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THE NEWSLETTER FROM BDO'S NATIONAL ASSURANCE PRACTICE

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THE 2014 AICPA SEC AND PCAOB CONFERENCE

The annual AICPA National Conference on Current SEC and PCAOB Developments was held on December 8-10, 2014 in Washington, DC, where representatives of the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB) shared their views on various accounting, reporting, and auditing issues. The remarks made by members of the Office of the Chief Accountant are available on the SEC's website at www.sec.gov, under News/Speeches.

OVERVIEW

The issue as to whether US issuers will transition to International Reporting Standards (IFRS), which has remained dormant over the last few years, has now become a priority of the SEC. The SEC staff is exploring alternatives to adoption of IFRS and is considering allowing US issuers to voluntarily provide supplemental IFRS-based financial information.

There is also a renewed focus on disclosures. The SEC staff has undertaken a review of S-X and S-K requirements as part of a disclosure effectiveness project and the FASB has a disclosure framework project on its agenda. The ultimate goal for all parties is to provide disclosures that are most useful to investors in their decision making.

The following comments provide additional insight into the SEC and PCAOB staff positions on these and other accounting, reporting, and auditing issues.

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IFRS FOR US ISSUERS

In late 2008, the SEC proposed a roadmap for the potential use of IFRS by US issuers preparing financial statements for submission to the SEC. A spirited debate ensued, followed by years of silence. But that is all about to change. Noting that continued uncertainty around IFRS has resulted in uneasiness for investors worldwide, SEC Chair White has made this issue a priority.

Based on feedback received by the SEC staff, it appears that US stakeholders generally do not support full or optional adoption of IFRS for a number of reasons including legal concerns, implementation costs, and lack of comparability. Issuers are no longer demanding conversion to IFRS, perhaps in part due to the convergence achieved in several key areas of accounting standards. So the staff is exploring other alternatives that might allow US issuers to incorporate or align with IFRS and, in so doing, enhance comparability and provide investors with high quality information.

One alternative suggested by the SEC staff would allow US issuers to voluntarily provide IFRS-based financial information to supplement – not replace – financial statements prepared under US GAAP. Such an approach would retain the primacy of US GAAP for the protection of US investors, and yet allow for expanded use of IFRS, when appropriate. For example, IFRS-based information could be used to provide comparability for a US issuer whose competitors use IFRS. The volume of IFRS-based information voluntarily provided could also help gauge the appetite for IFRS information and whether further action may be warranted.

The current timetable envisions the SEC staff discussing alternatives with the Commissioners in the coming months and a recommendation exposed for public comment after that. The SEC staff noted that any alternative will raise issues and concerns. For example, the voluntary alternative suggested above raises questions as to presentation (e.g., complete financial statements, selected financial data, reconciliation to US GAAP), location (i.e., forepart or financial statements), and level of assurance (e.g., audit or not), among others. As a result, the SEC staff stressed that stakeholder participation in the process will be critical in charting the appropriate course for the US.

Regardless of the outcome, the SEC staff noted that the US is a primary user of IFRS (with other 500 IFRS foreign private issuers accessing US capital markets) and, as such, deserves "a seat at the international table." And the SEC staff reaffirmed that the FASB and the IASB should continue to strive, where practicable, for aligned high-quality global standards.

DISCLOSURE EFFECTIVENESS

There has been a general frustration with disclosure "overload" for years, as many disclosure requirements are considered to be voluminous, duplicative, or irrelevant. But interest in addressing the concerns increased in 2014, as the SEC staff was tasked with developing recommendations for updating disclosure requirements. The last comprehensive review was over 20 years ago. The SEC staff observed that the system is not fundamentally broken but acknowledged that it can be improved.

The project is focused on what information investors want and the implications to each issuer group. The goal is to update existing requirements to reduce costs and burdens on issuers, eliminate duplicative disclosures, and provide information which investors find most useful. Although the SEC staff is looking for ways to streamline disclosure, if gaps in disclosures or opportunities for increased transparency are identified, new disclosures may be recommended. The final outcome may be SEC filings viewed as effective communications tools and not just compliance documents.

The initial phase of the project is focused on business and financial disclosures that flow into periodic and current reports (10-K, 10-Q, and 8-K) and transactional filings. One team is addressing specific requirements in S-K and the Industry Guides and identifying, among other things, outdated disclosures (e.g., ratio of earnings to fixed charges), information that is now available from other sources (e.g., historical market prices), and redundant disclosures (e.g., off-balance sheet arrangements now addressed by US GAAP).

Another team is focused on S-X and financial statements for entities other than the registrant, such as acquired businesses, equity method investees, and guarantors. The rules can be both challenging and costly to apply and the financial statements may not satisfy the needs of the investor. Although the rationale when the rules were initially adopted still applies, there may be better ways to provide the information. For example, financial statements under Rule 3-05 do not reflect purchase accounting and although pro forma information helps, it has limitations. One avenue being explored is whether expanded pro forma information could replace historical financial statements and provide meaningful information to investors more quickly.

In later phases, differences in disclosure requirements in the 33 Act and the 34 Act will be considered (e.g., S-3 requirement to recast financial statements). Opportunities to harness technology to share information in more meaningful ways will be explored (e.g., hyperlinks

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or better use of Edgar). And a "core disclosure" system, where information that does not change frequently is supplemented by periodic and current reports, will be considered.

All stakeholders – issuers, investors, and others – were encouraged to contribute to the team effort and share their views with the SEC. A page has been set up on the SEC website for this specific purpose. In the meantime, the SEC staff suggested that registrants can improve the focus and usefulness of their disclosure documents, in the absence of rule changes, by reducing repetition, focusing the disclosures, and eliminating outdated information.

REVENUE RECOGNITION

In May 2014, the new standard on revenue recognition was issued, marking a significant milestone in the convergence efforts of the FASB and the IASB. But more work is required. Companies are now faced with implementation issues involving both accounting (i.e., how to apply the standard) and process (i.e., process and system changes to produce necessary information). As stressed by the SEC staff, a successful implementation of the standard is critical to ensure comparable, high-quality financial reporting for investors.

Accounting questions posed to date range from those that may require action on the part of the FASB to those that may simply need clarification as to the FASB's intent. The hope is that the FASB will ultimately be able to focus on the more novel and interpretive questions that are arising in connection with new principles introduced in the standard. Since comparability is a hallmark of US financial reporting, identifying and addressing potential diversity during the implementation stage – not after adoption – is a priority.

The SEC staff noted that the standard cannot be implemented in a timely and consistent manner until the accounting questions are addressed. This is particularly true for registrants that intend to apply the standard retrospectively and need to put new processes in place to capture the necessary data. As a result, unresolved questions regarding the identification of performance obligations and accounting for licenses may impact the ability of registrants to implement the standard by its current effective date. The SEC staff acknowledged that such issues could potentially delay the adoption date.

Internal controls over financial reporting should also be considered as registrants implement the new revenue standard. The SEC staff suggested registrants consider the adequacy of controls early in, and throughout, the implementation process and install new controls or redesign existing controls, where necessary. For example, new controls may be needed to support management estimates regarding variable consideration or disclosures of remaining performance obligations, among others. To the extent changes are made in advance of adoption, registrants should be mindful of their quarterly obligations to disclose material changes to their internal controls.

The SEC staff also reminded registrants about guidance issued earlier this year regarding selected financial data. To not discourage retrospective adoption, registrants may continue to present the earlier years under the old basis of accounting. Disclosure that describes the basis and highlights the lack of comparability would be required.

INTERNAL CONTROL OVER FINANCIAL REPORTING (ICFR)

Consistent with prior years, the SEC staff is concerned that material weaknesses are not being properly identified and disclosed. Disclosure is required if there "could" be a material misstatement, not just when an error actually occurs. But in practice, rarely is a material weakness identified in the absence of a material restatement. The SEC staff attributes this, in part, to an inappropriate focus on the actual error and not the control deficiency. Generally, such an approach will not result in a full understanding of the limitations of a control or sufficient remediation.

The SEC staff continues to believe that the top-down, risk-based approach is most effective in determining whether material weaknesses exist. Such an approach focuses on what could happen in the context of current and evolving financial risks and not just on what did. This is particularly important in connection with misstatements where management might otherwise assess the risk too narrowly (i.e., focus on the error rather than the risk).

Similarly, a full and accurate description of a deficiency helps management focus on the underlying cause, not the error. When describing a control deficiency, the SEC staff suggested management consider factors such as: (a) nature of the deficiency (e.g., design or operating effectiveness), (b) impact on financial reporting and ICFR, (c) cause, (d) how the deficiency was discovered, and (e) measures necessary to remediate. Statements and descriptions that focus only on the error may call into question management's understanding of the implications of the deficiency and whether the severity was appropriately evaluated.

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As part of the "what could go wrong" assessment, management should consider the nature and extent of any changes in the risks to reliable financial reporting. Changes can result from a variety of sources including changes in the business (e.g., expansion into a foreign market or growth through a new VIE), nature of transactions (e.g., unique customer terms), overall business environment, and accounting requirements (e.g., new revenue standard).

The SEC staff also reminded registrants that the Committee of Sponsoring Organizations of the Treadway Commission (COSO) stopped supporting the original 1992 framework in mid-December 2014. The SEC staff will not object if registrants use the 1992 framework for their 2014 ICFR assessments, but cautioned that the longer registrants wait, the more likely it is that the SEC staff will question the acceptability of the 1992 framework. During this transition period, management should continue to identify the framework used in its assessment.

ACCOUNTING ISSUES

The SEC staff shared its views on various accounting issues recently addressed in both formal and informal consultations – but with a qualifier. The SEC staff cautioned registrants not to place too much reliance on staff speeches. The issues addressed involve considerable judgment, many scenarios are complex, and the conclusions are based on specific facts and circumstances. The SEC staff stressed that the objective in sharing these views is not to provide absolute assurances but rather, a level of transparency into some of the issues addressed and the current thinking of the SEC staff (which may evolve over time).

Similar caution should be exercised when considering non-authoritative guidance (e.g., firm guides). Such guidance does not go through a deliberative or open process and will be challenged by the SEC staff if it feels it is inconsistent with US GAAP (i.e., does not provide a safe harbor). When analyzing the accounting, the SEC staff encouraged registrants to focus on the standards and prepare thoughtful, researched analyses that include, when available, an understanding of what the standard setters sought to achieve (e.g., basis for conclusions).

PREFERRED SHARES

When a debt instrument is amended or exchanged, the transaction is accounted for as a modification or extinguishment based on specific guidance in US GAAP focused on the significance of the change. Although similar guidance does not exist for amendments or exchanges involving preferred shares, the SEC staff believes that the same basic principle should apply (i.e., accounting driven by significance). The SEC staff identified four approaches used in practice and the thresholds that would trigger extinguishment accounting under each:

- Qualitative – the changes in contractual terms, along with the business purpose and the potential influence of such changes on the economic decisions of the investor, are deemed significant.
- Fair value – the fair value of the preferred shares, immediately before and after the changes, changes by 10% or more.
- Cash flows – same as the fair value approach but cash flows – not fair values – are compared.
- Legal form – a legal exchange that results in the issuance of new preferred shares.

All the approaches would seem to yield reasonable conclusions. But the SEC staff cautioned that the cash flow approach is only appropriate if there are well-defined periodic contractual cash flows. Further, the legal form is just one data point to consider when evaluating the accounting and alone would not be determinative.

For changes that are not accounted for as extinguishments, the SEC staff stated that analogizing to share-based payment guidance on modifications (ASC 718) would be appropriate. The carrying value of preferred shares would be increased for incremental fair value, if any, with an offsetting deemed dividend or, in certain unique circumstances, expense (e.g., compensation for agreeing to restructure). Whether the incremental fair value should be charged to equity or earnings would depend on the underlying purpose for, and circumstances surrounding, the modification.

CONVERTIBLE INSTRUMENTS

When financial instruments are issued in an arm's length transaction, the general expectation is that the proceeds received will equal the fair value of the financial instruments issued. But for entities in financial distress and requiring financing, that is often not the case. Such companies may be forced to issue "sweeteners" and the fair value provided the investor or lender may exceed the proceeds received. For example, a registrant may issue $10 million of convertible debt with an in-the-money conversion option valued at $12 million. If the conversion feature is bifurcated and measured at fair value (i.e., qualifies for derivative accounting) a question arises as to how to account for the $2 million.

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In such a situation, the SEC staff stated that registrants should verify that: (a) the fair value ascribed to the financial liability is appropriate, (b) the transaction was conducted on an arm's length basis and no related parties were involved, and (c) no rights or privileges that would qualify as assets were received. If the answer to each question is yes, the excess fair value should be recognized as a loss. Given the unique nature of such a transaction, the SEC staff would expect robust disclosure that describes why the entity entered into the transaction and the benefits received.

GOODWILL IMPAIRMENT

In connection with the adoption of Statement 142 (now ASC 350) in 2002, the SEC staff concluded that a change in the goodwill impairment testing date was a change in accounting principle and, if goodwill was material, a preferability letter was required. This position was based on the fact that the use of fair value measurements in US GAAP was relatively new and the change to a new impairment date represented a change in the method of applying an accounting principle.

The accounting landscape has changed considerably over the last decade. All parties – issuers, auditors, and regulators – have gained more experience and comfort in applying fair value. And in light of the internal controls in place today, coupled with the interim assessments in the event of certain triggering events, such a change is not expected to have a material effect on the financial statements. As a result, some registrants do not view this as a material change in method, even if goodwill is material to the financial statements.

As a result, the SEC staff announced a change in position. If the change in testing date does not represent a material change in the method of applying an accounting policy (an assessment that may be qualitative), a preferability letter will not be required. However, such a change must be prominently disclosed in the financial statements.

DEFINED BENEFIT PLAN OBLIGATIONS

Mortality is a key assumption used in measuring a defined benefit plan's costs and obligation. In late 2014, the Society of Actuaries (SOA) published updated mortality tables that reflect improved longevity and questions regarding the appropriateness and use of the data soon followed. Since plan sponsors have historically used the SOA mortality data, the SEC staff believes it would be inappropriate for registrants to disregard the new data in determining their best estimate of mortality. Further, the impact of the change should be disclosed if it results in a significant change in the benefit obligation.

JOINT VENTURES

There is no guidance in US GAAP on how to account for contributions of assets and businesses in the stand-alone financial statements of a joint venture. Joint ventures are scoped out of business combination accounting (ASC 805) and no alternative accounting has been provided. As a result, in practice assets and liabilities are reflected at full or partial step-up basis by some joint ventures and at predecessor basis by others. This diversity has created a lack of comparability for transactions that are substantially similar.

Determining whether an entity qualifies as a joint venture is a critical first step in assessing the accounting, one that requires significant judgment. The formation of an entity that is not a joint venture could be a merger or put-together transaction that should be accounted for as a business combination. When making such an assessment, the SEC staff believes all characteristics of a joint venture captured in the US GAAP definition should be met, not simply joint control, and the purpose of the entity should be consistent with that of a joint venture.

The SEC staff publicly called on the FASB to provide clarity on the definition of joint venture and guidance on the accounting in stand-alone financial statements. In the meantime, registrants were encouraged to continue to consult with the staff on joint venture formation transactions.

SPINOFFS AND REVERSE SPINOFFS

In the current climate, spinoffs are occurring with some regularity. The SEC staff continues to field questions and shared some observations on the accounting and financial statement requirements. The basic question is whether a proposed transaction should be accounted for as a spinoff or a reverse spinoff. When identifying the accounting spinnor, management should focus on the explicit indicators in US GAAP consisting of: (a) relative size of the entities, (b) relative fair value of the entities, (c) which entity will retain senior management, and (d) length of time each entity will be held after the spinoff.

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However, US GAAP contains a rebuttable presumption that a spinoff should be based on the legal form. Tax planning consequences, once viewed as a potential indicator of a reverse spinoff, are no longer an explicit indicator. As a result, the SEC staff cautioned that significant judgment is required, particularly when indicators are mixed, to overcome the presumption and conclude a transaction is a reverse spinoff. If a transaction is determined to be a reverse spinoff (accounting spinnor/legal spinee), carve out financial statements – not registrant financial statements – may be required based on the unique facts and circumstances of the transaction.

VARIABLE INTEREST ENTITY (VIE) CONSOLIDATION MODEL

Under US GAAP, when power over a VIE is shared there is no primary beneficiary and no consolidation. For shared power to exist, all decisions related to the significant activities of the VIE must require the consent of each party sharing power. The SEC staff described a scenario in which multiple parties share decision making rights over certain significant activities and have unilateral decision making rights over the remaining significant activities. In this fact pattern, the party with more power, relative to the others, over the significant activities of the VIE, should consolidate. The SEC staff also highlighted that only decisions related to significant activities should be considered in this primary beneficiary assessment.

DISCLOSURES

COMMENT LETTER OBSERVATIONS

Consistent with prior years, the SEC staff provided observations based on the filing review process. But first, the SEC staff attempted to dispel some myths about the process. The purpose of SEC reviews is to provide investors with information that will assist in their decision-making. Cross-references that lessen duplication, and enhance the usefulness of a document, are wholly supported by the SEC staff. Comments are not an automatic request for additional disclosure but rather the beginning of a dialogue. Lastly, the comment process should not be viewed as a barrier to improved disclosure; changes in disclosure from one year to the next are not tracked by the SEC staff and will not automatically trigger a comment.

The SEC staff also identified the following frequent areas of comment and provided suggestions for registrants to consider:

- Critical accounting estimates – should describe the assumptions in estimates that subject them to change and not replicate accounting policies. For example, a discussion on goodwill should describe any uncertainties, identify key assumptions and assess the likelihood of impact (e.g., recovery from a downturn in revenue).
- Known trends or uncertainties – should address events that are reasonably expected to have a material impact in future periods, not just those that have impacted the current period. For example, the loss of a significant customer would require discussion even if the impact on the current period was not material.
- Results of operations – should provide detail sufficient to understand an income statement line item that goes beyond information in the notes. For example, a registrant with foreign taxes should describe what makes up foreign tax expense, identify the countries involved, and disclose the statutory and effective tax rates for each.

Certain US GAAP disclosures that are often overlooked were also highlighted. In connection with segments, registrants should disclose if reporting segments are an aggregation of operating segments and provide entity-wide disclosures, including revenue for each product and service (or group of similar products and services), unless impracticable. Regarding fair value, when assets and liabilities are measured at fair value on a non-recurring basis in periods subsequent to initial recognition (e.g., impaired assets) registrants should disclose the reasons for the change, the valuation method and assumptions used, and the applicable level within the fair value hierarchy. The SEC staff also noted that if there is no impairment of an intangible asset or goodwill and one may be indicated, it may comment on the fair value measurement.

SEGMENTS

In late 2012, the post-implementation review of Statement 131 (now ASC 280) was completed. Although it did not suggest any further action on the part of the FASB was required, it did highlight a lack of compliance with the standard. As a result, the SEC staff continues to focus on segment disclosures and put registrants on notice that it will be taking a “refreshed approach” in the upcoming filing reviews. The SEC staff also shared its current thinking on how to apply the provisions of the standard:

- Chief operating decision maker (CODM) – the CODM is the individual who makes key operating decisions and may be someone closer to the day-to-day operations (e.g., may not be a CEO whose focus is on strategic decisions).

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- Operating segments – the CODM report is simply a data point to consider in identifying operating segments and is not alone determinative. Other data points might include the organization chart, overall management structure, the basis on which budgets and forecasts are prepared, and the basis on which executive compensation is determined.
- Aggregation of operating segments – aggregation by design is a high hurdle with no bright lines. It is only appropriate if: (a) aggregation is consistent with the underlying principle in the standard, (b) operating segments have similar economic characteristics, and (c) operating segments are similar in each of five specific areas.

The SEC staff stressed that aggregation is based on the principle that separate reporting will not add significantly to an investor's understanding of an entity if operating segments have characteristics that are so similar they can expect to have the same future prospects. In the SEC staff's experience, most entities will have more than one, but less than ten, reportable segments.

INITIAL PUBLIC OFFERING (IPO)

The IPO market has been, and continues to be, very active. To help potential registrants navigate the process, the SEC staff shared a couple tips. First, all financial statements required at the time of initial filing (or initial confidential submission) must be included to initiate the review. Companies cannot omit the earliest year required, under the assumption that the year will be replaced with the most recent fiscal year prior to effectiveness.

Second, stock compensation is generally a critical estimate for a private company going public. Since the shares are privately held, fair value estimates used for pre-IPO share grants can be complex and highly subjective. The required disclosures, outlined in section 9520.2 of the Financial Reporting Manual, were streamlined in early 2014. They now focus on the methods and assumptions used in determining fair values (including the level of complexity and subjectivity in the estimates) and a statement that estimates will not be required once the shares begin trading. If the SEC staff asks for more detailed information or explanations for fluctuations, it is simply to confirm that the appropriate accounting has been applied and not a request for additional disclosure.

CURRENT ACCOUNTING ISSUES

Consistent with prior years, a panel of technical partners from the national offices of the large accounting firms discussed a number of current practice issues.

CASH FLOW STATEMENTS

Errors in cash flow presentation occur with regularity, despite clear guidance in US GAAP. For example, fixed assets in accounts payable are frequently reflected as an investing cash outflow (with an offset in operating). Until actually paid, this is a non-cash transaction that should be supplementally disclosed, if material. Similarly, purchases and sales of a noncontrolling interest (NCI), by an investor that retains control, are often reflected as an investing activity. Since NCIs are by definition owners, such transactions should be reflected as a financing activity and the associated costs should be presented in a manner consistent with the accounting (i.e., operating if an expense and financing if charged to equity).

In some cases no specific guidance exists and the result is diversity in practice. For example, payment of contingent consideration related to a business combination is generally reflected as a financing activity for the initial value and an operating activity for subsequent changes. However, some registrants view contingent consideration as part of purchase consideration and accordingly reflect all payments as an investing cash outflow. In such situations, there should be transparent disclosures in the financial statements or notes sufficient to describe the approach taken and why.

The SEC staff noted that restatements involving cash flows continue to increase year over year. Since the majority of errors do not result from complex applications of US GAAP, as demonstrated by the observations above, registrants were advised to revisit their processes and controls for preparing statements of cash flows.

ASSET ACQUISITION OR BUSINESS COMBINATION

The accounting for a business combination or an asset acquisition is dramatically different. Costs, such as transaction costs or IPR&D, may be capitalized or expensed. Contingent consideration may be recorded at the time of acquisition or when considered probable. These differences make determining whether a company is acquiring a business or an asset critical. The assessment is often challenging in practice,

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particularly in certain industries such as real estate (e.g., a commercial building with tenants and leases) and life sciences (e.g., a license for product candidates with researching resources).

The FASB has a project on the definition of a business that may clarify the issue or lead the FASB to reconsider the inconsistencies in treatment that currently exist, but it is in its infancy. Until then this is an area that continues to require significant judgment.

STOCK COMPENSATION

Under a long held SEC staff view, the IPO price is presumed to reflect the fair value of common shares for the immediately preceding twelve months (the "cheap stock" issue). In other words, if shares or awards are granted during the preceding one year below the IPO price, they are presumed to be compensatory. Objective evidence that may rebut the presumption includes contemporaneous valuations that reflect management's knowledge at the time or transactions involving third parties. Today, companies generally have contemporaneous valuations performed, primarily for income tax purposes (409A valuations). In the event of an IPO, they are also used to support the fair values ascribed to shares granted during the pre-IPO period.

However, other transactions may occur during this timeframe. Preferred shares may be repurchased or sold and employee options may be sold to outside third parties (a secondary market). The prices paid in such transactions may create a price discrepancy that suggests common shares were granted at a substantial discount. Based on the specific facts and circumstances, compensation expense or a deemed dividend may need to be recognized. Companies were cautioned not to place undue reliance on a 409A valuation since it is not a safe harbor for US GAAP purposes.

AUDIT COMMITTEES

The Sarbanes-Oxley Act significantly expanded the roles and responsibilities of audit committees. Today audit committees play a critical role in providing oversight over a company's financial reporting system. But the disclosure requirements of the audit committee, dating back to 1999, have not kept pace. Investors want to hear more from audit committees; other jurisdictions are reassessing the adequacy and usefulness of disclosures; and some audit committees have taken the initiative to provide enhanced disclosures beyond those required. As a result, the SEC staff is in the process of considering current audit committee disclosure practices and public observations and communications to determine whether improvements can be made.

Auditor independence – in both fact and appearance – is the foundation of an audit and essential in retaining objectivity and promoting credibility. The SEC staff believes that auditors, management, and audit committee members all share responsibility for auditor independence. Consistent with last year, the SEC staff encouraged management and audit committee members to consider whether the policies and procedures in place are sufficient to evaluate non-audit services provided by a company's auditors. Such policies should include continuous monitoring to ensure that expansions or changes in services ("scope creep") do not result in impermissible services that would impair auditor independence. Unplanned auditor changes and potential re-audits can be costly, serve as a distraction to management, and interfere with capital raising plans.

INTERNATIONAL ISSUES

VENEZUELA

Venezuela is in a state of flux with circumstances changing all the time. The economy is considered highly-inflationary, multiple – and widely disparate – exchange rates exist, and companies continue to have difficulty accessing US dollars. With this as the backdrop, the SEC staff reminded registrants that they are obligated to address known trends in MD&A. Registrants with significant operations in Venezuela should consider disclosing: (a) summarized financial information for Venezuelan operations, (b) the exchange rates used for translation purposes, and (c) net monetary assets and liabilities exposed to exchange rate changes, if material. A complete list of recommended disclosures is included in the minutes of the May 2014 meeting of the International Practices Task Force which are available on the CAQ website.

RULE 3-09 FINANCIAL STATEMENTS

Under Rule 3-09 of S-X, registrants are required to provide financial statements for significant equity method investees. Applying the significance test and understanding the financial statement requirements can be confusing, particularly in a cross border arrangement involving domestic and foreign entities. The SEC staff provided the following clarification:

- The significance test is based on the accounting used by the registrant (the registrant GAAP).
- The content and presentation of financial statements is based on the investee and whether or not it qualifies as a foreign business.
- A reconciliation to US GAAP is required if the financial statements are prepared under home country GAAP and significance exceeds 30%.
- If pro forma is required, it is based on the registrant GAAP.

FOREIGN PRIVATE ISSUERS

The SEC staff has been involved in a number of IPO filings involving entities under common control or a put-together of various entities. Since IFRS does not provide direct guidance on such transactions, companies were encouraged to discuss the accounting with the SEC staff in advance of any filing. Consistent with prior years, XBRL data for IFRS filers will not be required for 2014.

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STANDARD SETTING ACTIVITIES

Investor confidence in financial reporting is predicated on high quality audits that are performed objectively by independent auditors. The SEC staff believes that the most effective way to improve audit quality is to update standards that directly address auditor performance and incorporate the knowledge gained through the inspection process and public information on restatements and other data. As a result, the SEC staff expressed concern with the PCAOB's continued focus on standards on auditor reporting and rotation which, although important, are not as critical.

The SEC staff also expressed frustration over the pace at which audit standards are vetted and adopted. Over the past few years, the SEC staff has publicly encouraged the PCAOB to accelerate the pace of standard setting. Despite these pleas, the SEC staff noted a continued lack of progress and a significant standard setting backlog. Although standards such as audit estimates, including fair value measurements, and use of other auditors and specialists have been on the PCAOB agenda and discussed for several years, they have not advanced for public comment. As a result, the SEC staff has committed to working jointly with the PCAOB staff to take a fresh look at the standard setting process and help identify improvements that will speed up the timing of a project from inception to adoption or termination.

INSPECTIONS

In planning for the 2014 audits, the PCAOB staff encouraged registrants and auditors to consider recent events involving the economy and environment. Such events may have a significant effect on financial reporting risks and will be a focus for the 2015 inspections. For example, high cash levels and low interest rates have created significant M&A activity so that business combinations (both auditing the transactions and the underlying controls) may be a significant area of risk. As US issuers continue to grow their profits in lower tax jurisdictions, undistributed earnings and cash held overseas can create risks in income tax accounting and disclosure. Risks regarding cybersecurity, in light of recent hacking episodes, and falling oil prices, should also be considered.

Based on recent inspections, the PCAOB identified other areas that may warrant more attention. The most common deficiencies relate to audits of internal controls (which generate the highest number of deficiencies), assessing and responding to risk of material misstatement, auditing fair value measurements and estimates, and testing of data and reports. The most frequent findings in terms of financial statement areas relate to revenue recognition, inventory, goodwill, intangible assets, and business combinations.

Board member Jay Hanson noted that individual firm inspection reports, which serve as the PCAOB's primary avenue for communicating findings, have improved. Reports are issued more timely and now cite the auditing standard that gives rise to each deficiency. But he acknowledged more is needed to make these reports more meaningful and noted that providing context might be one avenue to explore. For example, deficiencies may result from non-compliance with firm policy or inadequate firm guidance. An audit may have been a "train wreck" or a one-off deficiency that is easy to address. Being able to drill down and understand these distinctions would be useful.

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The PCAOB staff continues to be barred from performing inspections in some foreign jurisdictions including certain countries in Europe, as well as China and Hong Kong (whose issuers combined have a market capitalization in excess of $1 trillion). This lack of access continues to be a concern. The PCAOB staff believes that, without the benefit of PCAOB inspections, audit quality in these parts of the world will continue to lag and Investors will continue to face additional risks.

AUDIT QUALITY INDICATORS (AQIS)

The PCAOB staff project on AQIs continues. The purpose of the project is to provide indicators that could be used by audit committees in evaluating the audit. The indicators, which would be quantitative measures, could provide a degree of objectivity when assessing the quality of an audit and facilitate an open dialogue between the auditors and the audit committee members.

A concept release, which was originally slated for 2014, has been delayed. But during the intervening time, the PCAOB staff noted it has gained knowledge through outreach efforts and momentum has grown, both domestically and abroad. Investors are even suggesting that AQIs should be publicly available to allow comparisons between companies. A concept release is expected to be issued in the first quarter of 2015.

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