significant effect on financial reporting risks

M&A activity

- Cash flow projections used to support valuations
- Controls around business combinations

Income taxes

- Undistributed earnings
- Accounting and disclosure controls

Investment returns

Falling oil prices

Statement of cash flows

Cybersecurity

# Auditing developments (cont'd)

## Audit standard-setting update

### Auditor's report model

- Initially released in August 2013, the proposal sought to enhance relevance of the audit report through the inclusion of “critical audit matters,” often described as audit related matters that “keep the auditor up at night”
- After analysis of comments received, a reproposal is expected in early 2015 to further define critical auditing matters

### Audit transparency

- Would require audit firms to disclose:
  - The name of the engagement partner
  - Names, locations, and extent of involvement of certain other audit firms participating on the audit
- Reproposal expected in first quarter of 2015 and will include alternative methods for such disclosures



# Auditing developments (cont'd)

## Internal control over financial reporting

### Consideration of ICFR

- Identification, evaluation, and disclosure of material weaknesses
  - Not identifying deficiencies
  - Not appropriately evaluating severity of deficiencies
- Relevant factors to consider:

---

Nature of control deficiency

---

Impact of deficiency on financial reporting and ICFR

---

Cause of deficiency

---

How the deficiency was identified

---

Remediation procedures

---

- Relationship of deficiency with various COSO components

# Q&A



**Deloitte.**