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THE NEWSLETTER FROM BDO'S NATIONAL ASSURANCE PRACTICE

BDO KNOWS: SEC

SEC YEAR IN REVIEW

CONTENTS

SIGNIFICANT 2017 DEVELOPMENTS

Unlike the past few years, the Securities and Exchange Commission's 2017 agenda was not dominated by Congressionally-mandated rulemaking activities (e.g., rulemaking required by the Dodd-Frank Act, the JOBS Act, and the FAST Act). With the change in administration and Chair White's departure at the end of President Obama's term in January, the SEC's activities were largely driven by the new SEC Chairman, Jay Clayton, who was sworn in on May 4. After Chairman Clayton's arrival, two of the five Commission seats remained vacant until December 21 when President Trump's nominees to fill those seats, Hester Peirce (a Republican) and Robert Jackson (a Democrat) were confirmed by the Senate. While some speculated that Chairman Clayton would wait for a full Commission before undertaking major initiatives, in December the Commission took a significant step, appointing an entirely new Public Company Accounting Oversight Board. The Disclosure Effectiveness Initiative projects begun under Chair White raised a large number of significant issues that will take time to consider and address. Therefore, it is not surprising that we did not see significant rulemaking activities that affected financial reporting in 2017.

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Prior to being sworn in as Chairman, Jay Clayton was a securities lawyer at a major law firm. Based on his guiding principles and policy views, it is clear that his background working with companies in the capital markets will influence Commission activities. He was quickly vocal about his concern over the declining number of public companies in the U.S., addressing this in his initial **speech** as Chairman. Throughout 2017, he has highlighted his intent to focus on capital formation activities because he believes they will (1) help businesses raise the money they need to grow and (2) provide more ways for "Mr. and Ms. 401(k)" to participate in the growth of small and medium sized companies. Recognizing that rulemaking takes time, the SEC staff implemented important policy changes in 2017 to immediately facilitate capital formation. They include:

- Expanding the classes of issuers and transactions eligible to submit draft registration statements for nonpublic review by the staff;
- Updating staff compliance and disclosure interpretations (C&DIs) to expand circumstances in which financial statements that are otherwise required by the rules but will not be needed at the time of the official filing or offering can be omitted from earlier versions of registration statements; and
- Making greater use of the delegated authority provided to the staff under Rule 3-13 of Regulation S-X to waive financial reporting requirements when the disclosures may not be material to the total mix of information available to investors. The staff updated its Financial Reporting Manual (FRM) in August with staff names for each S-X topical area and phone numbers to call to discuss the process for seeking relief.

One of Chairman Clayton's other key focus areas is cybersecurity – i.e., ensuring that registrants are timely identifying, managing and disclosing cybersecurity risks to keep investors informed about cyber threats and breaches on a timely basis. For now, registrants are directed to the staff's cybersecurity disclosure guidance issued in 2011, which remains relevant today. Nonetheless, William Hinman, the new Director of the Division of Corporation Finance appointed in May, has signaled the potential need for Commission-level interpretive guidance on cybersecurity disclosures to further emphasize their importance. Furthermore, the newly appointed Co-Directors of the Enforcement Division, Stephanie Avakian and Steven Peikin, announced the creation of a Cyber Unit[1] in September that will focus on cybersecurity fraud.

Meanwhile, both the Commission and staff continued their work on the SEC's Disclosure Effectiveness Initiative, a broad-based review of the SEC's disclosure rules designed to improve the disclosure regime for both companies and investors. Such activities included:

- Final rules requiring the use of hyperlinks to exhibits in filings;
- A request for comment on possible changes to Industry Guide 3, *Statistical Disclosure by Bank Holding Companies*;
- Proposed amendments required by the FAST Act to modernize and simplify certain disclosure requirements in Regulation S-K; and
- Proposed rules to require the use of "Inline XBRL."

With the change in the administration at the beginning of the year and proposed Congressional legislation that would revise or eliminate certain Dodd-Frank Act disclosure requirements, some speculated that the requirements would be rescinded in 2017. While this has not happened, there were several notable developments related to Dodd-Frank Act related disclosure rules. In February, President Trump signed a resolution passed by Congress which nullified the resource extraction issuer disclosure rule. In April, a U.S. District Court entered a final judgment in the ongoing lawsuit related to the SEC's conflict minerals rule. The Court set aside those portions of the rule that require companies to report that any of their products have not been found to be conflict free. As a result, the SEC staff indicated that it will not enforce compliance with certain aspects of the rule. And lastly, in September, the Commission and staff issued interpretive guidance to assist companies in their efforts to comply with the pay ratio disclosure rule which will take effect with the spring 2018 proxy season.

The staff was also very focused on registrants' readiness to implement the significant new accounting standards that take effect in 2018 (revenue standard) and coming years (particularly, the new leases and current expected credit losses standards), urging management, audit committees and auditors to "keep going/get going" and "finish strong." The staff continued to emphasize this at the AICPA Conference on SEC and PCAOB Developments (the Conference) held December 4-6 in Washington D.C. The staff offered several other **observations** and insights about the implementation and application of these standards that registrants should keep in mind going forward. Other key topics and themes of the Conference included capital formation activities (the staff emphasized that they are "open for business" when it comes to considering requests for relief), disclosure effectiveness,

1 Refer to Stephanie Avakian's **speech** from October 26th for further information about the Cyber Unit.

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and cybersecurity. Tax reform was highlighted as a new emerging area of focus given the significant impact it could have on registrants' operating results, cash flows and disclosures. For further insights on this, see our BDO Knows: Tax Reform newsletter available **here** .

The staff issued other guidance throughout the year to assist registrants and others with interpreting and complying with the SEC's rules and regulations. The highlight was the issuance of Staff Accounting Bulletin No. 118 a related C&DI that address accounting and Form 8-K reporting for the effects of the Tax Cuts and Jobs Act. This guidance was issued on December 22 – the day the Act was signed into law. The staff also updated its C&DIs and the FRM for reporting matters unrelated to the capital formation activities noted above.

In October, the SEC approved a new PCAOB auditing standard and related amendments that will result in the first significant change in auditor reporting since the 1940s. The standard requires new information about Critical Audit Matters and auditor tenure and a statement on independence, among other changes. Like the Commission, the PCAOB also did not operate with a full Board in 2017. Of the five PCAOB Board seats, one was vacant and three were held by members whose terms expired in 2017. As noted above, the SEC addressed this on December 12, announcing the appointment of an entirely new board, consisting of Chairman William Duhnke III and new Board members, J. Robert Brown, Kathleen Hamm, James Kaiser, and Duane DesParte.

As we look forward to 2018, we expect continued progress on the Disclosure Effectiveness Initiative. The staff has signaled that it expects the Commission to adopt final rules to eliminate outdated and redundant disclosure requirements and potentially propose rules to modernize Rules 3-05 and 3-10 of Regulation S-X and further scale disclosure for smaller companies. The staff is working on a major refresh of the FRM, which has not had a comprehensive update since it was first issued in 2008. We also expect the staff to continue its focus on the implementation of, and disclosure issues related to, the significant new accounting standards.

This publication summarizes 2017 Commission rulemaking and activities, staff activities and guidance, and other practice issues covered at the Conference that affect financial reporting. We discuss rulemaking, other activities and staff guidance first, followed by practice issues. While not the focus of this newsletter, we also discuss the relevant PCAOB 2017 standard-setting and related activities.

COMMISSION ACTIVITIES

CAPITAL FORMATION

As mentioned above, Chairman Clayton is keenly focused on capital formation activities. Several SEC staff activities and policies announced in 2017 underscore the SEC's efforts to facilitate capital formation.

Confidential Submissions

In June, the SEC staff announced that it was making the confidential submission process (i.e. submission of draft registration statements for nonpublic review) available to an expanded class of issuers and transactions including the following:

- Initial public offerings of common equity securities under the Securities Act made by all companies – not just emerging growth companies (EGCs). Under this program, the Division of Corporation Finance requires that the Securities Act registration statement (e.g., Form S-1), as well as the initial confidential submission and all amendments, be publicly filed with the SEC no later than 15 days prior to any road show or, if there is no road show, the requested effective date of the registration statement;
- Initial registrations of a class of securities under Exchange Act Section 12(b) on Forms 10, 20-F or 40-F (e.g., an initial listing on a national exchange or registration in connection with a spin-off transaction); and
- Securities Act registration statements within one year of an IPO or Exchange Act Section 12(b) registration.

Previously, the confidential submission process was only available to EGCs and certain foreign private issuers (FPIs) conducting IPOs on a Securities Act registration statement (e.g., Forms S-1 and F-1). The confidential submission program addresses concerns some companies may have about publicly disclosing sensitive or proprietary information early in the IPO process. It also allows companies to start the IPO process away from public attention while considering other alternatives.

The staff also issued a set of **frequently asked questions** about the expanded procedures. Issuers may submit any questions about their eligibility to use the expanded processing procedures contained in the announcement to **CFDraftPolicy@sec.gov**.

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Financial Statement Requirements in Registration Statements

In August, the SEC staff updated its **C&DIs** related to the circumstances in which financial statements may be omitted from registration statements. Whether financial statements may be omitted depends on whether (1) the registrant is an EGC or not, (2) the financial statements are annual or interim financial statements, and (3) the document is a confidential draft submission or a publicly filed registration statement.

- C&DI 101.04 now states that EGCs may omit interim financial information from draft registration statements that they reasonably believe they will not be required to present separately at the time of the offering. Previously, EGCs were not permitted to omit interim financial statements from their filed or draft registration statements if the interim period relates to an annual period required at the time of the offering.

  For example, under the staff's new policy, a calendar year-end EGC that submits a draft registration statement in November 2017 and reasonably believes that it will commence its offering in April 2018 (when annual financial information for 2017 will be required) may omit its 2015 annual financial information and the nine-month interim financial statements for 2016 and 2017 because this information will not be required at the time of the offering in April 2018. However, if this same EGC publicly files the registration statement in January 2018, it must include the nine-month interim financial statements for 2016 and 2017 because they relate to annual periods that will be required at the time of the offering. The staff made conforming updates to the **FAST Act C&DIs** to reflect this change (see Question 1).

- C&DI 101.05 now states that non-EGCs may also omit interim financial statements from draft registration statements that they reasonably believe will not be required to be included at the time the registration statement is publicly filed. Non-EGCs are not permitted to omit any interim or annual financial information at the time the registration statement is publicly filed.

  For example, a calendar year-end non-EGC that submits a draft registration statement in November 2017 and reasonably believes it will first publicly file in April 2018 when annual financial information for 2017 will be required may omit from its draft registration statements its 2014 annual financial information and interim financial information related to 2016 and 2017 because this information would not be required at the time of its first public filing in April 2018.

In summary, based on the staff policies about the required financial statements in draft and publicly filed registration statements:

	Draft Registration Statements	Publicly Filed Registration Statements
EGCs	May omit annual and interim periods that will not be required to be presented separately at the time of the offering.	May omit annual periods that will not be required at the time of the offering. May not omit interim periods that relate to longer historical periods required at the time of the offering.
Non-EGCs	May omit annual and interim periods that will not be required to be presented separately at the time of the public filing.	May not omit annual or interim periods at the time of the public filing.

Conforming edits were also made to the **FRM** (see paragraphs 10220.1 and 10220.5).

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BDO OBSERVATIONS:

In planning the timetables for their offerings, registrants should take into account the fact that if recent financial statements are omitted from confidential submissions, this could increase the amount of time it will take the staff to review updated financial statements when they are provided. Registrants should keep timing implications in mind when deciding whether to take advantage of these accommodations.

The ability to omit certain financial statements also applies to FPIs. The age of financial statements rules in Item 8 of Form 20-F require financial statements of a FPI to be as of a date within nine months of the effective date of a registration statement. As a result, interim financial statements covering at least the first six months of a financial year may be required. Additionally, more recent interim financial information published by an FPI in its home market must be included in a registration statement. At the Conference, the SEC staff clarified that the guidance for the omission of financial statements also applies to this additional home market interim financial information.

Rule 3-13 Waivers

Under Rule 3-13 of Regulation S-X, a registrant may request a waiver or modification of its SEC reporting requirements, and the SEC staff may grant the request where doing so is consistent with the protection of investors. In his first speech as Chairman, Clayton encouraged registrants to consult with the staff on these matters, particularly when the disclosures called for by the rules are not material to the total mix of information available to investors and such modifications might be helpful in connection with capital raising activities. Clayton also assured registrants that the staff is placing a high priority on responding to such requests with timely guidance. In August, the staff updated the FRM to include a section preceding the table of contents that describes how registrants may communicate with the Division of Corporate Finance's Office of the Chief Accountant when requesting reporting relief under S-X Rule 3-13, answers to interpretive request letters or informal interpretive advice, or help in explaining the SEC's rules, regulations, forms and guidance. A staff name for each S-X topical area and the phone number to call are provided.

At the Conference, the staff encouraged registrants to call the staff to discuss the issue before submitting a pre-filing letter that requests relief or interpretive guidance. The staff reminded registrants that pre-filing letters should be succinct, focus on the relevant facts and circumstances, and explain how the request is consistent with investors' needs for information. Both Hinman and Mark Kronforst, Chief Accountant in the Division of Corporation Finance,[2] encouraged registrants to request relief when disclosures required by the rules may be burdensome or costly and not material to the investor. They also highlighted the staff's prompt turnaround of the requests noting that simple fact patterns were being addressed, on average, within five business days from submission. The staff provided examples of common requests where the staff provided relief, including the use of:

- Alternative measures of significance of an acquired business under S-X Rule 3-05, particularly when the income test is influenced by anomalous results or is substantially higher than both the asset and investment tests;
- Pre- and post-acquisition audited periods to satisfy the S-X Rule 3-05 financial statement requirements for an acquired business in a registration statement; and
- Abbreviated financial statements for a predecessor entity that is a carve-out of a larger business, where post-succession date audited financial statements are being provided for a significant period of time.

BDO OBSERVATIONS:

Through recent experience working with registrants on pre-filing letters, we've witnessed prompt responses from the staff (in some cases, one or two-day turnarounds) as well as a willingness of the staff to discuss the requests with the registrants in advance of submitting their letters for formal consideration.

2 Mark Kronforst recently announced that he would leave the SEC in January 2018. Upon his departure, Kyle Moffatt will become the Division's Acting Chief Accountant.

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DISCLOSURE EFFECTIVENESS INITIATIVE

The staff discussed its progress on the Disclosure Effectiveness Initiative throughout the Conference and emphasized that the rules and proposals to date do not signal the end of the initiative. Rather, these activities reflect the traction that the initiative is gaining. The staff continues to consider potential amendments to the rules, including amendments to Regulation S-X requirements for financial statements of entities other than the registrant, as well as industry-specific disclosures relevant to mining and banking registrants. Rulemaking and other activities related to the initiative from 2017 are discussed further below.

Exhibit Hyperlinks and HTML Format
(Release No. 33-10322)

In March, the SEC adopted **final rules** requiring the use of hyperlinks to exhibits in filings. The rules, which are applicable to all forms for which exhibits are required under Item 601 of Regulation S-K, will require registrants to include a hyperlink to each exhibit (excluding XBRL exhibits) listed in the exhibit index of their periodic and transactional filings. To facilitate the use of hyperlinks, exhibits must be filed in HTML format. The intent is to facilitate easier access to these exhibits for investors and other stakeholders.

The rules became effective for filings submitted on or after September 1, 2017. Smaller reporting companies and filers other than large accelerated or accelerated filers who use ASCII format (instead of HTML format) need not comply until September 1, 2018.

Proposal to Require Inline XBRL
(Release No. 33-10323)

In March, the SEC proposed to require the use of "Inline XBRL." Historically, issuers have been required to provide XBRL data in an exhibit to their filings. Consequently, issuers copy their financial statement information into a separate document and tag it in XBRL. The **SEC's proposal** would require issuers to embed XBRL tags directly in their financial statements using a format known as Inline XBRL in lieu of providing tagged data in a separate exhibit. The proposal follows an SEC order issued in June 2016 which permitted, but did not require, issuers to use Inline XBRL. The intent of the proposal is to reduce the preparation costs and increase the quality and usefulness of the data, thereby increasing its use by investors and other market participants.

The Inline XBRL requirements would become effective for large accelerated filers in the second year following the effective date of the rule, followed by accelerated filers in the third year, and all other filers in the fourth year.

Comments on the proposal were due on May 16, 2017.

Request for Comment on Possible Changes to Industry Guide 3
(Release No. 33-10349)

In March, the SEC issued a **request for comment** on possible changes to the disclosures called for by Industry Guide 3, *Statistical Disclosure by Bank Holding Companies*. Guide 3 was first published over 40 years ago. The request sought input on the overall scope and applicability of Guide 3 disclosures and solicited feedback on whether the disclosures continue to provide the information investors need to make informed investing and voting decisions. It also questioned whether there are additional disclosures that would be relevant to investors and whether to eliminate overlapping or duplicative disclosures.

Comments were due in July.[3] Our comment letter is available **here**.

FAST Act Modernization and Simplification of Regulation S-K
(Release No. 33-10425)

In October, the SEC **proposed amendments** to modernize and simplify certain disclosure requirements in Regulation S-K. The proposal would not make major changes to Regulation S-K. Rather, in Commissioner Piwowar's words, the proposed amendments respond to the SEC's mandate under the Fixing America's Surface Transportation (FAST) Act to "prune the regulatory orchard" – i.e., clear away the unnecessary or inconsequential to allow enhanced focus and attention on what is material to a filing. The amendments are based primarily on recommendations made in the staff's November 2016 **Report on Modernization and Simplification of Regulation S-K** and are intended to update or streamline the disclosure framework while still providing investors with all material information required to make informed decisions.

Among other things, the proposed amendments would revise:

- S-K Item 303, *Management's Discussion and Analysis*, to emphasize that the registrant focus its discussion of comparative periods on changes that are material to its financial condition and operations. The proposed amendments emphasize concepts in the SEC's **2003 MD&A Interpretive Release,** which encourages registrants to take a "fresh look" at previous periods. The proposal would permit registrants to omit the discussion of the earliest period presented if it is no longer material or of continuing relevance to an investor.
- S-K Item 102, *Description of Property*, to replace references to "major" encumbrances and "materially important" physical properties with a materiality threshold. The proposal would require a description of property only if it is material to the registrant or its business. However, the proposed amendments would not apply to registrants in the mining, real estate, and oil and gas industries.
- S-K Item 601, *Exhibits*, to permit registrants to redact confidential information from material contracts without first submitting a confidential treatment request to the SEC staff where such information is both not material and competitively harmful if publicly disclosed.

The proposal would also make changes to use technology to improve access to information.

Comments were due on January 2, 2018.

BDO OBSERVATIONS:
We support the Commission's efforts to modernize and simplify certain disclosure requirements in Regulation S-K. We believe that some of the proposals may encourage registrants to take a fresh look at their disclosures and support changes designed to elicit disclosure that is material to investors. As proposed, the amendments to Item 303 of Regulation S-K would permit registrants to omit a discussion of the earliest year presented in the financial statements from MD&A if the discussion is not material and included in a previously filed Form 10-K. However, we believe registrants should simply be permitted to omit the discussion if it was previously filed in any filing (not solely a 10-K filing). Moreover, we believe the materiality standard for eliminating the discussion will be difficult to apply, so registrants are apt to include the discussion when it may not be necessary We elaborate on our recommendations related to this particular aspect of the proposal and other observations in our **comment letter**.

3 Release No. 33-10349 extended the comment period from May to July.

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THE DODD-FRANK ACT

Pay Ratio Disclosure

In 2015, the SEC adopted amendments to Item 402 of Regulation S-K that require registrants to disclose the median annual total compensation of all employees except the chief executive officer, the annual total compensation of the CEO, and the ratio of the median annual total compensation of all employees to the annual total compensation of the CEO.[4] These disclosures are collectively referred to as the "pay ratio" disclosures and are required for a registrant's first fiscal year beginning on or after January 1, 2017. For example, a registrant with a fiscal year ending on December 31, 2017 would be first required to include the pay ratio information relating to compensation for fiscal year 2017 in its proxy or information statement for its 2018 annual meeting of shareholders and to include or incorporate by reference this information in its 2017 Form 10-K.

In September, the SEC adopted **interpretive guidance** to assist companies in their efforts to make the pay ratio disclosures. As the pay ratio rule permits the use of estimates, assumptions and statistical sampling to determine the median employee, some constituents expressed concern about the compliance uncertainty and potential liability associated with the required disclosures. The SEC's interpretive guidance was partly issued to alleviate these concerns and states that the Commission will not take an enforcement action that challenges a registrant's pay ratio disclosures if the estimates have a reasonable basis and are made in good faith. The interpretive guidance also clarifies that the consistently applied compensation measure used to calculate the median employee may be derived from existing internal (such as tax or payroll) records even if those records do not include every element of compensation (for example, equity awards) and that the determination of workers that meet the definition of an employee may be drawn from pre-existing published guidance under employment or tax laws.

Additionally, the staff updated its **C&DIs** to reflect the Commission's guidance and issued separate **interpretive guidance** to help registrants understand how they can utilize statistical sampling and estimates in making their pay ratio disclosures. The guidance provides hypothetical examples related to the use of sampling and other reasonable methodologies.

BDO OBSERVATIONS:
Early in 2017, Commissioner Piwowar requested feedback from registrants about challenges they faced in their pay ratio compliance preparations and whether any relief was needed. This request, in connection with provisions contained in U.S. Department of Treasury reports and the proposed Financial Choice Act, fueled speculation that the pay ratio rule would be overturned in its entirety in 2017. However, in light of the Commission and staff guidance, it appears the pay ratio disclosures will need to be implemented. Accordingly, registrants should continue with their compliance efforts heading into 2018.

Disclosure of Payments by Resource Extraction Issuers

In February, President Trump signed a resolution passed by Congress which nullified the resource extraction issuer disclosure rule (Rule 13q-1). Rule 13q-1 would have required resource extraction issuers to disclose information about certain payments made to United States and foreign governments for the commercial development of oil, natural gas, and minerals. Originally adopted in 2012 pursuant to a Dodd-Frank Act statutory mandate, the rule was vacated after being challenged in a federal court. In response to the federal court's decision, the SEC rewrote the rule and adopted it in 2016. However, as a result of the nullification, Rule 13q-1 will not go into effect and the rule may not be reissued in the substantially same form.[5]

Conflict Minerals Reporting

In April, a U.S. District Court entered a final judgment in the ongoing lawsuit related to the SEC's conflict minerals rule. The final judgment upholds a U.S. Court of Appeals decision that a portion of the conflict minerals rule infringes upon a company's constitutional right of free speech. More specifically, the courts determined that the requirement for a company to describe its products as "having not been found to be 'DRC conflict free'" violates the company's first amendment constitutional rights.

In light of the final judgment, then-Acting Chairman Michael Piwowar issued a statement directing the SEC staff to begin work on a recommendation for the Commission. The SEC staff also issued updated guidance on how a company should comply with aspects of the conflict minerals rule not affected

4 For further information about the adopted amendments, refer to our previous **SEC Flash Report**, "SEC Adopts Rule Requiring Pay Ratio Disclosures".

5 Under the **Congressional Review Act**, a rule that is nullified may not be reissued in substantially the same form unless it is specifically authorized by a law subsequently enacted.

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by the Court's decision. The guidance clarifies that the SEC staff will not enforce compliance with Item 1.01(c) of Form SD, the specialized disclosure form used for conflict minerals reporting. Item 1.01(c) requires companies to conduct due diligence on the source and chain of custody of conflict minerals. Piwowar expressed support for this guidance in his statement, explaining that the primary purpose of the work required by Item 1.01(c) is to make a disclosure which has since been found to be unconstitutional.

BDO OBSERVATIONS:
While the staff guidance indicates that it will not enforce compliance with certain aspects of the conflict mineral disclosure requirements, multiple provisions contained in recent proposed legislation and federal reports would repeal the conflict minerals rules altogether. Pending further developments in such legislation, registrants should continue to comply with rules taking into account the guidance discussed above.

THE JOBS ACT

Final Rule and Technical Amendments Related to the JOBS Act
(Release No. 33-10332)

In March, the SEC adopted **technical amendments** to several rules and forms to reflect securities law amendments included in the JOBS Act of 2012. Title I of the JOBS Act created the "emerging growth company" filer status, which permits reduced disclosures in an IPO registration statement and provides a temporary exemption from certain financial reporting and governance requirements thereafter.[6] As Title I of the JOBS Act was self-executing, SEC rulemaking was not required for emerging growth companies to take advantage of the relief provided by Title I. However, the SEC's rules and forms did not reflect the Title I provisions until the technical amendments made in March. These amendments also modified the cover page of various periodic and transactional reports to include two check boxes – the first to indicate whether the issuer is an emerging growth company and the second to indicate whether the issuer has elected not to use the extended transition period for complying with any new or revised accounting standards.

In addition to the form and rule amendments, the SEC also adopted new rules to include an inflation-adjusted threshold in the definition of an emerging growth company. The JOBS Act requires the Commission to index to inflation the annual gross revenue amount used to determine emerging growth company status every five years. Accordingly, the emerging growth company revenue threshold was increased from $1,000,000,000 to $1,070,000,000. Similar inflation adjustments were made to the offering and investment limits in the crowdfunding rules as well (e.g., the maximum amount an issuer can sell under Regulation Crowdfunding in a year increased from $1,000,000 to $1,070,000).

OTHER COMMISSION ACTIVITIES

Cybersecurity

In a September statement, Chairman Clayton highlighted the importance of cybersecurity to the Commission and to all market participants. Clayton's focus on the issue is not surprising in light of the significant cyber risks that companies face in today's environment, particularly with more recent high-profile cyber attacks reported by Equifax, Deloitte, and the SEC itself. In his statement and other public remarks, Clayton has stressed the importance of identifying and managing cybersecurity risks as well as ensuring that investors are appropriately informed about these risks. In this regard, he highlighted the SEC's focus on cybersecurity disclosures and referred registrants to the Division of Corporation Finance Disclosure Guidance (CFDG Topic No. 2) on cybersecurity which is still relevant today. This guidance addresses the specific disclosure obligations that may require a discussion of cybersecurity risks and cyber incidents in SEC filings.

At the Conference, the SEC staff also reminded registrants of the importance of disclosure controls with respect to cybersecurity. A company must have sufficient controls in place to ensure the implications of cyber breaches are escalated internally, and communicated externally, on a timely basis. The staff acknowledged that restraints on information that can be disclosed exist and thoughtful disclosures require time to draft. Nevertheless, the staff asserted that a legal investigation does not overcome these disclosure obligations. Registrants should also contemplate their insider trading policies when evaluating information and disclosures related to cyber breaches.

6 Additional information about the JOBS Act, EGC status and reporting relief is available **here**.

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BDO OBSERVATIONS:
We encourage all registrants to review CFDG Topic No. 2 as they prepare their upcoming interim or annual SEC filings to ensure their cybersecurity disclosures are appropriate in light of the risks and any attacks or breaches they have faced. We expect the SEC staff may increase its focus on such disclosures in their filing reviews and question the timing of "untimely" disclosures of cyber breaches. The Director of the Division of Corporation Finance, William Hinman, recently expressed his belief that Commission-level interpretive guidance on cyber disclosures may be needed to emphasize their importance, so registrants may hear more on this topic in the coming months.

Use of IFRS Taxonomy

In March, the SEC announced the release of the IFRS taxonomy which will allow foreign private issuers that prepare their financial statements in accordance with IFRS as issued by IASB to submit their financial statements in XBRL format. Such issuers will be required to submit their financial statements in XBRL for fiscal periods ending on or after December 15, 2017 (though may voluntarily begin using the taxonomy earlier).

STAFF GUIDANCE

STAFF ACCOUNTING BULLETINS

The SEC staff released **Staff Accounting Bulletin (SAB) No. 116** in August to conform its staff guidance on revenue recognition with Topic 606, *Revenue from Contracts with Customers*. SAB No. 116 states that SAB Topic 13, *Revenue Recognition*, and SAB Topic 8, *Retail Companies*, are no longer applicable once a registrant adopts Topic 606. It also modifies Section A, *Operating-Differential Subsidies* of SAB Topic 11, *Miscellaneous Disclosure*, to clarify that revenues from operating-differential subsidies presented under a revenue caption should be presented separately from revenue from contracts with customers accounted for under Topic 606 or as a credit in the costs and expenses section of the statement of comprehensive income. Prior to adoption of Topic 606, registrants should continue to refer to prior SEC guidance on revenue recognition topics.

The SEC also issued two companion releases to update its interpretive guidance on revenue recognition:

- **Release No. 33-10402, Commission Guidance Regarding Revenue Recognition for Bill-and-Hold Arrangements** states that upon adoption of Topic 606, registrants should no longer rely on the bill-and-hold arrangement guidance in Release No. 23507 and Accounting and Auditing Enforcement Release (AAER) No. 108, *In the Matter of Stewart Parness*, because Topic 606 provides specific guidance on recognizing revenue for those arrangements. Until a registrant adopts Topic 606, it should continue to refer to the guidance in Release No. 23507 and AAER No. 108.
- **Release No. 33-10403, Updates to Commission Guidance Regarding Accounting for Sales of Vaccines and Bioterror Countermeasures to the Federal Government for Placement into the Pediatric Vaccine Stockpile or the Strategic National Stockpile** states that vaccine manufacturers should recognize revenue and provide the disclosures required under Topic 606 when vaccines are placed into Federal Governmental stockpile programs because control of the vaccines will have been transferred to the customer and the criteria to recognize revenue in a bill-and-hold arrangement under Topic 606 will have been met. The accounting treatment of those vaccines under Release No. 33-10403 is consistent with prior SEC guidance. Until a registrant adopts Topic 606, it should continue to refer to prior SEC guidance.

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In November, the staff released **SAB No. 117** to clarify that the guidance within SAB Topic 5.M is no longer applicable upon a registrant's adoption of Topic 321, *Investments – Equity Securities*.[7] SAB Topic 5.M addresses the recognition of other than temporary impairment (OTTI) of investments of equity securities measured at fair value with the changes in fair value recorded through other comprehensive income. Upon adoption of Topic 321, a registrant will record the changes in fair value through income rather than other comprehensive income. Consequently, the guidance within Topic 5.M will no longer be applicable. Prior the adoption of Topic 321, a registrant should follow the guidance within Topic 5.M.

On December 22 – the day the Tax Cuts and Jobs Act was signed into law – the staff issued **SAB No. 118**, which addresses accounting for the effects of the Act. SAB No. 118 communicates that a registrant that has not yet completed its accounting for certain income tax effects of the Act by the time the registrant issues its financial statements for the period that includes December 22, 2017 (the date of the Act's enactment) may apply a "measurement period" approach to complying with ASC Topic 740. Under this approach, registrants are permitted to file financial statements that only recognize amounts for which they are able to make reasonable estimates. SAB No. 118 is discussed further in our BDO Knows newsletter available **here**.

The staff also issued a **C&DI** , which confirms that the remeasurement of a deferred tax asset to incorporate the effects of newly enacted tax rates or other provisions of the Act does not trigger an obligation to file under Item 2.06 of Form 8-K.

FINANCIAL REPORTING MANUAL

The staff of the SEC's Division of Corporation Finance published two updates to the **Financial Reporting Manual (FRM)** in 2017.[8] As updates are published, the staff includes a summary immediately following the FRM cover that describes the nature of the changes and lists the paragraphs that were updated. The staff also annotates the FRM to communicate the date a paragraph was most recently updated. At the Conference, the staff indicated that it is working on a major refresh of the FRM.

In addition to the 2017 updates described above within the Capital Formation section with respect to Rule 3-13 waiver requests and the omission of certain financial statements from draft and filed registration statements, the staff made several other changes including:

- Revisions to Section 2065 to clarify that registrants may request permission from the Office of the Chief Accountant within the Division of Corporation Finance to provide abbreviated financial statements in lieu of full financial statements for an acquired business that is identified as a predecessor of the registrant. Previously, the FRM indicated that Section 2065 of the FRM did not apply if the business acquired represents the predecessor of the registrant.

7 Topic 321 was issued in connection with the issuance of Accounting Standards Update (ASU) No. 2016-01, which is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years.

8 The FRM is an internal SEC staff reference document that provides general guidance covering several SEC reporting topics. While the FRM is not authoritative, it is often a helpful source of guidance for evaluating SEC reporting issues.

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- Revisions to guidance related to the impact of adopting new accounting standards on pro forma financial statements:[9]
  - If a registrant adopts a new accounting standard as of a different date or using a different transition method than a significant acquired business, the registrant should conform the adoption dates and transition methods of the acquired business to its own in the registrant's pro forma financial statements that reflect the acquisition. The staff noted that it will consider requests for relief from this requirement.
  - If a registrant retrospectively adopts a new accounting standard at the beginning of its fiscal year, and later acquires a significant business for which pro forma financial statements are required, the pro forma income statement for the last completed fiscal year need not reflect the new accounting standard before it is reflected in the historical financial statements of the registrant. For example, if a calendar year end registrant adopts Topic 606 on January 1, 2018 using a full retrospective approach and acquires a significant business in September 2018, the registrant's pro forma income statement for the year ending December 31, 2017 included in the registrant's Form 8-K need not reflect the adoption of Topic 606.[10] However, registrants should make appropriate disclosure in the notes to the pro forma financial statements if the adoption of the new standard is expected to be material.
- Revisions to address the adoption of new accounting standards when EGC status is lost. An EGC may elect to use an extended transition period for complying with any new or revised accounting standards. If an EGC that makes this election loses its EGC status after it would have been required to adopt a new standard absent the extended transition period, the company should generally adopt the standard in its next filing after losing status. The staff expects that EGCs should plan appropriately to adopt new accounting standards if they have taken advantage of the extended transition period provision. However, the guidance also indicates that the staff may consider other alternatives upon the loss of EGC status depending on facts and circumstances.
- Conforming and non-substantive revisions to Topic 11, *Reporting Issues Related to the Adoption of New Accounting Standards*. Conforming edits were made to address the guidance above and the issuance of ASU 2017-13 (which permits certain public business entities to adopt the new revenue and leasing standards using the effective dates applicable to private entities).[11]

COMPLIANCE AND DISCLOSURE INTERPRETATIONS

The SEC staff updated its **C&DIs** several times during the year. Many of these updates were legal in nature and provide guidance on non-GAAP financial measures,[12] Regulation Crowdfunding, Regulation S-K, and Securities Act Form, among others.

In addition to the C&DIs described within the Capital Formation and Staff Accounting Bulletins sections, several other notable C&DIs under Securities Act Rules addressed financial statement requirements following a Regulation A offering and subsequent Exchange Act registration. Some contemplating Regulation A transactions are concerned about the lack of a market in which the securities they offer can trade after the offering. Accordingly, some of these issuers register their securities under the Exchange Act immediately after their offerings are complete in order to list their securities for trading on an exchange. The C&DIs published in 2017 address the financial statement requirements after such issuers become Exchange Act registrants. These C&DIs communicate that an issuer must file any periodic reports covering periods after the date of the latest financial statements included in the offering circular used to conduct the Regulation A offering.

9 The updates are consistent with previously published guidance on how to think about the adoption of the new revenue standard (Topic 606) in the context of pro forma financial statements. However, this particular FRM update relocates and expands this guidance so that it now applies more broadly to all new accounting standards.

10 This fact pattern assumes that the registrant has not already filed revised financial statements as of and for the year ending December 31, 2017 reflecting the adoption of the new accounting standard. A registrant that has already filed such financial statements reflecting the new accounting standard (e.g., on a Form 8-K or with a new or amended registration statement filed prior to the acquisition) would be required to reflect the new accounting standard in the pro forma income statement for the year ending December 31, 2017.

11 Refer to the New Accounting Standard section below for further information about this guidance.

12 The 2017 updates to the non-GAAP C&DIs clarify that financial forecasts provided to a financial advisor in connection with a business combination are not considered non-GAAP financial measures (and therefore, are not subject to the rules) if certain conditions are met. Refer to C&DIs **101.01 and 101.02**.

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PRACTICE ISSUES

In addition to the SEC rulemaking and other activities mentioned above, the SEC staff discussed various other topics throughout the year. This section addresses those practice issues, including observations from the staff at the Conference.

NEW ACCOUNTING STANDARDS

The implementation of new accounting standards was a prominent theme throughout the Conference, with various regulators offering their perspectives on accounting and disclosure issues, effects on internal control over financial reporting, auditing considerations, and other topics related to the new standards.

At the Conference, Wes Bricker emphasized that one of the Office of the Chief Accountant's highest priorities is to "support successful implementation of new GAAP standards including revenue recognition, leases, and current expected credit losses."

Revenue Recognition

The SEC staff highlighted the importance of appropriate planning for changes to processes, controls and systems, each of which will be essential for fulfilling the new disclosure requirements under Topic 606. Sagar Teotia, Deputy Chief Accountant in the Office of the Chief Accountant, stated that "For those companies whose [Topic 606] implementation efforts are still underway, we urge you to keep the momentum going. Companies cannot afford to get the accounting for revenue wrong for investors and other users of the financial statements."

The staff also reminded registrants of the critical role played by audit committees and auditors in the implementation process, encouraging registrants to discuss their current Topic 606 implementation status and ongoing activities with investors, audit committees, and auditors (while being mindful of auditor independence requirements).

While registrants implement the new standard, the staff continues to actively monitor these efforts and the related transition disclosures in order to understand areas of potential diversity and the types of judgments being made. The staff expects registrants to provide the estimated impact of the new standard in their SAB 74 disclosures to allow investors to understand the effects.

Additionally, as registrants work through the application of the standard, the staff remains available for consultations. The staff emphasized that preparers should be able to articulate all relevant facts and demonstrate a comprehensive analysis of the different accounting alternatives in arriving at a reasonable judgment related to each transaction. Although the staff stressed that reasonable judgments will be respected, they will question material omitted disclosures and instances in which accounting conclusions appear incorrect.

Based upon Topic 606 implementation consultations to date, the staff shared the following observations:

- **Pre-production activities –** These arrangements commonly consist of (1) an entity undertaking various activities before beginning production of a good (e.g., engineering, design, molds, or tooling) and (2) the counterparty promising cash consideration in contemplation of those activities either upfront, as the pre-production activities occur, or in the future as part of the cost per unit. The staff indicated that a registrant that has historically considered pre-production activities to be a service deliverable under Topic 605 should begin by evaluating whether pre-production activities are a performance obligation under Topic 606. A registrant may conclude that a service deliverable under Topic 605 does not result in a performance obligation related to pre-production activities under Topic 606. Further, the staff would not object to a registrant continuing to apply its historical non-revenue model to such pre-production arrangements. However, the staff encourages consultation in the event that a registrant believes it should change its historical approach, either by applying a revenue model under Topic 606 to arrangements which were previously accounted for as non-revenue arrangements or by making other changes to its historical non-revenue model.
- **Performance obligations –** The staff reminded registrants of the importance of carefully applying the framework to determine whether the nature of the promise, within the context of the contract, is to transfer each of the goods or services individually or, instead, to transfer a combined item to which the promised goods or services are inputs. The staff provided an example of a consultation in which it objected to a registrant's conclusion that separate promises in a contract constituted inputs into a combined output representing one performance obligation. The staff reminded registrants that two or more promised goods or services must significantly affect each other for them to be highly interdependent or highly interrelated (and therefore, combined into a single performance obligation).

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- **Gross versus net presentation –** The staff noted that the determination of whether an entity is a principal or an agent has been a topic of frequent consultation, and that applying the guidance can be more challenging in certain industries such as digital advertising, where transactions may involve multiple parties and transactions often occur instantaneously. The staff stated that the indicators of whether an entity is acting as a principal or an agent included in Topic 606 should not be viewed as a "checklist," and that registrants must "understand the nuances of the transactions and faithfully apply the Topic 606 model to their specific set of facts and circumstances."
- **Shipping and handling –** The staff observed that questions on shipping and handling related to activities to fulfill a promise have arisen because Topic 606 superseded prior guidance which included an explicit policy election regarding classification of such costs. Given the absence of comparable guidance under the new standard, the staff would not object to a registrant classifying such shipping and handling costs within cost of sales, or in a category other than cost of sales. If a registrant elects to classify such costs outside cost of sales, it should consider disclosing the amount of such costs and the line item or items on the income statement that include them.

Leases

To date, many of the issues addressed by the SEC staff related to the new leasing standard concern scoping and transition.

For example, at the Conference, the SEC staff discussed a recent question about whether executory costs, such as insurance, maintenance and taxes, should be included in, or excluded from, the amount of minimum rental payments at the transition date. The transition guidance in Topic 842 requires the lessee to initially measure the lease liability using the remaining minimum rental payments. Under Topic 840, there is diversity in practice on whether such executory costs are included in, or excluded from, the amounts disclosed in the five-year obligations table. The SEC staff observed that the term "minimum rental payments" is not explicitly defined in Topic 840. Therefore, the staff did not object to the consistent application of historical accounting policy conclusions regarding the composition of minimum lease payments when concluding whether executory costs should be included in remaining minimum rental payments for purposes of establishing lease liabilities in transition.

A second issue discussed by the staff concerns the determination of the discount rate used to measure lease liabilities in transition. The transition guidance for lessees states that, upon adoption, the lessee should measure a lease liability using the discount rate established as of the beginning of the earliest period presented in the financial statements or the commencement date of the lease, if later. However, registrants observed that the transition guidance does not specify whether such rate should be based on the original lease term or the remaining lease term. The staff concluded that the consistent application of either approach, that is, the use of either the rate based on the original lease term or the remaining lease term, would be reasonable when determining a lessee's lease liabilities in transition.

The SEC staff also emphasized the importance of careful implementation planning (including the identification of contracts that represent or contain a lease) and management of the implementation of the new leasing standard. The staff also encouraged entities to educate themselves on the differences between the transition guidance and the guidance applied on a go-forward basis and to allow themselves sufficient time to gather relevant information to apply both the transition and general provisions of the standard.

Credit Losses

Even though the mandatory adoption of the new credit loss standard (CECL) is still a few years away (January 1, 2020 for calendar year-end issuers), staff members of the SEC and FASB addressed various aspects of implementation at the Conference. The SEC staff reminded registrants that CECL applies to a broad range of businesses - not just financial institutions and those with long term receivables - since trade receivables and held to maturity debt securities are also within the scope of CECL. The staff highlighted that companies need to identify the accounting models that are likely to be applicable, which includes a consideration of practical expedients.

The staff also noted that registrants have begun to engage in pre-filing consultations and the staff is available for consultations as issues arise. They shared a few observations based on recently completed pre-filing consultations. In one consultation, a registrant applied the general expected credit loss model when the foreclosure of a collateral-dependent loan was not probable. The staff did not object to this model, even though the standard provides a practical expedient to estimate credit losses based on the fair value of the collateral when foreclosure is not probable. In another consultation,

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the staff concluded that a loan purchased shortly after origination, with no purchased credit deterioration (PCD) associated with the loan as of the initial recognition date, did not qualify for the purchase credit deteriorated model. Additionally, the SEC has objected to the application of the PCD model when the loans in question were originated rather than purchased.

Adoption Dates for Certain Public Business Entities

Sagar Teotia announced at the July EITF meeting that the SEC staff would not object if an entity that qualifies as a public business entity (PBE) solely because its financial statements or financial information is included in another entity's filing with the SEC[13] adopts Topics 606 and 842 under the effective dates applicable to private entities. In September, the FASB released ASU 2017-13, *Revenue Recognition (Topic 605), Revenue from Contracts with Customers (Topic 606)*, *Leases (Topic 840)*, and *Leases (Topic 842)* to amend SEC paragraphs to reflect this announcement.

Examples of PBE financial statements or financial information that may reflect the adoption of Topics 606 and 842 using private company effective dates include financial statements of an acquired business under S-X 3-05, financial statements of an equity method investee under S-X 3-09, and summarized financial information of an equity method investee under S-X 4-08(g).[14] Entities meeting this criterion may elect to adopt Topic 606 for fiscal years beginning after December 15, 2018 and interim periods within fiscal years beginning after December 15, 2019. Previously these entities were required to adopt the standard for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. These entities may also elect to adopt Topic 842 for fiscal years beginning after December 15, 2019 and interim periods within fiscal years beginning after December 15, 2020. Previously these entities were required to adopt the standard for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

Such entities may still elect to adopt these standards using the public company effective dates outlined above.

13 Criterion (a) of the FASB Master Glossary definition of a public business entity includes other entities whose financial statements or financial information are required to be or are included in a filing with the SEC. Further information regarding the definition of a public business entity is available **here**.

14 The staff subsequently **clarified** at the September meeting of the Center for Audit Quality's SEC Regulations Committee that financial statements prepared pursuant to Rule 3-10(g), *Recently Acquired Subsidiary Issuers or Subsidiary Guarantors*, are also within the scope of this guidance.

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BDO OBSERVATIONS:
Although the staff has relaxed the timetable for implementing these new accounting standards in acquired business financial statements, careful planning will still be required when making an acquisition. An acquirer will need to reflect the new standards in the acquired business' financial statements immediately after the acquisition, and the acquirer's pro forma information for periods after it has adopted the new standards will also need to reflect the effects of the new standards on the acquired business' financial statements.

NON-GAAP FINANCIAL MEASURES

Non-GAAP financial measures continue to be a focus of the SEC and staff. During the Conference, Mark Kronforst emphasized that the staff continues to review non-GAAP measures, dubbing the measures and related disclosures as "very risky" as the market tends to react to the results of, and changes in these figures. Kyle Moffatt, Associate Director[15] in Disclosure Operations in the Division of Corporation Finance, also emphasized that registrants should refrain from labeling a non-GAAP figure with a similar name to GAAP, such as "operating earnings."

Throughout the Conference, it was emphasized that Regulation G applies to all publicly disclosed information, including investor presentations, transcripts, and webcasts, all of which the staff may review for non-GAAP measures discussed and highlighted that may be given greater prominence than the most directly comparable GAAP figure, or may not be reconciled to the most comparable GAAP figure.

Additionally, key performance indicators, or "KPIs," were highlighted, as several registrants have started to include KPIs within their MD&A disclosures. When discussing KPIs, it is important for companies to follow the required non-GAAP rules under Regulation G and Regulation S-K, Item 10(e). The following recommendations about disclosing KPIs were highlighted during the Conference:

- Clearly define what is being measured;
- Tie the measure to the performance of the company; and
- Tell investors why the measure is important.

BDO OBSERVATIONS:
The staff's focus on non-GAAP financial measures has been viewed by some as a pendulum - companies increase their non-GAAP disclosure and discussion and the SEC responds with comment letters or enforcement action, leading companies to reign in their use of such measures. In time, companies begin to again increase their disclosures and use of non-GAAP measures. The staff has indicated that the corporate response to the regulatory call for improvement has been positive and they anticipate fewer comments on non-GAAP measures in the future. However, as summarized above, the Division of Corporation Finance Chief Accountant has emphasized that the staff will continue to scrutinize non-GAAP figures due to the level of risk associated with the measures.

OTHER ACCOUNTING AND REPORTING TOPICS

The Definition of a Business

In January, the FASB issued ASU 2017-01 to clarify the definition of a business, which is fundamental in the determination of whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses.[16] As a result of this new guidance, many common transactions that have historically been accounted for as business combinations will now be accounted for as asset acquisitions. Consequently, some stakeholders questioned whether the shift in the FASB's guidance would impact the definition of a business under Article 11 of Regulation S-X, particularly as it relates to acquisitions of working interests in an oil and gas or real estate properties. At the March meeting of the Center for Audit Quality's SEC Regulations Committee, the staff indicated that the issuance of ASU 2017-01 **does not affect** the definition of a business under Article 11 of Regulation S-X. Therefore, it is likely that there will be more circumstances in which a transaction is accounted for as the acquisition of an asset in the financial statements, but is treated as the acquisition of a business under S-X (thereby, requiring historical financial statements of the business if it is significant to the registrant).

15 Kyle Moffatt will become the Division's Acting Chief Accountant in January 2018 upon Mark Kronforst's departure.

16 Refer to BDO's FASB Flash Report on 2017-01 for further information.

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Staff Communications

During the Conference, the SEC staff reiterated that the Sarbanes-Oxley Act requires a review of registrant filings once every three years. Staff reviews may also occur on a more frequent basis, while transactions are subjected to a screening process. The staff also reviews and may comment on information outside of periodic filings, such as analyst calls, press releases, investor presentations and a company's website. While continuing to monitor recurring comment letter topics including non-GAAP financial measures, cybersecurity and other disclosures, the staff will also focus on new disclosures, such as pay ratio disclosures required by the Dodd-Frank Act, financial statement disclosures related to Topic 606, and tax reform disclosures.

INTERNAL CONTROL OVER FINANCIAL REPORTING

Throughout the Conference, the SEC staff emphasized the importance of effective ICFR to the preparation of reliable financial information. Specifically, the staff reminded registrants that Principle 9 of the COSO Framework requires companies to identify and assess changes, both internally and externally, that could significantly impact their system of internal control. The staff highlighted that the inability to timely adapt to changes, such as new accounting standards, may reveal deficiencies in a registrant's risk assessment, which may have existed and gone undetected for a significant period of time. Similarly, when a registrant identifies errors in its financial statements related to significant, complex, or unusual transactions, management, the audit committee, and the auditors should question why the registrant was not adequately prepared to account for such transactions and whether that signifies a deficiency in the ongoing risk assessment controls.

The staff noted that designing effective controls often requires significant judgment, especially for complex controls that contain judgments related to management's review. In that regard, the staff provided several considerations for designing effective controls, such as (1) identifying the objective of the control, (2) understanding the risk addressed by the control, (3) considering the precision of the control, (4) evaluating the appropriateness of thresholds set to identify items for further investigation, and (5) verifying the completeness and accuracy of information used in the operation of the control.

PCAOB DEVELOPMENTS

NEW AUDITOR'S REPORTING MODEL

In October 2017, the SEC approved the Public Company Accounting Oversight Board's new auditor reporting standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, as adopted by the PCAOB in June 2017. The SEC also approved related amendments to certain other PCAOB standards.

The new standard and related amendments retain the pass/fail opinion in the existing auditor's report, but significantly change the existing auditor's report through the following requirements:

- The new standard requires the auditor to communicate in the auditor's report any critical audit matters (CAMs) arising from the audit, or state that the auditor determined that there were no CAMs. CAMs are matters that were communicated or required to be communicated to the audit committee, and that (1) relate to accounts or disclosures that are material to the financial statements and (2) involve especially challenging, subjective, or complex auditor judgment.
- The auditor's report will include disclosure of the auditor's tenure (i.e., the year in which the auditor began serving consecutively as the company's auditor).
- The auditor's report will also include a statement that the auditor is required to be independent.
- The phrase, "whether due to error or fraud," will be included in the auditor's report in describing the auditor's responsibility under PCAOB standards to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements.
- The opinion will appear in the first section of the auditor's report, and section titles will be added to the report.
- The auditor's report will be addressed to the company's shareholders and board of directors or equivalents (additional addressees are also permitted).

The communication of each CAM in the auditor's report will include:

- Identification of the CAM;
- A description of the principal considerations that led the auditor to determine that the matter was a CAM;
- A description of how the CAM was addressed during the audit; and
- A reference to the applicable financial statement accounts or disclosures.

The standard generally applies to audits conducted under PCAOB standards. However, communication of CAMs is not required for audits of emerging growth companies, brokers and dealers, investment companies other than business development companies, and employee stock purchase, savings, and similar plans. Auditors of these entities may choose to voluntarily include CAMs in the auditor's report. The other requirements of the final standard applies to these audits.

The PCAOB adopted a phased approach to the effective date for the new standard and amendments to provide accounting firms, companies, and audit committees more time to prepare for implementation of the critical audit matter requirements, which are expected to require more effort to implement than the other improvements to the auditor's report.

The final standard and amendments will take effect as follows:

New Auditor Reporting Provisions	Effective Date
Report format, tenure, and other improvements	Audits for fiscal years ending on or after December 15, 2017
Communication of CAMs for audits of large accelerated filers	Audits for fiscal years ending on or after June 30, 2019
Communication of CAMs for audits of all other companies	Audits for fiscal years ending on or after December 15, 2020

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The PCAOB plans to conduct a post-implementation review of the new standard to ensure it is working as intended and does not lead to any unintended consequences.

The standard and related amendments can be accessed **here**.

Additionally, the PCAOB has developed a fact sheet on the standard, which may be helpful in understanding the main provisions of the standard. It is available **here**.

The PCAOB also recently published staff guidance, which is available **here**, to help firms comply with the requirements of the new standard and amendments.

BDO OBSERVATIONS:

Auditor Tenure. For audits of fiscal years ending on or after December 15, 2017, the disclosure of auditor tenure is one of the more significant changes. The tenure disclosure is meant to address calls from investors for such information to be readily available. The disclosure of auditor tenure should reflect the entire relationship between the company and the auditor, including the tenure of predecessor accounting firms and predecessors of the company under audit.

Critical Audit Matters. The intent of the disclosure of critical audit matters within the auditor's report is to provide a discussion of matters, from the auditor's unique perspective, that will be useful to investors at a level that investors and other financial statement users would understand. Investors expect these disclosures to be unique to each issuer's circumstances; accordingly, the use of boiler plate language would not meet investor expectations. Additionally, the delayed effective dates for the communication of critical audit matters is designed to allow for a trial run of the communication of matters that may have been considered CAM.

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OTHER STANDARD-SETTING ACTIVITIES

Proposed Auditing Standard, Auditing Accounting Estimates, Including Fair Value Measurements, and Proposed Amendments to PCAOB Auditing Standards

In June, the PCAOB proposed for public comment a new auditing standard, *Auditing Accounting Estimates, Including Fair Value Measurements*, along with related amendments, to enhance the requirements applicable to auditing accounting estimates, including fair value measurements. This proposed standard would replace three existing auditing standards: AS 2501, *Auditing Accounting Estimates*, AS 2502, *Auditing Fair Value Measurements and Disclosures*, and AS 2503, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*. The proposed single standard also would include a special topics appendix that addresses auditing the fair value of financial instruments, including the use of information from pricing services.

The proposed single standard would strengthen existing requirements by:

- Prompting auditors to devote more attention to addressing potential management bias in accounting estimates, while emphasizing the importance of professional skepticism;
- Extending certain key requirements in the extant standard on auditing fair value measurements to all accounting estimates in significant accounts and disclosures, to reflect a uniform approach to substantive testing;
- Prompting auditors to focus on estimates with a greater risk of material misstatement;
- Providing specific requirements to address certain unique aspects of auditing fair values of financial instruments, including the use of pricing sources (e.g., pricing services and brokers or dealers); and
- Updating other requirements for auditing accounting estimates to provide clarity and specificity.

The proposed standard can be accessed **here** and a fact sheet that summarizes the main provisions of the proposed standard can be accessed **here**. The comment period closed in August. The PCAOB staff is currently analyzing the comments received to determine its next steps.

BDO OBSERVATIONS:
In our comment letter, we supported the development of a single standard that is aligned with the PCAOB's risk assessment standards and the addition of incremental guidance relating to third-party pricing services. However, we encouraged the PCAOB to include the application guidance from the International Auditing and Assurance Standards Board's International Standard on Auditing (ISA) 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, and the corresponding AICPA auditing standard, AU-C Section 540, as we believe the inclusion of such application guidance is necessary for a proper understanding to apply the requirements and would, accordingly, enhance audit quality. Additionally, we indicated that useful guidance from AS 2503, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, may have been lost in the process of merging the three separate standards on auditing accounting estimates and fair value measurements into a single standard. Our comment letter is available **here**.

Proposed Amendments to Auditing Standards for Auditor's Use of the Work of Specialists

Also, in June, the PCAOB proposed amendments to strengthen requirements regarding when auditors use the work of specialists in an audit. These proposed amendments would apply a risk-based supervisory approach to both auditor-employed and auditor-engaged specialists, as well as strengthen requirements for evaluating the work of a company's specialist. Under this proposal, the PCAOB would amend two existing standards: AS 1105, *Audit Evidence*, and AS 1201, *Supervision of the Audit Engagement*. AS 1105 would be amended to add a new appendix that addresses using the work of a company's specialist as audit evidence, based on the risk-based approach of the risk assessment standards. AS 1201 would be amended to add a new appendix on supervising the work of auditor-employed specialists. The proposal also would replace AS 1210, *Using the Work of a Specialist*, and retitle it to *Using the Work of an Auditor-Engaged Specialist*, to set forth requirements for using the work of auditor-engaged specialists.

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The proposed amendments can be accessed here and a fact sheet that summarizes the main provisions of the proposed amendments can be accessed here. The comment period closed in August. The PCAOB staff is currently analyzing the comments received to determine its next steps.

BDO OBSERVATIONS:
In our comment letter, we supported the PCAOB's efforts to strengthen the requirements for evaluating the work of a company's employed or engaged specialist, including the application of a risk based supervisory approach to the use of specialists. As the use of the work of specialists has grown, in large part due to the increase in the use of fair value measurements in financial reporting frameworks, the importance of assessing the work of specialists has become an essential component in many audits. Our comment letter is available here.

Supplemental Request for Comment: Proposed Amendments Relating to the Supervision of Audits Involving Other Auditors and Proposed Auditing Standard, Dividing Responsibility for the Audit with Another Accounting Firm

In September, the PCAOB issued a supplemental request for comment on a proposal designed to strengthen existing requirements regarding a lead auditor's use of other auditors. In April 2016, the PCAOB had proposed a new auditing standard and amendments for audits that involve accounting firms and individual accountants outside the accounting firm that issues the audit report. Following the initial proposal, the Board received comments asking for clarification to some provisions and requesting changes to other provisions. In response to the comments received, the PCAOB proposed certain incremental clarifications and modifications to the requirements, primarily related to the following topics in the 2016 proposal:

- Planning, including the sufficiency of the lead auditor's participation and other auditors' qualifications;
- Supervision, including the communication between auditors and supervision of multiple tiers of other auditors;
- Division of responsibility, including situations that involve different financial reporting frameworks;
- Documentation, including documenting the lead auditor's review; and
- Engagement quality review.

The proposed clarifications are intended to increase the lead auditor's involvement in, and evaluation of, the work of other auditors and impose a uniform approach to the use of other auditors by:

- Directing the lead auditor's supervisory responsibilities to the audit areas of greatest risk, consistent with the PCAOB's risk-assessment standards;
- Clarifying that, to act as lead auditor, an audit firm must itself audit a meaningful portion of the financial statements; and,
- Requiring more explicit procedures involving communication between the lead auditor and other auditors, and more robust evaluation of other auditors' qualifications and work.

The supplemental request for comment, as well as the proposed auditing standard and amendments, can be accessed here. The comment period closed in November.

The PCAOB staff is currently analyzing the comments received to determine its next steps.

BDO OBSERVATIONS:
In our comment letter, we supported the PCAOB's efforts to strengthen the auditing standards relating to audits in which other auditors participate, and in particular where other auditors operate in different countries with differing cultures, languages, or economic markets. Our additional thoughts on the Supplemental Request for Comment were consistent with our previous view that a risk-based supervisory approach is the best approach to enhancing audit quality and serving the public interest. Our comment letter is available here.

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OTHER MATTERS

Staff Audit Practice Alert No. 15, Matters Related to Auditing Revenue from Contracts with Customers

In October, the PCAOB released Staff Audit Practice Alert No. 15. The auditing matters discussed in this Alert are relevant to the auditor's consideration of implementation of the new revenue standards issued by both the FASB and IASB, and are applicable for both interim reviews and year-end audits. Additionally, the Alert points out that certain matters discussed in the Alert may be applicable to auditing the implementation of the new accounting standards on leases and credit losses.

The Alert discusses the following:

- Auditing management's transition disclosures in the notes to the financial statements
- Auditing transition adjustments
- Considering internal control over financial reporting
- Identifying and assessing fraud risks
- Evaluating whether revenue is recognized in conformity with the applicable financial reporting framework
- Evaluating whether the financial statements include the required disclosures regarding revenue.

The matters discussed in the Alert are applicable to both planning and performing audit procedures with respect to revenue. The Alert also contains a caveat indicating that while the Alert highlights certain areas, it is not intended to identify all areas that might affect audit risk arising from the implementation of the new revenue standard, nor is it a substitute for the relevant auditing standards.

The complete text of Staff Audit Practice Alert No. 15 is available **here** on the PCAOB's website.

INSPECTIONS

The PCAOB staff observed that audit firms need to "strengthen their focus on both systemic and engagement-specific elements." As a result, the PCAOB staff will emphasize the quality control systems of the audit firms during their 2018 inspections, including tone throughout the organization, client acceptance and continuance, monitoring, and training and workload balance for engagement members. The 2018 PCAOB inspections will also focus on areas such as:

- Implementation of new accounting standards and related disclosures;
- Compliance with new PCAOB standards;
- Cybersecurity, which includes the protection of sensitive client information by auditors as well as the impact on a registrant's internal control environment;
- Software audit tools;
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