

2020 AICPA SEC & PCAOB Conference Highlights

The annual AICPA Conference on Current SEC and PCAOB Developments was held virtually on December 7-9, 2020, where representatives of the Securities and Exchange Commission and the Public Company Accounting Oversight Board shared their views on various accounting, reporting, and auditing issues.

Overview

The reporting, accounting and auditing environment continues to evolve. A changing regulatory landscape, the ongoing impact of new accounting standards remain at the forefront of the conversation. In an environment already rife with significant changes, the uncertainty associated with the COVID-19 pandemic creates additional challenges for stakeholders in the financial reporting process. The 2020 Conference focused on these matters and provided insight into the regulators' perspective on these and other accounting and reporting matters. Some of the highlights include:

- **SEC Reporting Matters** – reminders for registrants to pay attention to the risks and corresponding disclosures arising from the COVID-19 pandemic, including any impact on non-GAAP financial measures. Additionally, the SEC staff discussed various rulemaking updates.
- **Accounting Matters** – consultation examples from the staff within the Office of the Chief Accountant on topics including revenue recognition, consolidation considerations for voting and variable interest entities, payments received from vendors and LIBOR transition matters.
- **Auditing Matters** – the PCAOB staff provided post-implementation insights and reactions to the disclosure of Critical Audit Matters (CAMs) in audit reports and inspection findings and future areas of focus.

This publication summarizes these matters and other accounting and reporting issues addressed at the Conference. Our publication, [2020 SEC Reporting Insights](#), offers a more thorough discussion of SEC rulemaking and related staff activities during 2020.

SEC Reporting Matters

SEC RULEMAKING UPDATE

During the conference, the staff highlighted its recent rulemaking activities, including the following final rule amendments:

- **Amendments to Financial Disclosures About Acquired and Disposed Businesses** — In May 2020, the SEC [amended](#) S-X Rules 3-05 and 3-14 relating to financial statement requirements for acquired and disposed businesses as well as Article 11 pro forma financial information requirements.
- **Amendments to the Financial Disclosures for Registered Debt Security Offerings** — Given the significant disclosure requirements associated with registered debt offerings, the SEC [amended](#) the financial information disclosure requirements for guarantors and issuers of guaranteed securities and affiliates pursuant to S-X Rules 3-10 and 3-16.
- **Amendments to Regulation S-K** — In August 2020, the SEC [modernized](#) the disclosure requirements related to a registrant's description of its business, legal proceedings and risk factors. Further [amendments](#) to Regulation S-K in November 2020 eliminated the requirement to present selected financial data and simplified MD&A disclosure requirements.

FINANCIAL DISCLOSURES ABOUT ACQUIRED AND DISPOSED BUSINESSES

The SEC staff continues to receive implementation questions related to the S-X Rules 3-05 and 3-14 amendments in advance of the mandatory compliance date on January 1, 2021. At the Conference, the staff shared their views on various common inquiries received from registrants.

INVESTMENT TEST

The amended investment test requires a comparison of the registrant's investments in and advances to the acquired business to the registrant's aggregate worldwide market value. In this calculation, market value only includes the value of common stock traded on a market. The staff indicated that other instruments, such as convertible preferred securities and exchangeable non-traded common stock, are excluded from the Company's market value for purposes of the investment test. All registrants with traded common shares must use the aggregate worldwide market value to compute significance, including highly leveraged registrants. This methodology also applies to acquisitions and dispositions of equity method investments. However, for purposes of S-X Rules 3-09 and 4-08(g), the staff explained that total assets should be used in the denominator to measure the significance of the equity method investment. Companies without a market value (e.g., a company conducting an IPO) will utilize total assets instead of the average worldwide market value. In a pro rata spin-off transaction, the registrant receives no consideration for the disposed business. The registrant should continue to apply current practice by evaluating the carrying value of the disposed business in comparison to the registrant's total assets at the end of the most recently completed fiscal year.

INCOME TEST

The final rules added a revenue component to the income test. The revenue component applies when the registrant and the target company have material revenues for the two most recently completed fiscal years. When revenues of either the registrant or the target are insignificant, the registrant should consider whether the revenue comparison is meaningful to the significance assessment. The staff also commented that the revenue component should reflect the registrant's proportionate interest in the revenues of the acquiree with no adjustment to exclude noncontrolling interests.

To determine whether the revenue component of the income test applies for acquisitions of related businesses, a registrant should assess the materiality of the revenues of the combined group. Similarly, individually insignificant acquisitions should be separated into two groups based on reported income or losses. The registrant then evaluates the materiality of the combined revenues of each group.

ACQUIRED REAL ESTATE OPERATIONS

S-X Rule 3-14 financial statements provide insight into the impact of the acquisition on a registrant's operations. As such, a registrant may no longer substitute significant tenant financial statements for S-X Rule 3-14 financial statements when acquiring a real estate operation subject to a triple net lease. Nevertheless, registrants must continue to assess the concentration of assets subject to triple net leases on an annual basis and provide separate tenant financial statements when significant (i.e., the guidance in [Section 2340](#) of the Financial Reporting Manual still applies when preparing registration statements and annual reports).

TRANSITION MATTERS

For existing registrants filing a registration statement after the mandatory compliance date, the staff will not object to the presentation of pro forma financial information prepared in accordance with the old requirements if (1) the transaction reflected in the pro forma financial statements was consummated prior to the mandatory compliance date and (2) the related pro forma financial statements were filed prior to the mandatory compliance date. However, companies that are conducting an initial public offering may continue to comply with the old requirements after the mandatory compliance date as long as the pro forma financial information appeared in a publicly filed registration statement (i.e., not a confidential draft registration statement) prior to the mandatory compliance date.

NON-GAAP FINANCIAL MEASURES

The SEC staff frequently comments on non-GAAP financial measures presented in registrant filings. When monitoring these disclosures, the staff looks for measures that may mislead investors. In that regard, the staff's discussion focused on COVID-19 and revenue related adjustments as well as segment disclosures.

COVID-19 ADJUSTMENTS

The staff stressed that appropriate COVID-19 related adjustments are:

- Directly attributable to COVID-19;
- Incremental to normal operations; and
- Based on actual amounts rather than hypothetical or estimated amounts.

For instance, hazard pay to employees for performing normal duties and incremental cleaning expenses represent acceptable adjustments in the current period. However, if certain expenses become part of the registrant's normal operations, the related non-GAAP adjustment would no longer be appropriate.

The staff also provided examples of inappropriate COVID-19 adjustments. Rent and other expenses related to temporarily idled facilities and compensation to temporarily idled employees would not represent incremental costs. Additionally, any estimate of lost revenues due to the pandemic would be hypothetical.

REVENUE ADJUSTMENTS

Due to the perceived importance of revenues to investors, the SEC staff continues to challenge non-GAAP measures presented as an alternative to GAAP revenues. The staff objects to the inclusion of the term "revenues" in the description of such non-GAAP measures. For example, the staff would likely take exception to a non-GAAP measure labeled as "gross revenues" or "adjusted gross revenues" which adjusts GAAP revenues by adding back sales incentives (e.g., returns, allowances and/or discounts). However, such a measure may represent amounts invoiced to customers. The staff observed that a registrant may present the metric as a key performance indicator after changing the title to "billings" or "bookings."

Similarly, certain non-GAAP measures may subtract some, but not all, of the cost of revenues from GAAP revenues. The staff observed that the inclusion of "revenues" in the title of such measure (e.g., "net revenues" or "adjusted net revenues") would also be misleading. Instead, the registrant should use a more appropriate label and reconcile the measure to gross margin, the most directly comparable GAAP financial measure (even if gross margin is not presented on the face of the historical statement of operations).

SEGMENT DISCLOSURES

The SEC staff also discussed non-GAAP measures in the context of segment reporting. A registrant must disclose the measure of profit or loss used by its chief operating decision maker. ASC 280 does not require a registrant to calculate such measure in accordance with GAAP. When a registrant presents multiple measures of segment profit or loss which are not calculated in accordance with GAAP, the staff will question the rationale for, and may ultimately object to, such disclosures.

Additionally, the staff will object to the presentation of segment revenues, exclusive of certain costs (e.g., sales returns and allowances) which are included in GAAP revenues on the face of the income statement.

Accounting Matters

Consistent with prior years, the SEC staff provided insights on a variety of accounting consultation topics. Many of these accounting matters required significant judgment or estimation by registrants. Such judgments also require clear and comprehensive disclosures in a registrant's filings to enhance investor understanding. At the Conference, the SEC staff reiterated that supportable, well-reasoned judgments would be respected.

REVENUE RECOGNITION

Principal Versus Agent – A registrant must assess whether it controls the specified goods or services provided to a customer based on the individual facts and circumstances in each arrangement. The SEC staff described a [consultation](#) in which the registrant operated a platform that facilitated an advertiser's purchase of advertising space from a publisher. The registrant obtained the exclusive rights to potential advertising space through a bidding process, which it used to publish predetermined customer advertisements. Although the registrant retained pricing discretion and obtained momentary title to the advertising space, the registrant did not possess the ability to direct the use of the advertising space. Further, the registrant determined that the terms and conditions of the contract indicated it did not have primary responsibility for the delivery of the advertising space. Based on these and other facts and circumstances, the registrant concluded that it was an agent in the transaction, which resulted in the recognition of revenue on a net basis. The SEC staff did not object to this conclusion.

In another [consultation](#), a registrant sourced commodity products from either its own production, a related party, or a third party. The registrant marketed and sold all of the related party's commodity production. Upon procurement from the related party facility, the registrant received legal title to, and possession of, these commodity products. The registrant delivered these goods directly to its end customer. While in possession of the commodities, the SEC staff observed that the registrant maintained the ability to redirect their use, including transporting them to a different customer. The end customer paid the registrant the market price for the products sourced from the related party. The registrant then transferred these payments to the related party, net of a fixed percentage commission. The staff objected to the registrant's conclusion that it was an agent for the related party. Rather, the staff concluded that the registrant controlled the use of the product and obtained substantially all of the remaining benefits of the product.

Identification of Performance Obligations – A registrant must determine whether a promised good or service is distinct in the context of a contract or whether the company is providing a combined item for which the promised goods or services are inputs. In a recent [consultation](#), a registrant's software platform allows its customers to aggregate and analyze data on a real-time basis. The registrant asserted that periodic updates to the software were critical to its utility. When assessing the importance of each software update, the registrant considered the nature and frequency of the updates. The registrant determined that the software licenses and related updates were highly interdependent and significantly affect one another. As a result, the staff did not object to the treatment of the software license and related updates as a single, combined performance obligation.

CONSIDERATION RECEIVED FROM A VENDOR

GAAP requires an entity to account for consideration received from a vendor as a reduction of the purchase price of the goods or services acquired from the vendor unless the consideration represents: (1) a payment in exchange for a distinct good or service transferred to the vendor, (2) a reimbursement of costs incurred by the entity to sell the vendor's products, or (3) consideration for sales incentives offered to customers by manufacturers.

In a recent [consultation](#), the SEC staff explained that a registrant previously purchased fixed assets from a vendor and committed, on a non-cancellable basis, to purchase additional fixed assets from the same vendor. In response to a significant issue with the fixed assets, the vendor repaired the fixed assets and provided cash consideration to the registrant. The related purchase agreements did not provide a specific remedy for this situation. In the registrant's view, the vendor compensated the company for a variety of reasons, including a motivation to retain the registrant as a customer. However, the registrant noted that no distinct good or service was transferred to the vendor in exchange for the consideration and the other exceptions listed above were not applicable. For this reason, the SEC staff did not object to the recognition of the payments received from the vendor as a reduction of the purchase price for the acquired, and to be acquired, goods.

Cash Flow Presentation – The SEC staff also shared its views on the cash flow presentation for certain payments received from a vendor. In general, the presentation of cash payments and cash receipts on a gross basis within the statement of cash flows provides more relevant information to investors. However, ASC 230 allows net presentation in certain situations, including transactions with a quick turnover or short-term maturities. In this [example](#), the registrant presented cash payments to a vendor for fixed assets within investing activities, net of amounts received from the vendor. The registrant stated that these large transactions had a quick turnover due to near-term purchase contracts with the vendor for amounts in excess of the cash inflows. Also, as there were no stated maturities for these contractual cash inflows and outflows, the registrant indicated that the short-term maturity criterion was not relevant. Based on these facts and circumstances, the staff objected to the net presentation of the cash inflows and outflows.

RIGHT-OF-USE ASSETS

In another [consultation](#), a registrant identified specific leases for abandonment. The registrant determined that there was no impairment of the asset group which included the right-of-use assets related to these leases. As a result of the registrant's plan to abandon the leases at a future date and the lack of impairment, the registrant re-evaluated the economic life of the associated right-of-use assets. The SEC staff did not object to the registrant's determination that these right-of-use assets should be amortized ratably over the period between the identification of abandonment and the actual abandonment date.

CONSOLIDATION CONSIDERATIONS

Evaluating Rights in the Voting Interest Entity Model – Under the voting interest entity model, registrants generally consolidate an entity other than a limited partnership when the reporting entity holds majority voting rights. However, substantive participating rights allow a noncontrolling interest holder to effectively participate in certain significant financial and operating decisions made in the investee's ordinary course of business.

The SEC staff illustrated certain voting interest consolidation considerations based on a recent [consultation](#). In this instance, the registrant held a majority voting interest and provided funding for investments while the other owner identified investment opportunities and managed the investments. The economic rights conveyed to each investor through their respective ownership interests varied over time. Additionally, certain significant financial and operating decisions required the consent of the minority interest holder. In the event of a disagreement on these matters, a buy/sell clause allows each party to either acquire the other party's shares at fair value or consent to the decision.

The registrant concluded that the other investor did not have substantive participating rights as the other party was expected to agree with the registrant on these matters rather than risk removal from the venture. The SEC staff objected to the registrant's consolidation of the legal entity under the voting interest model.

Evaluating Power in the VIE Model - Identifying the primary beneficiary of a VIE requires a thorough understanding of the entity's purpose and design along with the variability delivered to its interest holders. The determination of the party with the power to direct the activities that most significantly impact a VIE's economic performance involves judgment and remains a frequent consultation topic.

In a recent [consultation](#), a registrant invested in, and operated, a VIE with another party, which had held an interest in the VIE since its formation. Upon the loss of its only customer, the VIE ceased operations and the registrant agreed to a fixed-price buyout of the other party's interest under a buyout agreement. In this fact pattern, the registrant identified certain activities that significantly impact the VIE's economic performance. These activities, which required a majority vote of the VIE's board of directors and approval from the registrant and the other party, included the approval of the annual budget and the suppliers used in fulfillment of the contract as well as the appointment, removal, or replacement of the CEO. Due to the voting and approval requirements, the registrant determined that both parties shared the power over the VIE's significant activities.

Additionally, the registrant concluded that the related party tiebreaker was not applicable since no de facto agency relationship resulted from the buyout agreement. Based on the substance of the fixed-price agreement, the registrant believed it was not economically equivalent to a loan because (1) the other party's equity interest was not directly financed by the registrant, (2) the other party invested in the VIE since inception, which was prior to the registrant's investment, (3) the other party continued to participate in the business without needing a loan, and (4) the buyout agreement facilitated the dissolution of the VIE.

In consideration of these facts and circumstances, the SEC staff did not object to the registrant's determination that it was not the primary beneficiary of the VIE.

APPLICATION OF EQUITY METHOD ACCOUNTING

When a company does not control an investee but exerts significant influence over the operating and financial policies of that investee, the investment is generally accounted for under the equity method of accounting. A registrant must apply judgment when assessing its ability to exercise significant influence

over an investment, particularly when the investment encompasses less than 20% of the common stock of a corporation.

The SEC staff discussed the evaluation of significant influence based on a recent [consultation](#). In this fact pattern, the registrant held less than 20% of the outstanding voting stock of an investee. Furthermore, a contractual voting agreement between the registrant and certain other investors allowed the voting group to appoint specific individuals to the investee's board of directors. The appointed individuals included representatives from the registrant and constituted a majority of the investee's board of directors. To guarantee these appointments, the vote depended upon the registrant's participation. Additionally, the registrant shared certain management personnel with the investee and had access to confidential information of the investee.

While the registrant lacked certain contractual rights, including the ability to independently appoint board representatives, the SEC staff concluded that the registrant had significant influence over the investee and the equity method of accounting was appropriate.

REFERENCE RATE REFORM

The SEC staff continue to encourage registrants to proactively evaluate their exposure to LIBOR-based contracts and consult, as necessary, in advance of the discontinuance of LIBOR. The SEC staff shared an [example](#) in which a registrant evaluated whether certain new SOFR-based interest rate reset features in a debt agreement meet the definition of an embedded derivative and require bifurcation. The interest rate reset conventions considered by the registrant were (1) Term SOFR, (2) Compounded SOFR "in-arrears," (3) Compounded SOFR "in-advance," and (4) Average SOFR "in-advance."

When assessing the unique factors associated with these new SOFR-based features, the registrant noted that the features were not intended to provide leveraged returns to investors. Rather, these features presented a market-based solution to the discontinuation of LIBOR. Moreover, to address consumer protection laws that mandate advance notice of interest rate changes, certain of these reset features will be required in specific lending products.

The registrant concluded that these reset features represent normal market conventions and form a part of the host debt contract. As such, they are not assessed for bifurcation. Based on current expectations for the market development of commercial and consumer based SOFR products, the SEC staff did not object. However, changing market conditions, facts and circumstances may impact the evaluation of any new interest rate features.

Audit Matters

The SEC staff reiterated the importance of audit quality to investors. Consequently, the staff continues to monitor the PCAOB standard-setting activities as well as global audit-related standards. At the Conference, the staff discussed certain matters impacting audit quality, including auditor independence considerations, ongoing CAM implementation and PCAOB inspection findings.

Additionally, the PCAOB staff highlighted current research and standard-setting projects related to:

- An audit firm's quality control system;
- The supervision of audits involving other auditors;
- Audit evidence; and
- The impact of data and technology in audits.

AUDITOR INDEPENDENCE

The SEC staff [emphasized](#) the critical role that auditor independence requirements play in minimizing the influence of external factors on an auditor's judgements and promoting investor confidence. The staff referenced the October 2020 [amendments](#) to the auditor independence requirements in S-X Rule 2-01 as an illustration of the SEC's efforts to enhance audit quality. These amendments updated certain aspects of the auditor independence requirements based on historical SEC staff observations. The staff noticed certain matters did not impair an auditor's independence and objectivity despite triggering rule violations or requiring time-consuming audit committee reviews. As a result, the amendments focused on relationships or services that are more likely to threaten an auditor's objectivity and impartiality.

CRITICAL AUDIT MATTERS

CAM disclosures in audit reports, as required by PCAOB Auditing Standard 3101, became effective in two phases. During the initial implementation phase, auditors communicated CAMs in audit reports for large accelerated filers. The second implementation phase affects audit reports for all other applicable companies for fiscal years ending after December 15, 2020. CAM disclosures provide audit-specific insights about matters involving especially challenging, subjective, or complex auditor judgment. The auditor must describe the principal considerations in the determination of a CAM as well as how the auditor addressed the matter.

At the Conference, the SEC staff shared [observations](#) related to the implementation of CAM reporting. The staff applauded the use of entity-specific information instead of boilerplate language within the CAM disclosures. The inclusion of detailed information such as specific inputs and assumptions driving a principal consideration provides valuable information to the users of the financial statements. Additionally, the staff discussed the PCAOB's post-implementation review process and encouraged stakeholders to read the PCAOB's [interim analysis report](#) regarding the initial implementation of CAMs.

PCAOB INSPECTIONS

The PCAOB staff communicated a few strategic efforts undertaken in 2020 to improve the overall effectiveness of the inspection program. In response to the COVID-19 pandemic, the PCAOB staff expanded inspection activities to include interim reviews for the first time, extended the inspection cycle to include audits of periods ending through June 30, 2020 (inspection cycles previously covered periods through March 31) and increased its focus on audit firms' system of quality control. Additional PCAOB staff observations and reminders during the COVID-19 pandemic can be found on the PCAOB [website](#).

The PCAOB staff highlighted the areas of recurring inspection findings, including ICFR, revenue recognition, accounting estimates (specifically those related to business combinations and the allowance for loan losses) and auditor independence violations.

As part of the 2021 PCAOB inspection cycle, the PCAOB staff plans to increase the percentage of randomly selected inspections, while also placing an emphasis on risk-based selections for larger, more complex companies and industries with an elevated risk during the inspection period. The staff will focus on areas impacted by the COVID-19 pandemic and the current economic environment, such as:

- Goodwill and intangible assets;
- Going concern;
- Inventory; and
- Fraud procedures, including the evaluation of forecasts and management override.

The PCAOB staff will also emphasize the following areas during its upcoming inspection cycle:

- Recurring inspection findings;
- Reporting requirements related to CAM determinations and communications;
- The audit firms' system of quality control; and
- The custody and control of customer funds and securities in broker-dealer audits.

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