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# 2024 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 and auditing topics this week at the annual AICPA[1] & CIMA[2] Conference on Current SEC and PCAOB Developments (the Conference) in Washington, DC.

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

Highlights included:

***Change in the regulatory landscape*** — SEC Commissioner Mark Uyeda and US Rep. French Hill (R-Ark.) spoke about anticipated changes in leadership, regulatory priorities and policies, which they said may be significant. They emphasized the importance of focusing on capital formation, discussed potential changes to the PCAOB, advocated for a new approach to regulating crypto markets and emphasized that registrant disclosure requirements should be based on financial materiality.

PCAOB Chair Erica Williams said the SEC and the PCAOB continue to share the mission of protecting investors while PCAOB Board member Christina Ho said she welcomed a "more moderate approach" to regulation in the future.

***PCAOB inspections*** — Chair Williams said that PCAOB inspectors are seeing significant improvements in the aggregate Part I.A deficiency rates of the largest firms but emphasized that firms must continue working to reverse the trend of high deficiencies. Christine Gunia, Director of the PCAOB's Division of Registration and Inspections, highlighted industries on

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which the Board expects to focus its 2025 inspections, as well as other areas of expected focus, including the increased use of generative artificial intelligence (AI) and other emerging technology and audit execution challenges.

***Accounting, auditing and SEC reporting updates*** — SEC Chief Accountant Paul Munter underscored the role of accountants who promote the integrity of the capital markets and serve the public interest. He stressed that auditors should build and maintain trust and reiterated the importance of a strong tone at the top, with the foundation of trust lying within the auditor's required independence.

The SEC staff discussed the FASB's Accounting Standards Update (ASU) on segment disclosures, including the scope of the auditor's responsibility in auditing additional measures of segment profit or loss that are not calculated in accordance with US GAAP that are disclosed under the new guidance. The SEC staff also provided reminders about classifying financial instruments as liabilities versus equity, cash flow classification and observations on registrants' compliance with recently adopted SEC disclosure rules on cybersecurity, clawbacks and pay versus performance.

The FASB discussed its projects, including the recently issued ASU on disaggregation of income statement expenses and current exposure drafts.

***The importance of stakeholder engagement*** — Regulators and standard setters emphasized the importance of seeking and receiving feedback in the rulemaking and standard-setting processes. They highlighted that thoughtful, actionable feedback, whether through comment letters or informal engagement, is essential to adopting high-quality rules and standards to faithfully represent the economics of transactions, drive consistency and comparability and provide relevant and timely financial information to investors.

***Artificial intelligence*** — Speakers addressed the opportunities and risks of using AI in the accounting profession and more broadly in financial reporting. The PCAOB staff encouraged stakeholder engagement on the application of auditing standards in the context of the increased use of AI in auditing and financial reporting. The SEC staff provided considerations for registrants as they prepare disclosures about how they use AI and how it could affect their results of operations and business.

## Remarks by SEC Commissioner

Commissioner Uyeda said regulatory action needs to be practical and implementable and emphasized the importance of engaging with both preparers and the audit profession to that end. He discussed the upcoming transition under the administration of President-elect Donald Trump, who has announced he plans to nominate Paul Atkins to serve as SEC Chair.

When asked about the likely changes in Commission priorities under new leadership, Commissioner Uyeda said he expects a focus on capital formation and a new approach to crypto-related regulation. He said he believes it is too burdensome to be a public company in the current environment, and there are too few differences between the requirements for large and smaller issuers. He highlighted the need to reduce regulatory friction to make sure rules are efficient, effective and appropriately tailored. He also stressed the importance of minimizing unnecessary costs, which ultimately are passed on to investors and referred to listening to diverse investor views and using financial materiality as the threshold for disclosure as critical elements in rulemaking.

> "Capital formation […] is one of the core pillars of our mission.
>
> — Mark Uyeda, SEC Commissioner

On crypto-related regulation, he noted that current policy has largely been set through enforcement actions and highlighted the need for comprehensive regulatory due process, including actions to clarify obligations related to accounting, disclosures, custody and auditing of crypto reserves.

Commissioner Uyeda emphasized the importance of the SEC's oversight of the PCAOB and FASB and called for a retrospective review of the PCAOB to assess its effectiveness in achieving the goals set out for it in the Sarbanes-Oxley Act of 2002.

US Rep. French Hill echoed many of Commissioner Uyeda's comments in a separate session at the conference.

## Remarks by PCAOB Chair and Board members

Chair Williams said PCAOB inspectors are seeing significant improvements in the aggregate Part I.A deficiency rates of the largest firms. She also warned that now is not the time to lose focus and urged firms to keep the momentum going toward decreasing the number of deficiencies on behalf of investors.

> "PCAOB inspectors are seeing significant improvements in the aggregate Part I.A deficiency rates from the largest firms.
>
> — Erica Williams, PCAOB Chair

Chair Williams acknowledged the PCAOB's role in bringing about change, while eliminating the inspections reporting backlog and issuing inspections reports more efficiently and on a timelier basis. She noted that when deficiencies span a wide range of topics, this begs questions about overall firm culture and the exercise of professional skepticism and care.

Chair Williams noted that the PCAOB's inspections team conducted over 150 interviews with partners at the larger firms to better understand the connection between firm culture and audit quality. She highlighted key findings, which include the following:

- Culture can influence audit quality.
- Longer tenured partners have fewer Part I.A deficiencies.
- A centralized audit firm structure and standardized audit processes, tools and templates are correlated with audit quality.
- Remote and hybrid working environments impact the apprenticeship model for on-the-job training, the dissemination of culture and professional skepticism.
- Proper levels of accountability support audit quality.

Chair Williams also said transparency is still a priority of the PCAOB for the benefit of investors. She recapped that related efforts included adding new independence information in inspection reports and new tools to the PCAOB website to help users understand the reports. She said the Board has led outreach to audit committee chairs to emphasize their responsibility to help hold accounting firms accountable for audit quality and provide questions they can ask their auditors.

With regard to recent **standard-setting activities**, Chair Williams noted that the PCAOB has updated 27 standards and rules during her tenure, and has taken more formal actions this year on standard setting and rulemaking than in any other year since the PCAOB's formation in 2003. She noted that the project on noncompliance with laws and regulations was not ready for the Board's consideration, and the PCAOB is in the process of determining next steps while also publishing guidance reminding auditors about their existing obligations regarding illegal acts by companies.

Chair Williams also discussed how the PCAOB has been working to embrace and adapt to evolving technologies, such as generative AI, while considering both the related risks and opportunities. She said the Board continues to engage in conversations about how firms and issuers are using technology in audits and financial reporting. In addition, Chair Williams touched on enforcement matters from exam cheating to misinforming investigators, reiterating the need for firms to continue focusing on and enforcing the highest ethical standards.

Board member George Botic reiterated that the PCAOB and SEC share a common mission to protect investors, while Board member Christina Ho noted her support for a more moderate approach to standard setting and her disagreement with standard setting activity taking place since the election.

### How we see it

Historically, new administrations bring about changes to the regulatory environment. Commissioner Uyeda's comments may provide a preview of changes that could occur with the new administration under President-elect Trump. Commissioner Uyeda served as counsel to Paul Atkins when Mr. Atkins served as an SEC Commissioner.

## Remarks by SEC Chief Accountant

"Accounting is critical and disclosure is no substitute for getting the accounting right […].

— Paul Munter, SEC Chief Accountant

Mr. Munter **discussed** the responsibilities that come along with being a member of the accounting profession and urged professionals in the field to always keep in mind the "public" aspect of certified public accountant.

Mr. Munter emphasized that the recurrence of high-profile cases of unethical behavior by accountants seen around the world adversely affects the profession and global public markets by undermining public trust and raising broader concerns about the culture and governance in both accounting firms and issuers.

Mr. Munter said the value proposition of an accountant's services is dependent on their trustworthiness, adding that "trust is hard to gain and easy to lose, both individually and as a profession, so accountants should consider the importance of building and maintaining trust every single day."

He also reiterated the importance of a strong and ethical tone at the top, with the foundation of trust lying within the auditor's required independence, regardless of service line. He stated that audit firm leadership should champion ethics and independence, setting the tone that it is more than a compliance exercise, and that enforcement actions shouldn't be seen as merely the cost of doing business. He noted that a strong culture and tone at the top empower accountants to exercise professional skepticism and not succumb to pressures, which are key to elevating audit quality.

Mr. Munter also emphasized that an ethical culture needs to flow throughout the organization. He noted academic research supporting that "behavior is driven the most by the people that are directly around you," referred to as the "mood in the middle" or "buzz at the bottom." He noted this academic study showed that staff auditors are more likely influenced by the tone of their supervising senior over the partner of the engagement when those tones contradict. Mr. Munter emphasized that "when less experienced accountants' professional experience is anchored in doing the right thing, they are more likely to become leaders with this same mindset."

Mr. Munter noted the ongoing concern about the accounting profession being able to attract and retain talent. He said auditors may be faced with circumstances that "pit the public interest against self or firm interest," but that timely action to address those circumstances protects investors.

Mr. Munter discussed the importance of collaboration within the accounting profession. He referred to a 1989 speech by former SEC Chair David Ruder that highlighted the need for cooperative efforts among standard setters, stakeholders and the SEC in setting standards. Mr. Munter stressed that the development and implementation of high-quality standards are crucial for promoting investor confidence and lowering the cost of raising capital for issuers.

Mr. Munter emphasized the importance of providing consistent and comparable information to investors, saying that "accounting is critical, and disclosure is no substitute for getting the accounting right on difficult or complex issues." He encouraged stakeholders to engage constructively in the standard-setting process and provide actionable feedback to the FASB as part of its current agenda consultation process.

Mr. Munter noted that the statement of cash flows is important to investors, and the FASB currently has a research project to explore improvements. He expressed support for the FASB's efforts to improve consistency and comparability in cash flow classification, provide greater transparency on the relationship between the statement of cash flows and other financial statements and provide more information about non-cash transactions. He also reminded stakeholders that the statement of cash flows and related disclosures should receive the same quality focus as other components of the financial statements.

Additionally, Mr. Munter discussed the SEC's role in overseeing auditing standard setting, noting the Commission's recent approval of several PCAOB standards and rules, including updates to the general responsibilities of auditors and the quality control systems of audit firms. He reiterated that constructive engagement is crucial for both the PCAOB's standard-setting and rulemaking process and the Commission's consideration of those standards and rules.

### How we see it

The statement of cash flows is just as important as the other financial statements. Registrants' internal control over financial reporting (ICFR) and disclosure controls and procedures (DCPs) over the preparation of the statement and related disclosures (e.g., liquidity and capital resources in management's discussion and analysis) should be commensurate with its importance.

## Remarks by senior SEC staff members on accounting and disclosure matters

### Classification of financial instruments as liabilities versus equity

Gaurav Hiranandani, Senior Associate Chief Accountant in the SEC's Office of the Chief Accountant (OCA), discussed the classification of financial instruments as liabilities versus equity, including the evaluation of whether an instrument is considered indexed to the company's own stock under Accounting Standards Codification (ASC or the Codification) 815, *Derivatives and Hedging.*[3]

Mr. Hiranandani shared a fact pattern in which a registrant issues a warrant and assesses whether certain of its provisions would preclude the instrument from being considered indexed to the company's own stock, resulting in liability classification.

Specifically, the warrant provided that upon a fundamental transaction (e.g., an all-cash acquisition of the registrant) the warrant holder would be entitled to settle the warrant at a Black-Scholes value that has certain pre-specified inputs, such as the greater of share prices or volatility inputs. The warrant agreement also included a participation feature under which the warrant holders are entitled to share in dividends with common stockholders without regard to the strike price.

Mr. Hiranandani noted that both of these provisions are common in warrant agreements, and evaluating them under ASC 815-40-15 requires significant judgment, which has resulted in widespread diversity in practice. He said that terms of warrant agreements continue to evolve, and there are other provisions that adjust the settlement amount of warrants. Diversity in practice also exists in assessing these provisions. Mr. Hiranandani said that the SEC staff believes all stakeholders, including investors, would benefit from standard setting on this topic to drive consistency and reduce challenges and costs for investors in determining the financial reporting impact of warrants.

Additionally, Mr. Hiranandani encouraged registrants to consult with OCA on similar warrant issues or other complex accounting issues.

### Scope of recently issued Accounting Standard Updates

Mr. Hiranandani discussed the scope of recently issued ASUs, including those related to segment reporting, income tax disclosures and the disaggregation of income statement expenses. He said as registrants consider their implementation of these and other standards, certain industry groups have raised questions about whether entities that apply industry-specific GAAP are in the scope of these ASUs.

He emphasized that unless an entity has been specifically excluded from the scope of an ASU or existing accounting standard, or there is industry-specific guidance that would preclude certain accounting, the broad requirements of the Codification would apply to it.

As an example, Mr. Hiranandani highlighted that ASC 280, *Segment Reporting*, applies to all entities that meet the definition of a public entity in the Master Glossary of the Codification, which include investment companies that are required to file financial statements with the SEC.

*Ernst & Young LLP resources*

- Technical Line, ***A closer look at the FASB's new segment disclosure requirements***
- Technical Line, ***A closer look at the FASB's new disaggregated expense disclosure requirements***
- Technical Line, ***FASB issues guidance requiring additional income tax disclosures***
- Financial Reporting Developments, ***Consolidation: Determination of a controlling financial interest and accounting for changes in ownership interests***

### Scope of deconsolidation guidance

Jonathan Perdue, an SEC Professional Accounting Fellow, described a fact pattern involving the deconsolidation of a subsidiary that did not meet the definition of a business. He noted that it was important to consider the substance of the transaction when determining the scope of guidance to apply.

He highlighted that the deconsolidation evaluation started by referring to the guidance in ASC 810, *Consolidation*, because the subsidiary's assets and liabilities were held in a legal entity. Mr. Perdue said that even if the legal entity does not meet the definition of a business, the deconsolidation guidance in ASC 810 would apply unless the substance of the transaction is addressed by other ASC topics.[4]

Although the subsidiary held significant assets that were typically sold by the registrant in its ordinary business activities, the subsidiary also held other significant net assets and agreements (e.g., lease contracts, derivative contracts, receivables, liabilities). Mr. Perdue said the significance of the assets held by the subsidiary that were deemed to be part of the registrant's ordinary business activities raised a question about whether the substance of the transaction was directly addressed by ASC 606, *Revenues from Contracts with Customers*. However, the SEC staff considered the total mix of assets and liabilities held by the subsidiary when evaluating the substance of the transaction and concluded that ASC 606 did not directly address it. Therefore, the SEC staff did not object to accounting for the sale of the subsidiary in accordance with ASC 810.

### Deconsolidation of a subsidiary accounted for on a lag

Mr. Hiranandani discussed a separate fact pattern related to a registrant's accounting for the sale of a subsidiary that had previously been accounted for on a three-month lag in accordance with ASC 810-10-45-12.

To address the lag as part of the accounting for the disposition, the registrant believed that it should recognize the three months of income statement activity (i.e., the period not yet reflected in the statement of operations since the subsidiary was accounted for on a three-month lag) directly in shareholders' equity, with a corresponding adjustment to the subsidiary's assets and liabilities to reflect the carrying amounts as of the date of the sale. The SEC staff objected to the registrant's accounting.

## Remarks by senior SEC staff members on audit matters

### Evaluation of accounting errors and their materiality

Anita Doutt, Senior Associate Chief Accountant in OCA, discussed the continuing trend of questions about the ICFR implications when there are errors in previously issued financial statements.

Ms. Doutt noted the importance of performing both an objective materiality assessment and an objective ICFR severity assessment. She noted that a material error is a strong indicator of a material weakness, but a material weakness can also exist when there is not a material error.

Ms. Doutt said that registrants who disclose a "little r" restatement should perform a robust ICFR evaluation. She noted that defaulting to the conclusion that a "little r" restatement is immaterial to prior-period financial statements, and therefore a material weakness does not exist, ignores the potentially accumulating nature of the error. Ms. Doutt reminded registrants that the materiality of the actual error is only a starting point in the ICFR severity evaluation, and they need to consider other factors, such as an evaluation of the sufficiency of risk assessment, monitoring, tone at the top and other entity-level controls.

Mr. Hiranandani referenced a previous **statement** by Mr. Munter on assessing materiality and reiterated the importance of an objective assessment when evaluating errors in previously issued financial statements. He noted that the determination of whether an error is material should be focused on whether there is a substantial likelihood that a reasonable investor would consider the error important in making investment decisions.

Mr. Hiranandani stated that preparers and auditors should consider both quantitative and qualitative factors in determining materiality and noted that OCA would continue to carefully evaluate arguments supporting conclusions that errors are immaterial. He also noted that errors in disclosures in the notes to the financial statements should be evaluated using the same objective assessment used for errors in balances on the face of the financial statements.

### Independence

Ms. Doutt said that while Rule 2-01 of Regulation S-X is entitled *Qualification of Accountants*, the responsibility for independence is shared by the audit firm, audit committee and management. She noted there have been independence violations that indicate certain auditors, such as non-US members of a network firm, may not fully understand SEC and PCAOB independence rules or have proper controls in place to monitor relationships.

Ms. Doutt emphasized the importance of a firm timely applying independence restrictions when it is made aware that an entity under audit is planning an initial public offering (IPO). She also highlighted the need for controls related to performing updated independence assessments when there is a transfer in the office or network member firm of the lead auditor.

Ms. Doutt referenced Mr. Munter's **statement** regarding independence considerations when firms use alternative practice structures, stating that firms must be mindful when selling stakes to private equity investors or other non-traditional sources and encouraging accountants to reach out to the SEC staff with any questions.

### Firm culture and governance

Nigel James, Senior Associate Chief Accountant in OCA, reiterated some of Mr. Munter's points about firm culture and governance within firms and referenced a **statement** Mr. Munter made in 2024 discussing how audit firms can foster a healthy tone at the top.

Ms. Doutt echoed Munter's comments regarding "mood in the middle" and "buzz at the bottom" being enhanced by empowering lower levels to exercise professional skepticism and emphasized the importance of using that skepticism. Ms. Doutt also reiterated that supervisors should be exemplifying and supporting this behavior to operationalize the concept of the tone at the top and ethical firm culture.

Deputy Chief Counsel Shehzad Niazi discussed recent enforcement trends, noting an increase in recent Commission orders with respect to related party transactions. He said some auditors seem to ignore red flags or appear to be unfamiliar with the relevant laws, standards and requirements. Mr. Niazi emphasized the importance of applying heightened scrutiny when dealing with related party transactions as part of exercising appropriate due professional care and professional skepticism.

### Fraud risk assessment

Ms. Doutt emphasized the need for strong fraud risk assessment procedures throughout the audit and highlighted the importance of whistleblower programs as a tool for the fraud risk assessment. She cited the **Association of Certified Fraud Examiner's Report to the Nations**, stating the most common way frauds are detected is through whistleblower

reporting. She said auditors' fraud risk assessments should consider the design of clients' whistleblower programs, and auditors should evaluate the matters reported through them in connection with the audit procedures performed.

Ms. Doutt discussed the importance of performing fraud inquiries during the audit. She explained that inquiries should be performed by audit personnel whose level is commensurate with that of the individual of whom the inquiries are being made. For example, she noted that it would not make sense for audit staff to perform fraud inquiries of the chief executive officer or for an audit partner to interview staff at a company.

She also said auditors should make thoughtful and probing inquiries and not view these as a compliance exercise or simply walk through a standard checklist of questions.

## Division of Corporation Finance practice matters

### Segment reporting

*Ernst & Young LLP resources*

- Technical Line, ***A closer look at the FASB's new segment disclosure requirements***
- Financial Reporting Developments, ***Segment Reporting***
- Technical Line, ***Navigating the requirements for non-GAAP financial measures***

Staff from the SEC's Division of Corporate Finance (DCF) discussed reminders related to ASU 2023-07, *Segment Reporting (Topic 280): Improvements to Reportable Segment Disclosures*, and clarified how registrants should consider the interaction between ASC 280 and the SEC's rules and regulations and SEC staff compliance and disclosure interpretations (C&DIs) on non-GAAP financial measures (the SEC's non-GAAP guidance).

#### *Interaction with the SEC's non-GAAP guidance*

Melissa Rocha, Deputy Chief Accountant in DCF, said that although Item 10(e) of Regulation S-K prohibits the inclusion of non-GAAP financial measures in the notes to the financial statements, the SEC staff would not object to the disclosure of additional non-GAAP segment profitability measures in accordance with ASC 280 in the notes to the financial statements, provided that these measures otherwise comply with the SEC's non-GAAP guidance on the use of non-GAAP financial measures.

Ms. Rocha further explained that the related required non-GAAP disclosures may be included in the segment note or elsewhere in the entity's filing, such as MD&A. If these disclosures are presented outside the financial statements (e.g., in MD&A), the SEC staff does not expect entities to cross-reference from the segment note to other sections of the filing where the non-GAAP disclosures are located because there is no requirement to do so in ASC 280 or in the SEC's rules and regulations.

Sarah Lowe, Deputy Chief Accountant in DCF, discussed the evaluation of whether a measure of segment profitability is a non-GAAP financial measure. She highlighted that entities use a management approach under ASC 280, which provides that not every part of a public entity is necessarily an operating segment or part of an operating segment.[5] For example, certain corporate costs or costs of functional departments may not be fully allocated to operating segments and therefore are excluded from the measure of segment profitability. In this example, Ms. Lowe said the SEC staff would not consider the exclusion of these costs on their own to result in a non-GAAP financial measure.

In addition, she said the SEC staff would not consider an additional measure of segment profitability calculated using measurement principles consistent with those applied in the corresponding measure presented in the registrant's consolidated financial statements to be a non-GAAP financial measure (e.g., segment gross profit calculated in accordance with US GAAP).

Ms. Lowe said judgment should be applied to assess whether additional measures of segment profitability represent non-GAAP measures based on an entity's facts and circumstances.

*Auditor responsibilities*

Heather Rosenberger, Chief Accountant in DCF, said that the scope of the auditor's responsibilities related to the disclosures of additional non-GAAP segment profitability measures in the notes to the financial statements in accordance with ASC 280 is limited to evaluating the registrant's compliance with ASC 280. She said the scope of the audit would not include a registrant's compliance with the SEC's non-GAAP guidance, including whether an additional non-GAAP segment profitability measure is considered "misleading" under the SEC's non-GAAP guidance and the appropriateness of the related non-GAAP disclosures (i.e., the reconciliation between the most directly comparable GAAP measure and the additional non-GAAP segment profitability measure, and the accompanying narrative disclosures).

Accordingly, if an entity provides such non-GAAP disclosures required by Item 10(e) of Regulation S-K in the segment note and the auditor does not audit that information, the disclosures should be labeled as "unaudited."

However, Ms. Rosenberger said that the additional non-GAAP segment profitability measures themselves and the accompanying ASC 280 disclosures that apply to each measure cannot be labeled "unaudited" since they are presented and disclosed in accordance with ASC 280. Ms. Rosenberger also said that an auditor may choose to include an emphasis of matter paragraph in the audit opinion to communicate to investors which items were not subject to audit.

Finally, Ms. Rosenberger noted that as part of an auditor's determination of whether overall disclosures are presented fairly and in accordance with GAAP, the auditor needs to consider the requirements under Rule 4-01(a) of Regulation S-X and PCAOB Auditing Standard (AS) 2810, *Evaluating Audit Results*. She also highlighted an auditor's responsibilities under AS 2710, *Other Information in Documents Containing Audited Financial Statements*.

*Removal of an additional non-GAAP segment profitability measure in subsequent filings*

Ms. Lowe discussed whether the removal of an additional non-GAAP segment profitability measure from the notes to the financial statements would represent the correction of an error under ASC 250, *Accounting Changes and Error Corrections*.

She said the removal of the measure *solely* because it does not comply with the SEC's non-GAAP guidance (e.g., it is considered misleading under that guidance) would not be considered an error correction under ASC 250.

For example, if a registrant discloses an additional non-GAAP segment profitability measure that complies with ASC 280 but subsequently determines that the measure does not comply with the SEC's non-GAAP guidance, the removal of that measure in a subsequent filing would not represent an error correction under ASC 250. Ms. Lowe said in this case a registrant may need to assess the impact on its conclusions on the effectiveness of their DCPs.

## How we see it

Entities that choose to disclose additional non-GAAP segment profitability measures in their financial statement notes will need to apply judgment to make sure the measures are not misleading. We encourage entities to carefully consider the SEC's non-GAAP guidance and engage with their legal counsel and independent auditors when considering disclosure of such measures in the financial statements. We also note that a registrant can disclose an additional non-GAAP segment profitability measure outside its financial statements in the same filing as long as the measure complies with the SEC's non-GAAP guidance.

*Single reportable segment entities*

Ms. Rocha said the SEC staff would continue to expect that the required measure of profitability for single reportable segment entities managed on a consolidated basis (i.e., single operating segment) would be a consolidated GAAP measure, such as consolidated net income. She explained that this is because ASC 280 requires disclosure of the measure closest to GAAP, which is the measure most consistent with how amounts are measured in the consolidated financial statements.

Ms. Rosenberger said that for these entities, disclosure requirements under the significant expense principle and the existing disclosure requirements could potentially result in duplication of information already disclosed in the primary financial statements. As explained in ASU 2023-07, duplication of information included in the consolidated income statement is not required but also is not prohibited.[6]

She emphasized that an entity that decides to cross reference from the notes to the primary financial statements or to other disclosures in the financial statements must clearly state where that information is disclosed. She also highlighted that the significant segment expense categories, which are based on segment expense information regularly provided to the chief operating decision maker (CODM), could be different than the expense classifications in the consolidated income statement.

*Ernst & Young LLP resources*

- *SEC Reporting Update — Highlights of trends in 2024 SEC staff comment letters*

### Management's discussion and analysis

Ms. Rocha said that disclosures in management's discussion and analysis (MD&A) continue to be a frequent area of SEC staff comment, including the discussion of results of operations, critical accounting estimates and liquidity and capital resources.

She said the SEC staff often observes that registrants discuss changes in cash flows by repeating amounts in the statement of cash flows and disclosing the change period over period, but they fail to provide a detailed analysis of the underlying reasons for the changes, both in qualitative and quantitative terms. Ms. Rocha said that companies should consider whether discussing liquidity-related metrics (e.g., days sales outstanding, days payable outstanding) could help explain changes in financial condition and cash flows.

Ms. Rocha noted that some registrants with negative operating cash flows have not sufficiently disclosed how they will fund their operations in the short term or how cash deficiencies will be remediated. She highlighted the importance of robust liquidity disclosures in MD&A when a registrant is experiencing prolonged or significant liquidity challenges. She also emphasized registrants must make disclosures about their ability to obtain or generate adequate cash for the next 12 months. She noted the SEC staff has been commenting on these disclosures when a registrant's auditor has included a going concern explanatory paragraph in the audit opinion.

Ms. Lowe discussed upcoming disclosure considerations for registrants impacted by Pillar Two Global Anti-Base Erosion (GloBE) model rules. She reminded registrants to quantitatively disclose the reasonably likely impact of tax law changes on their results of operations or financial condition and said she expected these disclosures to evolve over time as companies continue to evaluate the impact of the tax law changes.

Ms. Rosenberger reminded preparers that the MD&A rules require disclosure of segment information when it is necessary to understand the business. She said that if significant segment expenses are disclosed in the notes to the financial statements to comply with ASU 2023-07, registrants should consider whether a similar discussion is necessary in MD&A to understand the company's business.

*Ernst & Young LLP resources*

- Technical Line, ***Navigating the requirements for non-GAAP financial measures***

## Non-GAAP financial measures

### *Labeling and prominence*

Ms. Rosenberger discussed the prominence and labeling of non-GAAP measures, which continue to be a frequent topic in SEC comment letters. She emphasized that registrants must present the most directly comparable GAAP measure with equal or greater prominence. She referred registrants to the SEC staff's views on prominence in Compliance and Disclosure Interpretations (C&DI) question 102.10.

Additionally, Ms. Rosenberger said registrants should clearly label non-GAAP adjustments to help investors understand the nature of each adjustment. She also said the SEC staff may issue comments on dissimilar adjustments that have been grouped in the same reconciliation line item, especially when the label of the adjustment is not clear.

Ms. Rosenberger noted that the SEC staff's comments may address both the labeling and the permissibility of the adjustment. She noted that simply re-labeling or revising the description of an adjustment may not be sufficient to address the staff's comment. A registrant should also assess whether the adjustment causes the non-GAAP measure to be misleading.

### *Adjustments that could result in potentially misleading measures*

Ms. Lowe elaborated on adjustments that could result in potentially misleading non-GAAP financial measures. Regarding the application of the guidance in C&DI question 100.01, she noted that the SEC staff has commented when a non-GAAP measure excludes items that appear to be normal, recurring expenses, such as markdowns on obsolete or excess inventory, and losses incurred on purchase commitments.

Ms. Lowe also identified the exclusion of cash compensation (e.g., annual bonuses) or rent expense (e.g., when leased assets are integral to a company's operations and generation of revenue) as examples of adjustments that could result in a misleading non-GAAP measure.

Ms. Rosenberger said that while C&DI question 100.01 refers to the exclusion of "normal, recurring, cash operating expenses," the SEC staff has said an adjustment may be misleading even if the expense excluded from the non-GAAP measure does not have all three of those attributes (i.e., normal, recurring, and cash) simultaneously. As such, an adjustment for a non-cash expense could be considered misleading under C&DI question 100.01.

Ms. Lowe also reminded registrants that making non-GAAP adjustments to change the accounting principles required by GAAP (i.e., the application of individually tailored accounting principles) could result in a misleading measure. She provided examples of adjustments that may be inconsistent with C&DI question 100.04, including changing the accounting of leases from sales-type to operating, removing accelerated depreciation from measures other than earnings before interest, taxes, depreciation, and amortization, and reversing the effects of purchase accounting in results of operations after an acquisition.

## How we see it

SEC staff members exercise significant judgment when concluding on whether non-GAAP measures are misleading based on the registrant's facts and circumstances. The SEC staff's views on which non-GAAP measures and adjustments are considered misleading have evolved over time, and we expect that to continue so registrants should closely monitor developments in this area.

***Measures included in debt covenants***

Ms. Lowe said that the SEC staff would not object to measures calculated in accordance with a debt covenant and disclosed in the liquidity and capital resources section of MD&A to comply with Item 303 of Regulation S-K. That is because such measures are excluded from the definition of a non-GAAP financial measure. She also said the SEC staff would not object to the presentation of the covenant measure in an earnings release in a manner similar to the MD&A disclosure if it is clear that information about the covenant is material to an investor's understanding of the registrant's financial condition and liquidity.

However, Ms. Lowe cautioned that the SEC staff would likely object if a covenant measure that includes an adjustment resulting in a potentially misleading measure (e.g., an adjustment to change the pattern of revenue recognition required by GAAP) is disclosed as a performance measure. She also reminded preparers that when they disclose a covenant measure, they should also consider disclosing the material terms of the credit agreement (including the covenant), the amount or limit required for compliance with the covenant and the actual or reasonably likely effects of compliance or noncompliance with the covenant on the company's financial condition and liquidity, as described in C&DI question 102.09.

*Ernst & Young LLP resources*

- Technical Line, ***Navigating the requirements for merging with a special purpose acquisition company***

### Clarifications on special purpose acquisition company reporting

Ms. Rocha clarified certain reporting requirements under the new and amended SEC rules adopted earlier this year for when a special purpose acquisition company (SPAC) conducts an IPO and when it subsequently combines with a private operating company in what is known as a de-SPAC transaction:

- A private operating company that would qualify as an emerging growth company (EGC) if it were conducting its own IPO can report as an EGC in a de-SPAC registration statement.
- In a de-SPAC transaction with a PubCo entity (i.e., an entity that will be the parent of both the SPAC and the target private operating company), the PubCo entity is considered a registrant and does not meet the definition of a business combination-related shell company. As such, the PubCo entity's financial statements are required to be included in the de-SPAC registration statement.
- Once the de-SPAC registration statement is effective, the PubCo entity must comply with the SEC periodic reporting requirements, despite the fact that the transaction may not have closed.
- For registration statements filed after the de-SPAC transaction, the SPAC's financial statements must be included as if the SPAC were the registrant until such time when the PubCo entity's financial statements include the period in which the de-SPAC transaction was consummated. Because the SPAC is considered to be a registrant, the SPAC's financial statements must be audited in accordance with PCAOB standards.

Ms. Rocha also reminded registrants that the SPAC's net tangible book value per share, as adjusted, and the difference against the offering price are required to be disclosed in the SPAC's registration statement.

### Audit requirements for a reverse merger with a registrant that is not a shell company

Ms. Rosenberger said the guidance in Section 12250.2 of **DCF's Financial Reporting Manual** (FRM) that addresses the audit requirements for reverse mergers between two operating companies where the accounting acquirer is a non-public company is not consistent with the SEC staff's current views. She provided an example to illustrate the staff's current view of these requirements.

In the example, there is a reverse merger involving two operating companies in which the non-public operating company is the accounting acquirer is (i.e., the public operating company is the accounting acquiree), and the non-public operating company is not considered to be the issuer with respect to its pre-acquisition financial statements included in a Form S-4, proxy statement or Form 8-K Item 2.01, *Completion of Acquisition or Disposition of Assets*, filing related to the merger.

In this example, the audit of the pre-acquisition financial statements of the non-public accounting acquirer included in the filings can be performed by an auditor that is not registered with the PCAOB. That is, the audit of the pre-acquisition periods of the non-public operating company in the filings can be performed in accordance with AICPA standards, and the auditor would not need to be compliant with PCAOB and SEC independence standards.

However, once the reverse merger is reflected in a periodic report filed with the SEC, the pre-acquisition financial statements of the non-public operating company become the historical financial statements of the registrant. Accordingly, all financial statement periods included in the periodic report (including the pre-acquisition periods of the accounting acquirer) must be audited in accordance with PCAOB standards by a PCAOB-registered firm that is compliant with both the PCAOB and SEC independence standards.

*Ernst & Young LLP resources*

- Financial Reporting Developments, ***Statement of cash flows***
- To the Point, ***SEC adopts rules to require 'clawback' policies and disclosures***
- Financial Reporting Developments, ***Accounting changes and error corrections***

### Statement of cash flows classification

Ms. Lowe noted that in certain circumstances a cash receipt or payment may have aspects of more than one class of cash flows (i.e., operating, investing or financing). In this case, a registrant may be required to apply significant judgment when determining the predominant source or use of cash flows for the item and, therefore, the cash flow classification in accordance with ASC 230-10-45-22A. The SEC staff suggests in this case that registrants describe how they reached their classification conclusion in their accounting policy disclosures.

### Clawback rules

Ms. Rosenberger discussed the use of the two new check boxes, added by the final clawback rules, on the cover of Form 10-K to indicate (1) whether the registrant's financial statements included in the filing reflect the correction of an error in previously issued financial statements and (2) whether any of those restatements required a recovery analysis of incentive-based compensation.

Ms. Rosenberger reminded registrants that the first box should be checked if the prior-period financial statements included in the filing reflect the correction of an accounting error as defined under ASC 250.[7] She said that registrants do not need to check the first box for the adoption of a new accounting standard with retrospective application, voluntary reclassifications of prior-year amounts to conform to the current year presentation (that are not errors), out-of-period adjustments or changes in permissible GAAP accounting methods, since these changes are not prior-period accounting error corrections.

Ms. Rosenberger addressed whether a registrant must recheck the first box for an error correction in the filing for the year after the year in which the error was corrected. For example, she said if a registrant's 2023 Form 10-K is amended in 2024 to reflect the correction of an error related to the 2023 financial statements and the registrant checked the first box on the cover of the 2023 Form 10-K/A, the registrant would not need to check the first box again when filing the 2024 Form 10-K. However, if the registrant reported the restatement using a form that did not have the boxes (e.g., Form 8-K, a registration statement form), the SEC staff would expect the registrant to signal the correction of the error to investors by checking the first box on the 2024 Form 10-K.

Ms. Rosenberger also said that a registrant must check the second box to indicate a recovery analysis was performed, even if there is no incentive-based compensation received by executive officers during the recovery period or incentive-based compensation received was not affected by the corrected error.

Additionally, Ms. Rosenberger addressed the recovery analysis disclosures required in annual reports and proxy statements when a registrant has an accounting restatement. She said that for any recovery analysis that results in a determination that there was no erroneously awarded incentive-based compensation, registrants must provide a brief explanation of the rationale for this conclusion in accordance with the disclosure requirements in the rules. She also reminded registrants that they are required to tag the disclosures using Inline XBRL.

*Ernst & Young LLP resources*

- Technical Line, ***How to apply the SEC's new pay versus performance disclosure requirements***

## Pay versus performance

Cicely Lamothe, Deputy Director of Disclosure Operations in DCF,[8] discussed the Division's second-year review of pay versus performance disclosures. These disclosures require registrants to provide a table in their proxy and information statements that discloses the relationship between their executive compensation and financial performance. She observed that overall, registrants have done a good job considering the guidance included in the C&DIs issued by the SEC staff in 2023 when preparing these disclosures. She offered the following reminders:

- Net income included in the pay versus performance table should be net income presented in a registrant's audited income statement, including net income attributable to non-controlling interests.
- A registrant that uses a non-GAAP financial measure as its company-selected measure must explain how the measure was calculated from its audited financial statements, and describe the measure clearly, along with any adjustments included in the measure.
- Registrants should clearly disclose required adjustments when determining executive compensation actually paid and label those adjustments using terminology in the rules.
- Registrants should follow legal vesting terms when determining executive compensation actually paid, including when an award has retirement eligibility provisions as described in C&DI 128D.18.

Ms. Lamothe also reminded registrants that they are required to tag the pay versus performance disclosures using Inline XBRL.

*Ernst & Young LLP resources*

- Technical Line, ***A closer look at the SEC's new rules on cybersecurity disclosures***

## Cybersecurity-related disclosures

Sebastian Gomez Abero, Associate Director of DCF's Disclosure Review Program, reminded registrants that materiality, not the discovery of a breach, is the trigger for disclosing a cybersecurity incident under Item 1.05, *Material Cybersecurity Incidents*, of Form 8-K. He referred registrants to the SEC staff **statement** on the voluntary disclosure of a cybersecurity incident that is not required to be reported under Item 1.05 (e.g., a cybersecurity incident for which the registrant has either not made a materiality determination or has determined it is not material) and said such incidents should be disclosed under Item 8.01, *Other Events*. He noted that if the registrant subsequently determines that the event is material, it must provide disclosure of the incident under Item 1.05. Mr. Gomez Abero also reminded registrants that both quantitative and qualitative factors should be considered in their materiality assessment of a cybersecurity incident.

Mr. Gomez Abero reminded registrants to provide sufficient detail in Form 10-K cybersecurity disclosures for a reasonable investor to understand the registrant's processes to assess, identify and manage material risks from cybersecurity threats, rather than just stating that a process exists. Mr. Gomez Abero noted that registrants with a management group that assesses material cybersecurity risks should disclose each member's individual expertise in accordance with Item 106 of Regulation S-K. Additionally, Mr. Gomez Abero reminded registrants that Inline XBRL tagging of cybersecurity disclosures will be required in the coming year.

*Ernst & Young LLP resources*

- Financial Reporting Developments, ***Business Combinations***
- Technical Line, ***Applying the SEC's requirements for significant acquired businesses***

## Regulation S-X Rule 11-01(d) waiver requests

Ms. Rosenberger noted that the SEC staff continues to receive waiver requests related to the definition of a business under Rule 11-01(d) of Regulation S-X. She reminded registrants that the definition of a business for SEC reporting purposes in Rule 11-01(d) differs from the US GAAP definition in ASC 805, *Business Combinations*, so it is possible to reach different conclusions about whether a business has been acquired under Article 11 of Regulation S-X and ASC 805. She also reminded registrants that when they apply Rule 11-01(d), there is a high threshold for overcoming the presumption in the rule that a separate entity, subsidiary or division is a business. She also noted that Rule 11-01(d) does not require the acquired entity to be revenue-generating to meet its definition of a business (e.g., a pre-revenue life sciences company could meet the definition).

Additionally, Ms. Rosenberger offered general recommendations for submitting waiver requests, including providing sufficient details, adding an alternative request or view in the event the SEC staff does not agree with the registrant's original request and involving the company's auditors in the waiver process.

## Foreign private issuers

Ms. Rocha highlighted the SEC staff's view on the application of SAB Topic 4.C, *Change in Capital Structure*, to foreign private issuers that apply IFRS Accounting Standards. Topic 4.C states that a change in capital structure (e.g., stock dividend, stock split, reverse split after the date of the latest reported balance sheet but before the release of the financial statements) must be given retroactive effect in the balance sheet.

Ms. Rocha emphasized that the SEC staff expects foreign private issuers to comply with SAB Topic 4.C, even when the financial statements prepared using IFRS Accounting Standards have previously been issued or authorized for issuance, so investors receive relevant and transparent information regarding the effects of capital structure changes.

Ms. Rocha also reminded preparers that when previously issued financial statements are incorporated by reference into a registration statement, the SEC staff would not object to the inclusion of the required Topic 4.C disclosure elsewhere in the registration statement in lieu of revising the previously issued financial statements.

### Emerging areas of risk disclosures

Ms. Lamothe stressed the importance of registrants staying vigilant about material emerging risks, which typically require MD&A, risk factor or description of business disclosures. She cited as examples the risks associated with supply chain disruptions, China-based issuers, commercial real estate, the banking industry and AI, noting an increase in AI-related disclosures in recent years.

Ms. Lamothe emphasized the importance of registrants having a reasonable basis for claims about the impact of AI on operations or future results. She encouraged registrants to consider operational dynamics, cybersecurity, data privacy, discrimination and bias, intellectual property issues, litigation, the cost of complying with federal and state AI regulations, consumer protection concerns and labor requirements in providing disclosures tailored to a company's circumstances.

Ms. Lamothe also said that registrants should consider providing disclosures about AI risk management and corporate governance policies. She urged registrants to carefully review their AI-related disclosures to make sure they are informative and useful to investors amid rapidly evolving AI development, use and regulation.

Quality audits do not happen by coincidence […].

— Christine Gunia, PCAOB Division of Registration and Inspections Director

## PCAOB standard-setting and inspection matters

### Inspection matters

*2024 inspection-related highlights*

Christine Gunia, Director of the PCAOB's Division of Registration and Inspections, said common deficiencies identified in PCAOB inspections included those related to controls with a review element, leases, loans and other investments. However, she noted that total Part I.A findings are leveling off, which would suggest an improvement in quality controls.

Ms. Gunia highlighted the increased number of PCAOB staff "Spotlight" publications issued in the current year as the staff's effort to provide more transparency and reminders in a timelier manner. She also emphasized that "quality audits do not happen by coincidence," and that in 2025 firms will benefit from never underestimating the power of strong quality controls and effective root cause analysis processes.

*Inspection outlook for 2025*

Ms. Gunia said that in 2025 the PCAOB expects to focus its inspections on (1) companies in industries negatively impacted by economic volatility, such as banking, real estate and information technology, (2) the increased use of generative AI and other emerging technologies and (3) audit execution challenges, such as workforce concerns and remote work. Ms. Gunia also reminded auditors of the PCAOB's annual inspection of compliance with standards and rules, such as independence, audit committee communications, auditor reports and Form AP.

### Standard setting and year-end reminders

Barbara Vanich, PCAOB Chief Auditor and Director of Professional Standards, reiterated some of the recent standard-setting activities discussed by Chair Williams. She also highlighted some key reminders for year-end reporting, such the recent changes to the confirmation standard and the importance of independence-related communications.

Ms. Vanich suggested revisiting "other auditor" determinations to make sure there were no changes to initial conclusions. She also emphasized the importance of critical audit matters (CAMs) and noted investor requests for more transparency in this area. Ms. Vanich challenged firms to take a fresh look at whether they are complying with the spirit of the standard to make opinions more informative, since the number of CAMs identified is trending downward.

Ms. Vanich also called for stakeholders to engage with the PCAOB on questions about the application of auditing standards as auditors and companies use AI more in auditing and financial reporting, respectively.

> "[…] We're incentivizing public companies to meet their existing obligations to maintain a system of internal accounting controls […].
>
> — Ryan Wolfe, SEC's Division of Enforcement Chief Accountant

## Enforcement matters

### Remarks from the SEC Division of Enforcement staff

Ryan Wolfe, Chief Accountant in the SEC's Division of Enforcement, discussed how the Division imposed reduced or no penalties on registrants in non-fraud cases if they remediated their internal controls and financial reporting. Mr. Wolfe also discussed audit-related enforcement matters involving quality control and auditor independence issues, as well as an enforcement action involving an audit committee.

Mr. Wolfe noted the SEC staff monitors registrants' disclosures under Item 4.02, *Non-Reliance on Previously Issued Financial Statements or a Related Audit Report or Completed Interim Review*, of Form 8-K. He highlighted that a restatement involves a violation of SEC rules, even if it doesn't lead to an enforcement case, because financial statements that do not comply with GAAP are presumed to be misleading. Additionally, he reminded registrants that ASC 250 requires material errors to be corrected and that companies should provide corrected information to investors as soon as possible.

Mr. Wolfe emphasized the importance of auditors possessing the necessary competence, experience and knowledge to undertake their engagements effectively, especially when accepting clients from new industries or auditing unfamiliar areas. He stressed that registrants are obligated to make sure that information provided to investors is reasonably correct and complete, even when they outsource financial reporting. Additionally, Mr. Wolfe noted that many of the Commission's enforcement actions are driven by inconsistencies between what registrants disclose publicly and their internal dialogue.

### Remarks from the PCAOB's Division of Enforcement and Investigations staff

William Ryan, Chief Counsel of the PCAOB's Division of Enforcement and Investigations, discussed the Division's enforcement actions for 2024, which included "making sanctions count," expanding on the types of cases pursued and extending its reach globally.

Mr. Ryan noted the Division broke its calendar-year penalty record by imposing $35 million in penalties. Of that, $25 million was collected from a Netherlands audit firm, the largest fine the PCAOB has ever imposed.

Mr. Ryan said the Division's priorities for 2025 remain primarily the same, and it will prioritize matters central to investor protection, including investigating significant audit and independence violations, as well as failure to cooperate with inspections or investigations, which erodes the integrity of the oversight process.

## Remarks by FASB Chair and staff

FASB Chair Richard Jones said the FASB's agenda and the decisions it makes in its projects are in response to feedback from its extensive stakeholder outreach. This input has helped the FASB and its staff identify financial reporting challenges and develop potential solutions through standard setting.

Mr. Jones said there are several due process documents outstanding for public comment and noted the FASB decided to stagger and extend certain comment periods to give stakeholders adequate time to provide feedback. He and Jackson Day, FASB Technical Director, also discussed the importance of cost and benefit considerations in the standard-setting process. Mr. Jones noted the next agenda consultation process is underway.

Mr. Jones and Mr. Day summarized the invitation to comment (ITC) process and discussed the recently issued ITC seeking stakeholder feedback on financial key performance indicators. Mr. Jones also previewed an upcoming ITC on the accounting for intangible assets.

Mr. Jones, Mr. Day and Helen Debbeler, FASB Deputy Technical Director, discussed the recently issued ASU on disaggregation of income statement expenses. Ms. Debbeler highlighted the FASB's current exposure drafts related to government grants, interim reporting, accounting for and disclosure of internal-use software costs, derivatives scope refinements and hedge accounting. She also provided an update on other FASB projects, including the expected exposure draft on accounting for environmental credit programs.

### How we see it

We encourage stakeholders to provide thoughtful and practical feedback to the FASB on its exposure drafts, ITCs and agenda consultation process, including proposing actionable solutions for challenging or complex accounting models or transactions.

Endnotes:

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[1] The American Institute of Certified Public Accountants.

[2] The Chartered Institute of Management Accountants (based in London).

[3] ASC 815-40-15.

[4] ASC 810-10-40-3A(c).

[5] ASC 280-10-50-4.

[6] Paragraph BC32 in the Background Information and Basis for Conclusions of ASU 2023-07.

[7] 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."

[8] Ms. Lamothe was named Acting Director of DCF effective 31 December 2024.

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