

2023 AICPA & CIMA Conference on Current SEC and PCAOB Developments

Compendium of significant accounting,
auditing and reporting issues

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Overview

Regulators and standard setters discussed a broad range of financial reporting topics and emerging issues this week at the annual AICPA¹ & CIMA² Conference on Current SEC and PCAOB Developments (Conference) in Washington, DC.

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

Highlights included:

The importance of the accounting profession – Regulators highlighted the importance of the accounting profession in promoting public trust in the capital markets and serving the public interest. Speakers also emphasized the importance of attracting and retaining talent, saying it is critical to the future of audit quality.

Communication – Regulators, standard setters and other speakers emphasized that financial reporting is a communication activity at its core, and the accounting profession plays a key role in providing investors with the information they need to understand an investment’s risks and price those risks into their capital allocation decisions. They emphasized the importance of robust communication, particularly in the current macroeconomic environment.

Audit firm culture – Regulators noted that a professional services firm that performs audits should have a culture that emphasizes audit quality and independence, and that culture should cascade through all of its service lines. They highlighted the tone at the top, firm



leadership's ways of incentivizing certain behaviors, and the firm's systems and structures (e.g., policies and procedures, performance management system, code of conduct) as some of the main elements of a culture that promotes audit quality.

Stakeholder engagement – Regulators and standard setters discussed the importance of seeking and receiving feedback in rulemaking and standard setting. They highlighted that engagement across the spectrum of stakeholders, especially investors, is critical to achieve the appropriate balance between requiring companies to provide useful information and addressing the challenges companies face in gathering and synthesizing that information.

PCAOB activities – PCAOB Board members, including Chair Erica Williams, emphasized that public trust should be the North Star of the auditing profession, noting that audit firm culture and professional skepticism are key elements of promoting public trust in the profession and in promoting audit quality. She noted that audit deficiency rates increased for the second year in a row. She and the other Board members also discussed the PCAOB's continued focus on modernizing auditing standards, enhancing inspections and the other strategic areas highlighted in the [Strategic Plan](#) for 2022-2026.

Accounting updates – SEC and FASB representatives discussed ways to provide investors with decision-useful and transparent disclosures. The SEC staff discussed the FASB's recent Accounting Standards Update (ASU) 2023-07, *Segment Reporting (Topic 280): Improvements to Reportable Segment Disclosures*, and said that if registrants choose to disclose additional measures of segment profit or loss under the new ASU that are not calculated in accordance with US GAAP, they would be considered non-GAAP financial measures. The SEC staff also said when a registrant has a single reportable segment that is managed on a consolidated basis, it would expect the registrant to conclude that the segment measure of profit or loss required to be disclosed is consolidated net income. FASB representatives also discussed the FASB's recently completed projects and technical agenda and stressed the importance of stakeholder feedback throughout the standard-setting process.

Remarks by SEC Chief Accountant

SEC Chief Accountant Paul Munter said it is critical to view the financial reporting process as a communication activity at its core, even if there is a compliance component to it (e.g., financial reporting standards, auditing standards), and noted that comprehensive disclosure is essential.

He emphasized that in the current macroeconomic environment there are many risks and uncertainties related to interest rates, exchange rates, supply chain disruptions and geopolitical developments, among other things, that should be adequately communicated to investors.

Mr. Munter emphasized the importance of an audit firm's culture and how it affects audit quality. He stressed that an audit firm needs to have "embedded in its DNA" a commitment to professionalism, the public interest and independence. Further, Mr. Munter emphasized that an audit firm's culture has to be one that cascades from the top leadership to all professionals of the firm as a whole and permeates throughout the network if it operates globally. Mr. Munter said professionalism, the public interest and independence should be priorities for all practices in a multidisciplinary firm, not only the audit practice, to elevate audit quality.

Mr. Munter said auditors should continually assess how business risks can manifest themselves into risks of material misstatement throughout the audit. He also said he worries about whether auditors are using the appropriate level of professional skepticism in relation to the auditors' responsibility for fraud. Mr. Munter made similar remarks in his previous statements on the [importance of a comprehensive risk assessment by auditors and management](#) and [auditors' responsibility for fraud](#).

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An audit firm [...] has to have embedded in its DNA a culture of professionalism and a commitment to the public interest and audit independence.

— Paul Munter,
SEC Chief Accountant

He emphasized the importance of determining whether the audit firm signing the opinion is in a position to be the principal auditor, saying “the more work being done by somebody other than the firm signing the audit opinion, the more attention there’s going to be on that question.” Mr. Munter also noted that the PCAOB’s new group auditing standards focus on a primary team’s direction and supervision of other auditors. He said regardless of whether the other auditors are from firms within the same network, there needs to be clear communication about the work the other auditor is performing and the use of that work in the group audit engagement, along with a substantive evaluation of the quality of the other auditor’s work.

Mr. Munter said it is important to appreciate that accounting is a profession rather than an industry because its members have a public interest calling and a lifelong commitment to learning. He noted there is an opportunity to better explain the profession’s value by focusing on how it supports the broader economy and wealth accumulation, not just the capital markets.

Finally, Mr. Munter said coordination among stakeholders and messaging about the importance of the accounting profession are needed to address the declining pipeline of new accountants.

Remarks by PCAOB Chair and Board members

Chair Williams emphasized the importance of investor trust in the auditing profession to support the capital markets. She noted that investor confidence is essential but not inevitable, and trust must be earned and maintained. She also noted that when audit firms fail to enforce a culture of honesty and integrity, they threaten the investor confidence on which the capital markets rely.

She said the PCAOB is currently working to finalize inspection reports for 2022 and emphasized that audit deficiency rates increased for both domestic and international firms for the second year in a row. Chair Williams said many of the firms have committed to improve, but she warned that it will likely take time and a persistent focus to reverse this trend.

Chair Williams and PCAOB Board members discussed the PCAOB’s priorities and key emerging themes, which align with the following key pillars of the PCAOB’s five-year strategic plan issued last year:

- ▶ *Modernizing auditing standards* – The PCAOB is engaged in an ambitious and comprehensive review, and to the extent necessary, the modernization of its auditing standards. Chair Williams noted that the PCAOB adopted many of the current standards in 2003 on what was intended to be a temporary basis. As part of the modernization effort, Chair Williams and PCAOB Board members George Botic and Christina Ho said the public comment process, which provides stakeholders with a formal opportunity to engage in standard setting, is an essential component of the PCAOB’s rulemaking process and emphasized the PCAOB’s obligation to consider feedback when adopting new or amended standards.
- ▶ *Enhancing inspections* – Inspections are at the heart of the PCAOB’s oversight activities that aim to drive improvement in audit quality.
- ▶ *Strengthening enforcement* – PCAOB Board members touched on how critical it is for auditors to remain vigilant to protect investors and prevent further harm. They also highlighted the importance of enforcement actions serving as a deterrent for wrongdoing.

Kara Stein, PCAOB Board Member, said “problems arise when the auditor steps out of its public trust role” and noted that an auditor’s commitment to objectivity and integrity should not be compromised by management or the audit firm’s interests.

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Quality audits
protect people.

— Erica Williams,
PCAOB Chair

Ms. Ho discussed the progress of the Technology Innovation Alliance (TIA) Working Group established in 2022 to advise the PCAOB on the potential impact of emerging technologies on audit quality and make recommendations on how the PCAOB's existing or future oversight programs might address auditors and preparers' use of emerging technologies. Ms. Ho said that artificial intelligence could be used to improve audit quality by automating routine and repetitive audit tasks (e.g., documenting interview notes, creating workpaper cross-reference numbers), supporting proactive fraud detection and synthesizing risk assessment information.

Mr. Botic highlighted various PCAOB communications that may assist investors and other stakeholders who have a role in promoting audit quality. These communications include inspection reports posted on the PCAOB website, Spotlight publications and public enforcement actions. Mr. Botic said these communications provide a broad picture of the current state of audit quality.

Anthony Thompson, PCAOB Board Member, highlighted audit committee feedback to the PCAOB that an auditor's remote supervision model appeared to be effective for low-risk areas but should be challenged for areas of greater audit complexity or risk. Further, he expressed concern about the declining number of critical audit matters presented in audit reports.

Mr. Botic also stated that it is incumbent on the PCAOB to think about audit firm culture and deeply understand how firm culture, behaviors, decisions and systems drive or detract from audit quality. Mr. Thompson also emphasized the importance of regular and timely communication between auditors and audit committees.

Remarks by senior SEC staff members on accounting and disclosure matters

Segment reporting

Staff from both the SEC's Office of the Chief Accountant (OCA) and the SEC's Division of Corporation Finance (DCF) provided reminders on applying Accounting Standards Codification (ASC) 280, *Segment Reporting*, and also discussed the recently issued ASU 2023-07, including how public entities should consider the interaction between the ASU and the SEC's rules and the SEC staff's guidance on the use of non-GAAP financial measures.

Interaction with the SEC's rules and regulations and SEC staff interpretations on non-GAAP financial measures

ASU 2023-07 requires public entities to disclose additional segment information, including significant segment expenses and other segment items, on an annual and interim basis. The ASU also allows, but does not require, public entities, including those with a single reportable segment, to report multiple measures of a segment's profit or loss if the chief operating decision-maker (CODM) uses those measures to allocate resources and assess performance. All public entities, including those that disclose only one measure of a segment's profit or loss, are required to explain in the notes to the financial statements how the CODM uses each reported measure of a segment's profit or loss in assessing segment performance and determining how to allocate resources.

Under ASC 280, if the CODM uses more than one measure of segment profit or loss for purposes of allocating resources and assessing performance, the segment measure that is required to be reported is the one determined in accordance with the measurement principles most consistent with those used in measuring the corresponding amounts in the registrant's consolidated financial statements (i.e., the segment measure most consistent with GAAP).

Ernst & Young LLP resources

- ▶ To the Point, [FASB requires public entities to disclose significant expenses and other segment items](#)
- ▶ Financial Reporting Developments, [Segment Reporting](#)
- ▶ Technical Line, [Navigating the requirements for non-GAAP financial measures](#)

Lindsay McCord, Chief Accountant in DCF, said additional segment profitability measures that a public entity chooses to disclose that are not determined in accordance with US GAAP would be considered non-GAAP financial measures because the accounting standard does not (1) *require* disclosure of additional measures of segment profit or loss or (2) *expressly permit* their disclosure by prescribing or otherwise specifying the additional measures that may be disclosed.

Therefore, these additional measures that are not calculated in accordance with US GAAP would be subject to the relevant SEC rules and regulations on the use of non-GAAP measures, including the prohibition of presenting non-GAAP financial measures on the face of the financial statements or in the notes. Notwithstanding the prohibition under the SEC's rules and regulations, Ms. McCord said that if, after adoption of the ASU, registrants disclose additional measures of segment profit or loss that are not calculated in accordance with US GAAP, such measures cannot be misleading (including consideration of the SEC staff's interpretive guidance) and the filing (e.g., management's discussion and analysis (MD&A)) must include the disclosure required for non-GAAP financial measures.

However, Ms. McCord encouraged companies early adopting ASU 2023-07 and planning to disclose additional measures of segment profit or loss that would be considered non-GAAP financial measures to consult with DCF's Office of the Chief Accountant about their fact pattern.

How we see it

The SEC staff's remarks highlighted the challenges companies will face in disclosing more than a single measure of segment profit or loss under the new guidance in ASC 280 and the SEC rules and staff guidance on non-GAAP financial measures. Registrants that are considering early adopting ASU 2023-07 and disclosing additional measures of segment profit or loss that are not calculated in accordance with GAAP should proceed with caution, including engaging with advisers. We also encourage registrants to monitor developments, which may include further guidance from the SEC staff before the ASU's effective date.

Carlton Tartar, Associate Chief Accountant in OCA, said when a registrant has a single reportable segment that is managed on a consolidated basis (i.e., a single operating segment), the SEC staff would expect the registrant to conclude that the segment measure of profit or loss required to be disclosed is consolidated net income.³

Other segment reporting reminders

Melissa Rocha, Deputy Chief Accountant in DCF, also provided the following reminders related to registrants' compliance with existing segment reporting requirements:

- ▶ The SEC staff would generally consider segment operating results that are reviewed by, or provided to, the CODM on a quarterly basis to meet the "regularly reviewed" and "regularly provided" frequency thresholds in ASC 280. However, she noted a review frequency less than quarterly could also constitute a regular review.
- ▶ "Revenues from external customers" is a specified amount that is required to be disclosed under ASC 280 for each reportable segment if it is included in the measure of segment profit or loss reviewed by the CODM or is otherwise regularly provided to the CODM, even if it is not included in that measure. The SEC staff said that such amounts are required to be determined on the basis of the applicable accounting principle (e.g., ASC 606, *Revenue from Contracts with Customers*) and has objected to the disclosure of amounts that are presented on a different basis.

Ernst & Young LLP resources

- ▶ Financial Reporting Developments, [Accounting changes and error corrections](#)
- ▶ Financial Reporting Developments, [Statement of cash flows](#)
- ▶ Financial Reporting Developments, [Fair value measurement](#)

Statement of cash flows

Mr. Munter discussed his recent **statement** highlighting the statement of cash flows (SOCF) as a critical component of high-quality financial reporting for investors. He emphasized that the SOCF, a primary financial statement, should be subject to the same level of due professional care; effective internal controls; and robust, high-quality audit procedures as other financial statements.

He noted the SEC staff has observed that preparers and auditors may not always apply the same level of rigor to the SOCF, which is evidenced by the fact that it is consistently a leading source of financial statement restatements. He said these restatements may also indicate a material weakness in internal control over financial reporting (ICFR).

Mr. Munter reminded preparers and auditors of the importance of performing an objective analysis from the perspective of a reasonable investor when evaluating the materiality of both the financial statement and the ICFR impacts of an error in the SOCF or elsewhere.

He further noted that, given that classification is the foundation of the SOCF, errors should not be considered immaterial solely because they relate to classification. Mr. Munter encouraged preparers to carefully consider how to best present cash and noncash information and whether to disclose additional information to facilitate an investor's understanding of the SOCF and the financial statements as a whole.

Mr. Munter also encouraged audit committees to discuss with management and their independent auditors how to better communicate cash flow information to investors, including the potential use of the direct method or additional disclosures of gross cash receipts and payments.

Fair value measurements

Gaurav Hiranandani, Senior Associate Chief Accountant in OCA, emphasized the significant judgment that can be required when applying ASC 820, *Fair Value Measurement*, to certain transactions, such as crypto assets, which will soon be required to be measured at fair value if they meet certain criteria. He highlighted the importance of determining the principal or most advantageous market because it drives the identification of market participants and the set of information and assumptions that a market participant would use in determining fair value.

Mr. Hiranandani observed that in traditional markets (e.g., equities, commodities), there may be a relatively limited number of venues where entities can transact, and the level of activity may be concentrated in just one or two of them. However, he cautioned that this may not be the case for crypto assets because crypto markets continue to evolve, sometimes rapidly, and the facts and circumstances relevant to identifying the principal market may change over time. Mr. Hiranandani noted that the market characteristics for crypto markets, such as pricing, regulatory oversight, and the general availability and reliability of information, may not be consistent from asset to asset and from entity to entity, depending on the activities in which an entity engages.

He also discussed the use of fair value in the measurement of loans and the related allowances for credit losses. He noted that loans that are held for investment, and do not meet the definition of a debt security under ASC 320, *Investments – Debt Securities*, are measured at amortized cost and must be assessed for expected credit losses under ASC 326, *Financial Instruments – Credit Losses*, if the fair value option is not elected.

However, ASC 326 provides a practical expedient to measure the allowance for credit losses for collateral-dependent loans based on the fair value of the collateral if the borrower is experiencing financial difficulty and the repayment of the loan is expected to be provided substantially through the sale or operation of the collateral. Mr. Hiranandani noted that entities

are required to measure the allowance based on the fair value of collateral if foreclosure is probable. He said that when measuring the fair value of the underlying collateral, entities need to apply the principles in ASC 820, which requires the use of market participant assumptions. He also noted that entities should make reasonable and appropriate judgments when measuring the fair value of the collateral, particularly in difficult economic times or when the collateral assets are illiquid.

Mr. Hiranandani also discussed the importance of identifying and consistently using appropriate valuation techniques, which could be affected by numerous variables. He noted that valuation techniques applied in fair value measurements should maximize the use of observable inputs. Additionally, he highlighted the requirement in ASC 820 for an entity to calibrate its valuation technique when it uses unobservable inputs and the initial transaction price was determined to represent fair value.

Mr. Hiranandani reminded registrants to consider whether their fair value measurements would constitute critical accounting estimates and, therefore, would have to be disclosed as such.

Financing arrangements in SPAC transactions

Shehzad Niazi, Deputy Chief Counsel in OCA, noted that while the volume of special purpose acquisition company (SPAC) business combinations has declined, the SEC staff continues to receive questions on debt versus equity issues related to SPAC and de-SPAC transactions.

Mr. Tartar discussed a recent issue the staff considered relating to a backstop arrangement entered into by a SPAC with a financing entity, in connection with the SPAC's proposed acquisition. In the arrangement, the financing entity agreed to purchase shares directly from redeeming shareholders of the SPAC, thereby allowing the shares of the SPAC to remain outstanding through the potential acquisition to ensure that there were sufficient shares for the acquisition to close.

Upon the close of the acquisition, the agreement required the registrant to pay cash equal to substantially all of the cash paid by the financing entity to acquire the SPAC's shares and place it in an escrow account controlled by the financing entity. The agreement also required that, if the financing entity sold any shares subject to the arrangement (i.e., shares acquired by the financing entity from redeeming shareholders), the registrant would receive the amount the financing entity paid for those shares. In addition, any shares not sold by the financing entity at the end of the agreement would be returned to the registrant and the financing entity would keep the remaining cash in the escrow account along with a minimum return for each share it didn't sell.

The registrant proposed to account for the arrangement under ASC 480, *Distinguishing Liabilities from Equity*, and initially recognize an asset equal to the up-front cash payment less a fair value adjustment related to the financing entity's option to either return or sell the shares. The registrant also proposed marking this asset to market in subsequent periods and recognizing any incremental liabilities related to its obligations under the arrangement.

The SEC staff objected to accounting for the cash prepayment as an asset under ASC 480. The staff said the substance of the prepayment was akin to a subscription receivable for the company's own shares, which must be presented as a reduction of equity in accordance with Rule 5-02 of Regulation S-X. The SEC staff also said the registrant would need to evaluate relevant guidance, including ASC 815, *Derivatives and Hedging*, when considering the subsequent accounting for the arrangement.

Mr. Tartar said there may be variations of these types of arrangements in practice and encouraged registrants and auditors to consult with OCA regarding the accounting for these types of arrangements.

Ernst & Young LLP resources

- ▶ Financial Reporting Developments, [Credit impairment under ASC 326](#)
- ▶ Technical Line, [A closer look at accounting for financial instruments issued by SPACs](#)

Deferred offering costs

Mr. Tartar also discussed offering costs incurred in connection with initial public offerings, noting that incremental costs directly attributable to an offering may be deferred and charged against the proceeds of the offering (i.e., treated as a reduction in equity rather than as an expense). However, such costs should not include management salaries or other general and administrative expenses. For example, he noted that the SEC staff would object to registrants deferring costs related to financial statement preparation and audits because such costs are not directly attributable to the offering.

Investment company accounting

Mr. Hiranandani said when an entity is evaluating whether to apply the investment company accounting guidance in ASC 946, *Financial Services – Investment Companies*, it should perform a robust analysis that considers all facts and circumstances.

Mr. Hiranandani described a recent consultation in which an investment adviser held an investment in a real estate fund and asserted that the fund met the criteria to apply the investment company accounting guidance under ASC 946 and that the fund's investments in real estate properties should, therefore, be measured at fair value. The investment adviser also provided development, construction and property management services to the investment properties of the fund.

The staff objected to the investment adviser's conclusion that the fund met the fundamental characteristics of an investment company as required under ASC 946. Mr. Hiranandani noted that although no single factor was determinative in the staff's analysis, the staff considered that the real estate fund had not committed to investors that its business purpose and only substantive activities were to invest funds solely for returns from capital appreciation, investment income or both, as required by ASC 946-10-15-6(a)(2). The fund, through its investment adviser, had undertaken substantive development, construction and property management activities allowing investors to participate in returns other than those noted above. The investment adviser, while also an investor in the fund, was actively managing and participating in the development, construction and property management activities in exchange for a return from these activities.

Remarks by senior SEC staff members on audit matters

Risk assessment and professional skepticism

Anita Doutt, Senior Associate Chief Accountant in OCA, emphasized that it is the auditor's responsibility to exercise professional skepticism in all aspects of the audit regardless of a particular area's complexity. She said auditors who are auditing areas that require judgment, such as fair value measurements, should (1) consider the use of specialists and other experts who contribute to the auditor's expertise to challenge assumptions, (2) be aware of biases that can affect auditor judgment and decision-making and (3) establish a culture that empowers staff to exercise professional skepticism and challenge the judgments of management.

She also highlighted the importance of audit committees having independent interactions with the auditor without management present.

Ms. Doutt explained that risk assessment and professional skepticism are closely aligned. She said that risk assessment forms the basis of the audit process, and a lack of professional skepticism can result in the auditor potentially not appropriately identifying all risks. Therefore, when identifying and assessing the risks of material misstatement, Ms. Doutt reminded auditors to remain alert to potential changes in companies' objectives, strategies and business risks that can arise from changes in the economic environment.

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Risk assessment
and professional
skepticism go
hand in hand.

— Anita Doutt,
SEC Senior Associate
Chief Accountant

She said that management and auditors are sometimes too narrowly focused on matters that directly impact financial reporting and are missing some potential red flags. To address this concern, Ms. Doutt said the SEC staff expects auditors to pursue an audit approach that is skillful, robust and iterative and that focuses on more than just meeting the minimum requirements.

Auditor independence

Mr. Niazi said the SEC staff continues to engage in consultations about auditor independence, including those related to the prohibitions of Rule 2-01(c)(3) of Regulation S-X (i.e., the business relationships rule). Mr. Niazi noted the rule provides exceptions to the business relationship prohibition when the accounting firm or covered person in the firm (1) is a consumer in the ordinary course of business or (2) provides professional services to an audit client.

Ms. Doutt emphasized that these consultations may require complex analyses due to the novelty of the business relationship being entered into and other factors. She said that while both of the exceptions require a nuanced evaluation of the facts and circumstances, the audit firm needs to also consider the intent of the transaction when determining whether it qualifies for the professional services exception.

She also noted that the SEC staff has recently considered consultations about non-audit services that were provided to potential audit clients after the accounting firm determined that such services would not impair independence because they would not be “subject to audit” in accordance with the provisions of Regulation S-X Rule 2-01. In making this assessment, Ms. Doutt cautioned firms about taking an overly narrow view of what non-audit services would be considered “subject to audit” and encouraged a thorough consideration of the parameters of the services that might be provided and whether they may be subject to audit in the future.

Finally, Ms. Doutt noted that section E of the OCA’s [Frequently Asked Questions](#) on the application of the Commission’s rules on auditor independence says that materiality is not a factor when determining whether the non-audit service would be subject to audit.

Auditor enforcement matters, and supervision and review

Ms. Doutt said the SEC staff has noted a number of enforcement cases this year that involved engagement-specific matters and deficiencies in an audit firm’s system of quality control. She noted that these cases related to the failure to supervise and review the audit, obtain sufficient and appropriate audit evidence, appropriately document work and assemble a complete set of workpapers within the 45-day requirement.

As it relates to supervision and review, Ms. Doutt further noted that a failure to supervise is consistent with some of the audit documentation deficiencies that have been alleged in these matters.

SEC regulatory update

Division of Corporation Finance practice matters

MD&A and risk factor disclosures

Erik Gerding, Director of the DCF, discussed the staff’s continued focus on and review of registrants’ MD&A and risk factor disclosures regarding macroeconomic factors, such as inflation and interest rate risk, along with other emerging trends and uncertainties. Mr. Gerding echoed Mr. Munter’s remarks that companies need to think about financial reporting as a communication exercise, not just a compliance exercise, and provide disclosures that are both meaningful to investors and tailored to a company’s specific circumstances.

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Boilerplate
[disclosure] is the
investor’s enemy.

— Erik Gerding,
SEC Division of Corporation
Finance Director

As an example, Mr. Gerding cited the staff's recent focus on banking institutions' disclosures, particularly those related to interest rate risk and liquidity risk. He said banking institutions' quantitative disclosures about market risk commonly provide interest rate sensitivity analyses, and investors often find helpful disclosure of key assumptions (e.g., balance sheet composition, growing deposit pricing, assets prepayments, anticipated deposit withdrawals, impacts from derivatives) used in the interest rate risk model.

Mary Beth Breslin, Industry Office Chief in the SEC's Office of Real Estate & Construction, reiterated Mr. Gerding's comments on interest rate risk disclosures and noted that the staff continues to focus its review on these disclosures across all industries, not just the banking industry.

Mr. Gerding also highlighted the importance of meaningful liquidity disclosures, including available sources of liquidity, potential costs and issues in accessing sources of liquidity, and actions companies have taken or plan to take to address liquidity risks.

Critical accounting estimates

Kevin Woody, Accounting Branch Chief in the SEC's Office of Manufacturing, said the staff continues to focus on disclosures about critical accounting estimates. Jonathan Wiggins, Deputy Chief Accountant in OCA, noted that the objective of critical accounting estimate disclosure is to provide qualitative and quantitative information necessary to understand the estimation uncertainty and the impact the critical accounting estimate has had or is reasonably likely to have on a registrant's financial condition or results of operations. He listed several questions that registrants may consider to avoid boilerplate critical accounting estimates disclosures:

- ▶ Can the investor understand from disclosure why that particular estimate is critical?
- ▶ Does the disclosure include both quantitative and qualitative considerations?
- ▶ Is it likely that an investor would find it difficult to understand the estimation uncertainty in the absence of any quantification?
- ▶ Does the disclosure provide information beyond what is in the financial statements' summary of significant accounting policies?
- ▶ Can an investor understand the past variability in the estimate?
- ▶ Does the disclosure include a discussion of the sensitivity of the reported amount to changes in assumptions and methods used from both a quantitative and qualitative perspective?

Other disclosure considerations

Ms. Rocha reminded registrants of several year-end reporting considerations related to inventory disclosures, including:

- ▶ Companies with substantial inventory losses (whether due to theft or obsolete inventory) that have a material impact on results should include robust disclosure within MD&A, including consideration of whether the inventory losses represent a known trend and uncertainty that will result in or is reasonably likely to result in a material impact to liquidity or results of operations.
- ▶ Companies with significant risks related to inventory valuation should include clear and concise risk factor disclosures.

Ernst & Young LLP resources

- ▶ [SEC Reporting Update – Highlights of trends in 2023 SEC staff comment letters](#)

Ms. McCord noted the SEC staff has continued to review MD&A disclosures related to supplier finance programs and encouraged registrants to revisit [Corporation Finance Disclosure Guidance Topic No. 9A](#) when preparing disclosures about these programs.

Non-GAAP financial measures

Ernst & Young LLP resources

- Technical Line, [Navigating the requirements for non-GAAP financial measures](#)

Sarah Lowe, Deputy Chief Accountant in DCF, noted that non-GAAP financial measures continue to be a frequent topic in SEC staff comment letters and elaborated on the staff's views expressed in non-GAAP Compliance and Disclosure Interpretations (C&DI) question 100.01, which addresses whether operating expenses are "normal" or "recurring," and C&DI question 100.04, which addresses non-GAAP adjustments to both revenue and expenses that could have the effect of changing the recognition and measurement principles required by GAAP, thereby rendering them "individually tailored" and potentially misleading.

Ms. Lowe said the staff may comment if a non-GAAP measure excludes items that appear to be normal, recurring expenses, such as startup costs and losses on purchase commitments. Last year, the SEC staff said the opening of new retail stores (or restaurants in the hospitality industry) would be considered normal activities for companies in those industries. She said that a similar thought process should be applied to companies in other industries, such as those that operate medical centers. Ms. Lowe said that while opening a medical center may result in a one-time cost for that center, the SEC staff looks at costs at the company level and would consider pre-opening costs for each location normal operating expenses.

She also reminded registrants that making non-GAAP adjustments to change the recognition and measurement principles required by GAAP could result in a misleading measure, and this view extends to non-GAAP measures beyond those related to revenue. For example, she said the staff has commented on registrants' presentation of a non-GAAP measure that includes adjustments to change the accounting for inventory from a basis acceptable under GAAP to one used internally by management that is not permitted under GAAP. Finally, she said the staff continues to see registrants presenting revenue-related non-GAAP measures that exclude transaction costs and effectively present the company as an agent when gross presentation as a principal is required by US GAAP. C&DI question 100.04 notes that this presentation could be misleading.

In addition, Ms. Lowe discussed the importance of appropriate labeling of non-GAAP financial measures and transparently describing non-GAAP adjustments in sufficient detail for investors to understand the nature of the adjustments and why they provide useful information.

How we see it

Non-GAAP financial measures remain a focus area in the SEC staff's comment letters to registrants, and many of the comments have focused on the December 2022 updates to the non-GAAP C&DIs. Management must be able to articulate why it believes the non-GAAP measures presented provide useful information to investors and otherwise comply with the SEC's rules and guidance.

Ernst & Young LLP resources

- ▶ To the Point, [SEC adopts rules to require 'clawback' policies and disclosures](#)

Clawback rules' Form 10-K check boxes

Ms. McCord discussed the use of the first of two new check boxes, added by the final clawback rules, on the cover of Form 10-K to indicate whether the financial statements of the registrant included in the filing reflect the correction of an error to previously issued financial statements. She clarified that registrants must check this box if the prior period financial statements reflect the correction of an accounting error as defined under ASC 250, Accounting Changes and Error Corrections.⁴ She said that in addition to “Big R” and “little r” restatements, a voluntary restatement would also require checking the box even though a clawback analysis would not be required. That is, the correction of an immaterial error in a prior period (which could include corrections in classification or revisions to footnote disclosures) would require the box to be checked.

She noted that registrants do not need to check the box for the adoption of a new accounting standard with retrospective application, voluntary reclassifications of prior year amounts that are not errors to conform to the current year presentation or out-of-period adjustments, since these changes are not prior period accounting error corrections.

Pay versus performance

Craig Olinger, Senior Advisor to Ms. McCord, discussed the recently adopted pay versus performance rules that require registrants to provide a table in their proxy and information statements that discloses the relationship between their executive compensation and financial performance.

He emphasized that a company's accountants have an important role in drafting these disclosures because they have experience preparing financial statements and determining the accounting inputs to the table (e.g., measuring equity awards at their grant date fair value).

He also reminded registrants that the SEC staff published 30 **pay versus performance C&DIs** in 2023, many of which addressed the most frequently asked technical questions.

Separately, Ms. Breslin said the SEC staff reviewed the 2023 proxy disclosures and requested revisions in future proxy statements when registrants did not fully comply with the requirements. For example, Ms. Breslin said that some registrants did not tag the disclosures using Inline XBRL, which is required by the rule. She also said registrants could improve these disclosures prospectively by:

- ▶ Providing meaningful disclosures that describe the relationship between actual executive compensation paid and company performance and making sure the disclosures are not obscured by other elective disclosures
- ▶ Considering whether the relationship between actual executive compensation paid and company performance could be more effectively communicated graphically rather than narratively
- ▶ Clearly disclosing any valuation assumptions that materially differ from those disclosed at the grant date of equity awards (the SEC staff said it was sometimes difficult to discern whether registrants were disclosing *changes* in valuation assumptions or just assumptions in general)
- ▶ Explaining how a company-selected measure that is a non-GAAP measure was calculated from the audited financial statements or providing a cross-reference to that explanation (the SEC staff said that registrants should explain how the measure is calculated in the proxy statement itself and that a cross-reference from the proxy statement to a registrant's Form 10-K is not sufficient)

Ernst & Young LLP resources

- ▶ Technical Line, [How to apply the SEC's new pay versus performance disclosure requirements](#)

Ms. Breslin reminded registrants that they are required to include the company-selected measure in a list of three to seven of the most important financial performance measures they use to link executive compensation actually paid to company performance for the most recent fiscal year. Further, she said the SEC staff expects consistency between this list and the description of the registrant's compensation decisions in its Compensation Discussion and Analysis.

How we see it

The SEC staff is likely to focus on registrants' pay versus performance disclosures during the 2024 proxy season.

Ernst & Young LLP resources

- ▶ Technical Line, [Applying the SEC's requirements for significant acquired businesses](#)

Significance tests and the acquisition of a business

Mr. Olinger addressed practice matters and reminders related to the SEC's significance tests in the context of an acquisition of business and Rule 3-05 and said that the discussion could also apply to significance tests performed for Rules 3-09 or 3-14.

He reminded registrants that they may use the acquiree's unaudited financial statements to perform the significance tests, as long as they comply with the accounting standards applied by the registrant, whether they are US GAAP or IFRS. However, if the registrant later determines that the amounts used do not comply with the applicable accounting standards, it is required to reperform the significance tests.

Mr. Olinger also addressed the determination of aggregate worldwide market value of the registrant's voting and non-voting common equity (WWMV) used in the denominator of the investment test. He indicated that a registrant would be required to use the WWMV calculated based on its shares listed on a principal market outside of the US when that market is its primary market. In addition, classes of common equity that are not publicly traded are excluded from WWMV, including shares that are exchangeable or convertible into classes of common equity that are publicly traded.

Furthermore, he reminded registrants that US GAAP and the SEC rules define a business differently. The definition of a business under Regulation S-X Article 11-01(d) focuses primarily on the continuity of revenue-generating activities before and after a transaction but does not necessarily require the company to be generating revenues. In certain circumstances, pre-revenue entities (e.g., biotech entities) may have other attributes that meet the definition of a business under Regulation S-X.

Foreign private issuers

Ms. Rocha discussed the impact of losing foreign private issuer (FPI) status on the requirement to disclose summarized quarterly information in accordance with Item 302(a) of Regulation S-K in the subsequent Form 10-K. The SEC staff said that a change in the accounting framework from IFRS to US GAAP due to the loss of FPI status is considered a material change requiring Item 302(a) disclosures. Further, Ms. Rocha noted that in these situations, the SEC staff would not object if the Item 302(a) summarized financial information in a registrant's first Form 10-K was limited to the four quarters of the most recent fiscal year, excluding the comparative prior year fiscal quarters.

Additionally, the SEC staff has said that registrants that lose their FPI status but continue to qualify as emerging growth companies can use the extended transition dates when adopting new accounting standards under US GAAP, assuming the information was not previously disclosed under IFRS. To use the extended transition dates, registrants must check the relevant box on the cover of Form 10-K.

PCAOB standard-setting and inspection matters

Inspection matters

Christine Gunia, Acting Director of the Division of Registration and Inspections (DRI) at the PCAOB, highlighted that the inspections process is one of the most important tools that the PCAOB has to protect investors. Citing recent PCAOB inspection results, she echoed comments made by Chair Williams regarding concerns over audit quality.

Ms. Gunia further addressed audit quality by stating that an audit firm's culture and its audit quality are "inseparable." She added that an inherent part of an effective system of quality control at an audit firm is the firm's culture. To address this matter, the DRI launched a new culture review initiative as part of its inspection of each of the six US audit firms that are considered Global Network Firms (GNFs). This initiative is intended to identify and assess aspects of culture at each of the US GNFs and the potential impact on their ability to consistently perform high-quality audits.

Returning to the need for improved audit quality, Ms. Gunia provided a call to action for auditors to:

- ▶ Perform an honest and effective analysis of the state of audit quality, including a robust root cause analysis of identified deficiencies
- ▶ Understand the business that is being audited, especially as risk assessments are performed
- ▶ Take a hard look at firm culture and make sure, among other things, it prioritizes audit quality
- ▶ Focus on talent and training
- ▶ Communicate with audit committees

Barbara Vanich, PCAOB Chief Auditor and Director of Professional Standards, also provided some year-end reminders for auditors, including reviewing the July 2023 PCAOB **Spotlight** publication that previewed the PCAOB's 2022 inspection findings. She also emphasized the importance of risk assessments, supervision and review, and professional skepticism.

2023 inspection highlights

Ms. Gunia said the PCAOB's 2023 inspection plan was informed by the economic and geopolitical volatility resulting in a focus on fraud-related audit procedures, risks related to cryptocurrency and audits in the financial services sector. She stated that inspections also included financial statement focus areas that are generally complex in nature, require significant judgment and may be particularly susceptible to the risks of material misstatement of financial statements, including (1) the robustness of the auditor's risk assessment, (2) any changes in the company's control environment, (3) the auditor's responses to those risks assessed as posing a risk of material misstatement to the financial statements, whether due to error or fraud, and (4) auditor independence (particularly, but not exclusively, on non-audit services).

Inspection outlook for 2024

For the PCAOB's 2024 inspections, Ms. Gunia said the PCAOB will consider overall business risks, such as persistent high interest rates, inflation and rapidly changing technology. In addition, the PCAOB will focus on financial statement areas with a risk of fraud, estimates involving complex models or processes, and disclosures that may be impacted by these complexities or risks. The PCAOB will also consider the impact of COVID-19 on audit firm staffing.

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Everyday people,
as well as many
different types of
investors across the
globe, depend on
high quality audits.

— Christine Gunia,
Acting Director of the
Division of Registration
and Inspections

Ernst & Young LLP resources

- ▶ To The Point, [PCAOB proposes expanding auditor's responsibilities for considering noncompliance with all laws and regulations](#)
- ▶ EY Comment Letter, [Quality control](#)
- ▶ EY Comment Letter, [General responsibilities of the auditor](#)
- ▶ EY Comment Letter, [Technology-assisted analysis of information in electronic form](#)
- ▶ EY Comment Letter, [Contributory liability](#)

Standard-setting

Ms. Vanich provided an update on the PCAOB's [standard-setting, research and rulemaking projects](#). She highlighted the new standard on the auditor's use of confirmation, which is effective for audits of financial statements for fiscal years ending on or after 15 June 2025, and the amendments relating to the supervision of audits involving other auditors and dividing responsibility for the audit with another accounting firm, which are effective for audits of financial statements for fiscal years ending on or after 15 December 2024.

She also discussed the PCAOB's proposed standards slated for adoption in 2024 on (1) quality control (QC 1000), (2) general responsibilities of the auditor in conducting an audit (AS 1000), (3) noncompliance with laws and regulations and (4) amendments related to aspects of designing and performing audit procedures that involve technology-assisted analysis of information in electronic form. Ms. Vanich also highlighted the PCAOB's recent proposed amendments to its rule on contributory liability.

Ms. Vanich said the PCAOB intends to issue proposals on addressing going concern, substantive analytical procedures, attestation standards, and firm and engagement performance metrics.

Enforcement matters**Remarks from the SEC Division of Enforcement staff**

Gurbir Grewal, Director of the SEC's Division of Enforcement (Division), and Ryan Wolfe, the Division's Chief Accountant, discussed the Division's recent enforcement actions related to accounting and disclosure issues and auditor-related matters.

Mr. Wolfe said that a healthy accounting profession is critical to the success of the capital markets and that the Division is focused on creating a culture of proactive compliance, while also holding individuals and organizations not acting in good faith accountable for their actions.

Mr. Grewal noted that companies seeking to access the capital markets have a responsibility to provide disclosures so investors can make informed decisions and assess risks, and that all communications provided by management to investors should be accurate and complete. Mr. Wolfe added that there shouldn't be a difference between what management is reporting to stakeholders internally versus externally. Mr. Wolfe highlighted recent enforcement actions related primarily to alleged deficiencies in registrants' disclosure controls and procedures and ICFR, and audit firms' quality control systems, while Mr. Grewal discussed recent audit-related enforcement matters involving quality control and auditor independence issues.

Mr. Wolfe underscored the significance of a robust quality control environment, which he said is likely to narrow the scope of an investigation, while a weak one may expand it.

Remarks from the PCAOB's Division of Enforcement and Investigations

Robert Rice, Director of the PCAOB's Division of Enforcement & Investigations (DEI), discussed the new measures the division has taken to strengthen the enforcement program. He also highlighted the PCAOB's enforcement actions in 2023 and the outlook for 2024. Noting that one of the pillars of the PCAOB's strategic plan is more rigorous enforcement, he reiterated Chair Williams' view that enforcement needs to be both aggressive and creative and said DEI will address misconduct using every available tool to hold violators accountable.

Mr. Rice said that DEI will continue to assess its enforcement program and determine ways to further strengthen it.

Remarks by FASB Chair and staff

FASB Chair Richard R. Jones said that the decisions the FASB makes are in response to the feedback received from its extensive stakeholder outreach, and stakeholder input has helped the FASB identify problems and develop potential solutions in standard setting.

Hillary Salo, FASB Technical Director, said that the FASB's mission is to provide decision-useful information to investors, which involves incorporating investor feedback into its processes. She said the FASB has asked for feedback on its internal processes, its technical and research agendas, and priorities.

Based on such feedback, Chair Jones said the Emerging Issues Task Force (EITF) will adopt a new process in which it will control its own agenda and deliberate issues, but the output of any EITF consensus will be a recommendation to the FASB in the form of an agenda request, including the proposed solution to the issue. The FASB will then follow its standard-setting process by seeking comment on the EITF-proposed solution. He said the new EITF process will allow the FASB to monitor and address emerging issues in a more timely manner.

Ms. Salo and Helen Debbeler, FASB Deputy Technical Director, highlighted the recently issued guidance on segment reporting and provided an update on the FASB's proposals related to crypto assets and income tax disclosures that are expected to be finalized by year-end. Ms. Salo and Ms. Debbeler also provided an update on several FASB projects, including disaggregation of income statement expenses, targeted improvements to the statement of cash flows, accounting for and disclosures of software costs, and accounting for government grants.

International matters

Linda Mezon-Hutter, Vice Chair of the IASB, discussed the IASB's current activities and said its staff is drafting a proposal on presentation and disclosures in financial statements. The IASB expects to issue a new standard in the first half of 2024 with an effective date of 1 January 2027.

She also said the IASB is analyzing stakeholder feedback related to its consultation exercise on IFRS 15, *Revenue from Contracts with Customers*. Stakeholders have said that the IASB should not make fundamental changes to IFRS 15 and that they prefer that IFRS 15 remain converged with ASC 606.

Ms. Mezon-Hutter also noted that the International Sustainability Standards Board (ISSB) issued its two inaugural sustainability standards on climate-related disclosures. She reminded stakeholders that the ISSB standards do not change the requirements in IFRS standards.

Endnotes:

- ¹ The American Institute of Certified Public Accountants.
- ² The Chartered Institute of Management Accountants (based in London).
- ³ The SEC staff stated that this view is consistent with ASC 280-10-55-15D in ASU 2023-07 and with long-standing staff views before the issuance of ASU 2023-07.
- ⁴ ASC 250 defines an error in previously issued financial statements as "An error in recognition, measurement, presentation, or disclosure in financial statements resulting from mathematical mistakes, mistakes in the application of generally accepted accounting principles (GAAP), or oversight or misuse of facts that existed at the time the financial statements were prepared. A change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of an error."

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SCORE No. 21854-231US

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