KPMG

Issues & Trends

AICPA National Conference on Current SEC and PCAOB Developments

December 2016

US GAAP

kpmg.com/us/frn

Contents

2016 AICPA Conference Highlights

The December 5-7, 2016 conference featured speakers from regulators, standard setters, preparers, auditors, audit committee members, financial statement users and others who discussed recent developments in accounting, auditing and financial reporting.

Importance of high quality financial reporting

Wesley Bricker, Chief Accountant, Securities and Exchange Commission's (SEC) Office of the Chief Accountant (OCA), explained in his keynote address that the US public capital markets function best when investors have the benefit of high quality financial information that is credible and reliable.

Internal control over financial reporting

Many speakers emphasized the important role of internal control over financial reporting (ICFR) when preparing high quality financial information, particularly as companies adopt new accounting standards. Additionally, speakers emphasized the importance of the different roles that preparers, auditors and audit committees play to ensure strong ICFR.

Non-GAAP financial measures

Regulators continue to focus on non-GAAP financial measures. While the SEC released guidance this year for preparers and has observed substantial progress, the SEC staff and others said that there is still much progress that needs to be made related to the appropriateness of non-GAAP financial measures, their prominence and the effectiveness of disclosure controls and procedures.

Implementing new accounting standards

Speakers dedicated time addressing implementation of the new accounting standards. They focused on the new revenue recognition requirements in Topic 606[1] particularly because of its significant effect on financial statements and the proximity of its adoption date. However, the new lease and credit loss standards were also discussed.

Speakers emphasized the need to disclose the expected quantitative and qualitative effects of adoption. If the effects are unknown, companies should consider disclosing in their public filings information about whether they have

---

[1] FASB Topic 606, Revenue from Contracts with Customers, available at http://www.fasb.org.

completed their assessment and the status of their implementation. Additionally, companies were reminded that they need to disclose changes in their ICFR and disclosure controls and procedures made in response to adopting the new standards.

High quality financial reporting

Mr. Bricker discussed the vital role that preparers, auditors, audit committee members, regulators and others serve in meeting investor needs for reliable financial information. Mr. Bricker and other SEC and PCAOB representatives highlighted the importance of remaining focused on effective ICFR, implementation of the new accounting standards, and the use of non-GAAP financial measures to supplement, rather than supplant, GAAP measures. Mr. Bricker also stated that the FASB’s independent standard-setting process and US GAAP will continue to be the source of accounting standards for domestic registrants for the foreseeable future.

The SEC encouraged registrants to take a fresh look at their disclosures to eliminate unnecessary or immaterial matters.

Internal control over financial reporting

SEC and PCAOB representatives expressed their continued expectation for improvements in the effectiveness of ICFR. Mr. Bricker emphasized that ICFR is a vital component in high quality, reliable financial reporting, and that investors continue to believe that effective internal controls are important. He also said that updating and maintaining effective internal controls will be particularly important as companies implement the major new accounting standards. The representatives stressed that ICFR will remain a significant focus of their regulatory efforts.

KPMG observations

In addition to establishing effective control activities and monitoring activities as the new accounting standards are adopted, registrants should also establish controls within the Control Environment, Risk Assessment and Information and Communication components of the COSO 2013 Framework as key elements of successful implementation of the new accounting standards.

Management’s responsibility for ICFR

Marc Panucci, Deputy Chief Accountant in OCA, stressed that management must take responsibility for ICFR. He said that timely identification, appropriate evaluation, and accurate disclosures of material weaknesses are predicated on an appropriate assessment of ICFR by management and on an effective audit by the independent auditor, when applicable.

Mr. Panucci highlighted the following points.

— Management has the responsibility to carefully evaluate the severity of identified control deficiencies and to report, on a timely basis, all identified material weaknesses in ICFR. Any required disclosure should allow investors to understand the cause of the control deficiency and to assess the potential effect of the identified material weakness.

— It is important to maintain competent and adequate accounting staff to accurately reflect the company's transactions and to augment internal resources with qualified external resources, as necessary. Qualified accounting resources and appropriate processes and controls will be vital when adopting the new accounting standards.

— Management's responsibility for its assessment of ICFR cannot be outsourced to third party consultants. At the same time, consultants can play an important role when assisting management in its evaluation of ICFR.

KPMG observations

A recent enforcement case illustrates a situation in which management did not maintain effective internal accounting resources and did not properly evaluate the related control deficiencies. Instead, it relied on a third party consultant that provided an inadequate deficiency evaluation. The company, CFO, CAO, third party consultant and audit engagement partner were charged with not properly evaluating the control deficiencies as material weaknesses.[2]

Panel discussion on current ICFR topics

A panel that included Jay Hanson, PCAOB Board Member; Kevin Stout, Senior Associate Chief Accountant, OCA; a corporate controller; an audit committee member; and an audit partner discussed challenges in making ICFR assessments.

Mr. Stout emphasized that enhancing the dialogue and furthering open communication among preparers, auditors, and audit committees as outlined in last year's AICPA panel on ICFR[3] could resolve many of the issues involving ICFR assessments.

ICFR assessment challenges

— **The enhanced communication proposals have not yielded the full benefits that regulators expected.** Mr. Stout said it was evident that there is still a lack of adequate communication among some preparers, auditors and audit committees to enable them to collectively address some of the ICFR assessment challenges.

— **Management review controls have not been a key area of discussion during 2016 meetings between companies and the SEC and the PCAOB staffs**. Mr. Stout said this may indicate that some benefits of the enhanced communications among management, auditors, and audit committees discussed at last year's panel may be beginning to appear.

— **Certain new challenges, however, have resulted from differences in preparers' and auditors' respective assessments of the risks of material misstatement** and the extent of audit effort required to address these risks.

Solution: ongoing communications

— **The panel reiterated the importance for discussions** among management, auditors and audit committees to occur in a timely manner and at the appropriate level of specificity.

---

[2] SEC Release No. 77345, March 10, 2016, available at www.sec.gov.
[3] 2015 Issues In-Depth: 2015 AICPA National Conference on Current SEC and PCAOB Developments.

Solution: ongoing communications
— **Active dialogue is critical to bridging different perspectives** on certain matters such as the identified risks of material misstatement, the population of controls to be tested, the extent of planned audit effort, and determining a management evaluation strategy and audit strategy that are effective and efficient.
Evaluation of deficiencies
— **Companies should take a broader view of PCAOB inspection findings**, Mr. Stout encouraged. ICFR audit deficiencies may also be indicative of deficiencies in management's controls and assessments. — **Timely identification and appropriate evaluation of the severity of control deficiencies are critical**, as required in the 2007 Commission Guidance for Management on ICFR.[4]

Audit committee

Mr. Bricker emphasized that as critical gatekeepers in the chain responsible for high quality financial reporting, audit committees must stay current on emerging issues, including financial reporting, internal controls, and disclosures, through continuing education and other means. In discharging their duties, some audit committees may need to engage expert advisors.

In fully exercising the audit committee's oversight over the external auditor, Mr. Bricker noted that the audit committee could consider asking the auditor the following questions to generate an appropriate dialogue.

— If you as the auditor were in management's shoes and solely responsible for preparation of the company's financial statements, would they have in any way been prepared differently?

— If you as the auditor were in an investor's shoes, would you believe that you have received the information essential to understanding the company's financial position and performance?

— Is the company following the same internal control over financial reporting and internal audit procedures that would be followed if you were in the CEO's shoes?

— Are there any recommendations that you as the auditor have made that management has not followed?

Mr. Bricker also reminded audit committees that auditors are accountable to the board of directors through the audit committee and not to management. He said that "audit committees should work with other board committees as needed to monitor that important corporate objectives, such as cost reduction plans, are not unintentionally implemented in ways that would be at cross purposes with management meeting their financial reporting responsibilities or the external

---

[4] SEC Release No. 33-8810, Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934, available at www.sec.gov.

auditor’s appropriate audit scope, engagement terms, and compensation.”

As it relates to the audit committee’s report, Mr. Bricker encouraged proactively providing voluntary disclosures describing how the audit committee executes its oversight responsibilities. He referenced a recent survey, in which 82 percent of audit committees of Fortune 100 companies disclosed in 2016 that the audit committee is responsible for the appointment, compensation and oversight of the external auditor.[5]

Implementation of new accounting standards

> Successful implementation requires companies to allocate sufficient resources and develop or engage appropriate financial reporting competencies.
>
> Wes Bricker, Chief Accountant, OCA

Mr. Bricker highlighted the importance of several new accounting standards, including revenue recognition, leases, and credit losses. He indicated that it is imperative that financial reporting under the new standards achieve the objectives the standard setter identified so investors realize the benefits of the changes. Mr. Bricker also stressed the importance of timely implementation along with useful pre-adoption and transition disclosures.

Mr. Bricker and the OCA staff reminded stakeholders that the new accounting standards will affect all companies. The new revenue recognition standard, for example, may result in only nominal changes in the timing of revenue recognized for some companies; however, additional enhanced disclosures will still be necessary. Changes to a company’s processes and ICFR will be critical to successful implementation to meet both the accounting and disclosure requirements. The Division of Corporation Finance (DCF) staff also reminded registrants about their obligation to identify and disclose changes in ICFR that have materially affected, or are reasonably likely to materially affect, their ICFR.

KPMG observations

Disclosure of changes in controls that have materially affected, or are reasonably likely to materially affect, ICFR are expected to be disclosed as the underlying business changes. Disclosure of such changes may be appropriate in connection with the implementation and adoption of the new accounting standards.

Mr. Bricker also reminded preparers and auditors to recognize the boundaries to auditors’ involvement as companies implement the new accounting standards. Auditors should never act as management or be involved in decision making. However, auditors can provide their perspective during the transition period by reviewing and providing input on management’s implementation process and new accounting policies, as long as they are mindful of the independence rules.

[5] *See* Ernst & Young, Audit Committee Reporting to Shareholders in 2016 (Sept. 2016).

The OCA staff said registrants should not be reluctant to disclose reasonable quantitative estimates, even if the final impact may be different.

They should disclose known or reasonably estimable quantitative information, even if only for a subset of the company's arrangements. The disclosures should be consistent with other information provided to the company's audit committee and investors.

Transition disclosures

The OCA staff reiterated its comments about transition disclosure requirements[6] addressing the impact that the new accounting standards are expected to have upon adoption. Mr. Bricker and the OCA staff stressed how important transition disclosures were to investors. Even if the impact of transition to a new accounting standard is unknown, companies should consider making more qualitative disclosures.

The OCA staff expects transition disclosures to include:

— a description of the effect of the accounting policy, if determined;

— a comparison to current accounting policies;

— the status of its progress on implementation; and

— significant implementation matters not yet addressed.

The OCA staff also emphasized the importance of ICFR as it relates to transition disclosures. As management completes portions of its implementation plan, and develops an assessment of the anticipated impact, effective internal controls should be designed and implemented to ensure appropriate disclosures.

The DCF staff said that it expects to issue comments on materially deficient disclosures when it reviews 2016 Form 10-K filings. The focus will be more on the substance of those disclosures than on the ICFR around the disclosures.

KPMG observations

Companies should continue to focus on transitioning to the new accounting standards and on designing and implementing appropriate internal controls over the adoption of the standards.

Although the DCF staff indicated it will not focus on commenting on the internal controls surrounding transition disclosures, companies should nonetheless design and implement effective internal controls.

Additional interpretations and observations on the new revenue recognition standard are available in KPMG's revenue publications.

Revenue

Mr. Bricker indicated that revenue is one of the most important measures used by investors to assess a company's performance and prospects. The new standard, including the disclosures, are an important step forward in financial reporting, and were designed to enhance the comparability of company's reported revenues regardless of industry or jurisdiction.

While clear progress has been made in the past year, more implementation effort is needed. He cited a recent survey that indicated 8 percent of respondents still had not started an initial assessment, while others were still

[6] SAB Topic 11M indicates that "registrants should discuss the potential effects of adoption of recently issued accounting standards in registration statements and reports filed with the Commission." The SEC staff believes that the disclosure guidance applies to all accounting standards that have been issued but not yet adopted unless the impact is not expected to be material.

assessing (75 percent) or implementing (17 percent) the new standard.[7] Where implementation is lagging, preparers and their auditors should discuss the reasons with audit committees. Management also should provide informative disclosures to investors about the status of their implementation.

A panel of preparers and auditors discussed issues that companies are facing related to implementation of the new revenue standard.

— Companies should expect to commit a significant amount of effort and resources to implement the new standard.

— The new disclosure requirements could result in additional system and data-capture requirements, even for those companies that do not anticipate a significant impact on the amount and/or pattern of revenue recognition.

— The importance of using all available resources when adopting the standard, including peer groups, auditors, publications from the large accounting firms, the FASB technical inquiry process, and the SEC pre-clearance process.

— The importance of designing and maintaining effective internal control over the implementation process, including maintaining documentation of key judgments and considerations throughout the process.

The OCA staff said that the regulatory guidance in FRR 28 and SAB 102 will continue to be relevant in evaluating how to comply with the objectives of the new credit losses standard.

Additional interpretations and observations on the new credit losses standard are available in KPMG's Issues In-Depth, Financial Instruments: Credit Losses.

Credit losses

The OCA staff said that it is monitoring the implementation of the new credit losses standard, which will affect more than just companies in the financial services sector due to the wide range of assets that the standard covers. While the standard goes into effect for calendar year-end SEC registrants in 2020, the OCA staff encouraged registrants to allocate appropriate time and not delay their implementation efforts. The OCA staff commented that registrants are in a unique position to identify significant implementation issues. Their first priority should be to assess how their existing processes for estimating incurred credit losses should be adjusted so they can develop an estimate of expected credit losses.

The OCA staff also noted that the standard does not specify a single method for measuring expected credit losses, and therefore different measurement methods will result in different implementation issues. Further, the OCA staff provided a reminder to management that it will continue to be necessary to document policies, procedures, methodologies and decisions, in addition to developing reasonable and supportable forecasts. Management's systematic methodology should ensure that matters affecting loan collectibility are consistently and appropriately identified and considered in a disciplined manner by persons exercising appropriate judgment.

[7] See PwC, 2016 Revenue Recognition Survey: Readiness update, impacts and remaining challenges (2016).

Additional interpretations and observations on the new leases standard are available in KPMG's Leases: Issues In-Depth.

Leases

A panel of preparers and auditors discussed implementation issues that companies are facing related to the new leases standard.

— The new standard may necessitate system upgrades that might require a long lead time to implement.

— The recognition of additional lease liabilities may affect lessees' debt covenants and require evaluating whether existing debt covenant provisions should be renegotiated.

— The recognition of right-of-use assets and lease liabilities for lessees could significantly affect metrics that are relevant to compensation and analyst measures.

— The standard requires modified retrospective adoption, but provides practical expedients in transition. Additionally, some companies are considering the implementation of non-GAAP policies for immaterial items, for example, by not recording leases on balance sheet below a specific dollar threshold.

KPMG observations

Companies are responsible for establishing processes and internal controls to monitor non-GAAP policies to ensure that they would not result in a material misstatement to the financial statements.

Short-duration insurance contracts

The DCF staff identified issues with the new disclosure requirements for short-duration insurance contracts, which requires companies to disclose incurred and paid claims development information by accident year for the number of years for which claims incurred typically remain outstanding (a claims development table).

— The disclosure standard does not provide specific guidance on how to reflect acquisitions, dispositions or the effects of foreign exchange in the claims development information. Claim development tables should be consistent with the disclosure principles of the new requirements.

— In the event that an insurance entity is considering a presentation approach that may conflict with some of the principles and requirements of the new standard, insurance entities are encouraged to consult with the staff on a pre-filing basis.

— Current guidance in SEC Industry Guide 6 requires a consolidated claims development table to be presented in either the business or MD&A section of an insurance entity's filing. Insurance entities will not be required to continue presenting the consolidated table once they adopt the new standard.

Other transition considerations

Selected financial data. The DCF staff observed that the new leasing standard requires modified retrospective transition, which requires application for all periods presented in a company's financial statements. However, the DCF staff said that registrants would not be required to recast years four and five in their selected financial data tables because the transition method prescribed is not the full retrospective method. With respect to the new revenue recognition standard, the DCF staff has previously communicated that it would provide transition relief so registrants would not have to recast years four and five in a selected financial data table when applying the full retrospective transition method.

Shelf takedowns. The DCF staff spoke about the requirement to file a post-effective amendment before capital is raised through a shelf takedown if there is a 'fundamental change'. The DCF staff said that it would find it unlikely that adoption of the new standard would constitute a fundamental change.

KPMG observations

It is up to a registrant's management and securities counsel to determine whether a fundamental change has occurred. The guidance from the DCF staff may provide relief for companies filing a post-effective amendment after applying the new revenue standard, (i.e. without retrospectively adjusting and auditing annual period financial statements otherwise required in the first Form 10-K filed after adopting the standard). However, it is unclear whether underwriters may require that additional information about how the standard affects previously issued financial statements be filed before initiating a shelf takedown.

Registration statements. The DCF staff said that a new registration statement filed on certain forms after a company files its first report (e.g. Form 10-Q) that reflects a change in accounting principle must include or incorporate by reference audited restated annual financial statements that retrospectively reflect the accounting change that occurred after the most recent fiscal year-end.

For example, calendar year-end companies that adopt the new revenue standard beginning January 1, 2018 using the retrospective transition method would need to include or incorporate by reference audited retrospectively restated historical financial statements for the three-year period ended December 31, 2017, including relevant disclosures. This would include 2015, which is a period that would not otherwise require retrospective revision for annual reporting requirements under the new revenue standard. At this time, the DCF staff has no plans to make any across-the-board accommodations.

KPMG observations

The requirement to include or incorporate by reference annual restated financial statements that retrospectively reflect an accounting change that occurred after the most recent fiscal year-end is found in Item 11(b) of Form S-3 and applies to all registration statements other than those filed on Form S-8.

The DCF staff observed that the new revenue standard refers to Topic 250 for transition guidance, which includes an impracticability exception when complying with the full retrospective method of applying a new accounting principle. The DCF staff noted that meeting the impracticability exception was a high hurdle and encouraged companies to consult with OCA if they have questions about applying the impracticability exception.

The DCF staff clarified that these issues do not arise with new standards that are adopted on a modified retrospective basis, such as the new leases standard.

The DCF staff pointed out that registrants adopting the new revenue standard on a modified retrospective basis may want to provide supplemental disclosure in their MD&A about the effect of adopting the revenue standard under a retrospective method. The DCF staff said this presentation would be permissible, but instructed companies to consider the following guidance:

— If expense line items are also affected by retrospective adoption, those effects should be disclosed.

— A full income statement should not be presented, only the income statement lines being affected.

— If there are assumptions or practical expedients that are being made, those should be disclosed.

KPMG observations

Registrants that plan to use the retrospective transition method when adopting the new revenue standard should consider their potential capital requirements and whether they will need to file a registration statement shortly after adoption. A registration statement filed after the first quarterly filing following adoption, and before the annual financial statements are issued, could require applying the standard to an earlier period than otherwise would have been required.

Non-GAAP financial measures

Mr. Bricker noted that with the release of the new Compliance and Disclosure Interpretations (C&DIs)[8] in May 2016 and with the SEC staff's engagement with companies and advisors, substantial progress has been made in addressing problematic practices primarily in the area of prominence of non-GAAP measures in comparison to the GAAP measures. However, companies need to continue to make progress, for example, in the evaluation of the appropriateness of measures, as well as the effectiveness of disclosure controls and procedures.

Mr. Bricker also provided an overview of the two key aspects that the SEC staff considers in their evaluation of the use of non-GAAP measures:

— **Proper presentation.** The SEC staff considers a variety of factors, including the characteristics highlighted in the C&DIs such as the prominence of non-GAAP items in comparison to relevant GAAP measures.

— **Quality of reconciling items.** The SEC staff considers the transparency and relevance of adjustments made. This includes evaluating whether descriptions may be misleading (e.g. items labeled as nonrecurring that may be recurring) or do not provide an investor with a clear understanding of the nature and basis for the adjustment.

Mr. Bricker emphasized that audit committee members should seek to understand management's judgments made in the design, preparation and

[I]t is important to keep in mind that businesses operate in uncertain environments. If non-GAAP adjustments replace that business reality with smooth earnings over time, accelerate unearned revenues or defer incurred expenses, those adjustments and disclosures should be evaluated closely under the C&DIs.

Wes Bricker, Chief Accountant, OCA

[8] SEC Compliance and Disclosure Interpretations (C&DIs), May 17, 2016, available at www.sec.gov.

presentation of non-GAAP financial measures and how those measures might differ from other companies.

Panel on non-GAAP financial measures and DCF staff commentary

The panelists, including Mark Kronforst, Chief Accountant, DCF, said that some companies' use of non-GAAP financial measures to communicate performance and explain results to investors has diverged from the SEC's rules and regulations and related interpretations.

Mr. Kronforst reiterated that the SEC staff does not intend to eliminate the use of non-GAAP financial measures, which are clearly permissible under the SEC's rules and regulations. He also agreed with Mr. Bricker that substantial improvements have been made by preparers subsequent to the release of the C&DIs. However, he acknowledged that the SEC staff continues to observe non-GAAP financial measures presented inconsistently with the C&DIs or that have the potential to be misleading.

The DCF staff is providing comments to companies related to their use of non-GAAP financial measures in communications and financial reporting, the majority of which are intended to point these companies to the C&DIs to remind them about their obligation to comply with the rules and interpretations.

Observations and specific measures

Mr. Kronforst highlighted that the most prevalent comment has been related to the requirement to present GAAP measures with 'equal or greater prominence' than the most comparable non-GAAP financial measure. He added that, "whatever you're leading with [in a filing or earnings release], however slightly, is more prominent." When providing the required quantitative reconciliation of a non-GAAP financial measure to the most directly comparable GAAP measure in accordance with Regulation G, the SEC staff expects that the reconciliation will begin with the GAAP measure and end with the non-GAAP financial measure.

Highlights from the panel discussion

— Reconciliations of non-GAAP financial measures to GAAP should be performed for forward-looking non-GAAP information. The C&DIs remind companies that they must reconcile these measures unless the exception for unreasonable effort to reconcile is met.

  If the exception is applied, this must be disclosed and companies must list what GAAP information is not available. It is not acceptable to exclude a reconciliation of forward-looking information simply because it is forward-looking.

— Companies must provide a clear and thorough explanation about why the non-GAAP financial measure is useful to investors and how management uses the information.

— The DCF staff will question whether adjustments, such as restructuring charges, may be characterized as nonrecurring if the company experiences these events in multiple reporting periods.

— Mr. Kronforst addressed the acceptability non-GAAP industry-specific and tailored accounting measures. These tailored accounting measures (e.g.

Highlights from the panel discussion

adjusting revenue to arrive at an amount that represents billings) are generally not acceptable.

However, limited circumstances exist in which an adjusted revenue measure could be appropriate, such as when companies disclose information to help investors understand the effect of the new revenue standard.

Mr. Kronforst encouraged companies to speak with the SEC staff if they believe a non-GAAP revenue measure may be appropriate.

— Voluntarily expanding the segment disclosure to include non-GAAP financial measures that the Chief Operating Decision Maker (CODM) reviews does not provide 'protection' or otherwise exempt the disclosure from the SEC's rules and regulations concerning non-GAAP measures.

— The DCF staff is considering mark-to-market adjustments (e.g. changes in fair value of derivative financial instruments) as a reconciling adjustment in a non-GAAP measure of profitability.

However, the DCF staff does not currently object to including straight-line rent adjustments as a reconciling item in a non-GAAP financial measure of profitability.

Ongoing evaluation of non-GAAP financial measures

The panelists highlighted certain best practices for non-GAAP financial measures. For example, management should routinely consider evaluating and documenting the population of non-GAAP financial measures, how they are used, and why the measures are relevant and important to investors and other users. This information should be communicated to, and discussed with audit committees and senior management. Companies should also consider how fully it incorporates the development and review of non-GAAP financial measures into its disclosure controls and procedures.

KPMG observations

In June 2016, the Center for Audit Quality published *Questions on Non-GAAP Measures: A Tool for Audit Committees.*[9] This tool can help audit committees assess whether non-GAAP financial measures are accurate, appropriate and useful to investors. This resource also reviews the auditor's role in this process and examines relevant regulations.

[9] Questions on Non-GAAP Measures: A Tool for Audit Committees, available at www.thecaq.org.

International perspective

International groups such as International Organization of Securities Commissions and European Securities and Markets Authority have been actively considering non-GAAP financial measures. Craig Olinger, Deputy Chief Accountant, Division of Corporation Finance, said that many jurisdictions are moving towards providing more guidance on non-GAAP financial measures. Mary Tokar, IASB Member, said that the IASB expects to issue a discussion paper covering alternative performance measures. She said that not all alternative performance measures are necessarily misleading.

Auditor independence

The SEC staff emphasized the importance of auditor independence to the capital markets, and said that management and audit committees, along with auditors, must improve processes to ensure auditor independence. Mr. Bricker stated that audit committees should consider whether management needs to improve policies related to corporate governance, policies and procedures to prevent costly independence issues.

While an auditor would impair its independence if it provides a specifically prohibited service under Rule 2-01(c) of Regulation S-X, Mr. Panucci said that auditors and their clients should also consider whether services or relationships not specifically addressed in the independence rules may nonetheless impair independence. Mr. Panucci reminded auditors and clients to consider whether any relationship or service provided by the auditor would:

— create a mutual or conflicting interest with the audit client;

— place the auditor in the position of auditing its own work;

— result in the auditor acting as management or an employee of the audit client; or

— place the auditor in a position of being an advocate for its client.

During the past year, the SEC's Division of Enforcement brought cases against audit partners involving inappropriate personal relationships with their audit clients that violated the general auditor independence provisions. These cases showed that a reasonable investor would conclude that the auditor was not capable of exercising objective and impartial judgment on all of the issues encompassed within the auditor's engagement. Andrew Ceresney, Director, Division of Enforcement, said that they would continue to focus on independence related matters.

Division of Corporation Finance focus areas

The DCF staff discussed the significant progress it has made over the past year advancing its initiative to modernize and simplify its disclosure regime for registrants through concept releases and proposed rules.

Filing review and comment letter process

The DCF staff highlighted the following reminders related to its filing review and comment letter process.

— The comment letter process is intended to be an open dialogue between management and the DCF staff. Questions from the DCF staff don't necessarily indicate that the DCF staff has concluded that a change to a filing is warranted. Based on the dialogue and facts presented to the DCF staff, it may determine that no change is necessary. Registrants should not automatically add a disclosure in response to a question simply to accelerate or end a review.

— If a registrant believes something is clearly immaterial, tell the DCF staff right away. Properly supported materiality assessments could significantly reduce the amount of time it takes to respond to a question from the DCF staff.

— Registrants should use caution when analogizing to other registrants' comment letters, which refer to similar fact patterns and concerns raised by the DCF staff. While the comment letter resolution may be an appropriate data point in a company's analysis, it should not be considered a safe harbor. There are numerous reasons why the DCF staff might close a review and the rationale may not always be apparent from the public correspondence.

The DCF staff needs sufficient time to review significant new information added to a pre-road show filing to highlight new disclosures for new developments or non-GAAP information. If a company's goal is to have minimal changes to its filing, it is best to give the DCF staff proper notice so it has adequate time to consider potential material updates.

KPMG observations

Registrants are reminded not to place undue reliance on what the DCF staff has accepted for other registrants' comment letters. There are many reasons the DCF staff might not comment further on a registrant's particular disclosures beyond saying that the staff is satisfied with the accounting or disclosure position in the particular facts and circumstances.

New policy for the interpretive and waiver process

The DCF staff commented on a new request for registrants in the interpretive and waiver process. This process is used for a company to consult with the DCF staff about the interpretation of a disclosure matter, or to request a waiver from a particular filing or disclosure requirement. To help facilitate an efficient process, the DCF staff expects that the auditors will be involved in a submission and will request that letters be reviewed by the company's auditor before the DCF staff review, if auditor involvement is not indicated in the letter.

KPMG observations

The request to involve auditors in the review of interpretive and waiver submissions to the DCF staff is similar to OCA's guidance for auditor review of pre-filing submissions on accounting matters. The new process was created to address perceived inefficiencies in the consultation process that occur when auditors have not shared their perspective before the client contacts the DFC staff.

New revenue standard disclosure requirement on disaggregation

The DCF staff noted that the new revenue standard requires disaggregation of revenues into categories that depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors. The DCF staff indicated that companies may need to use more than one category to meet this objective such as types of goods or services, geographic regions, and types of customers and contracts. Similar requirements are included in US GAAP requirements for segment reporting (Topic 280[10]), which requires enterprise-wide disclosures of revenue disaggregated by product and geography. However, the new revenue standard does not have an impracticability exception.

The DCF staff highlighted that the disaggregation of revenue will require a company to consider how information is presented for other purposes, such as investor presentations, earnings releases and information that is reviewed by the CODM. The DCF staff indicated that it will look beyond the filing to evaluate the basis for disaggregation in the revenue disclosures.

Observations from filing reviews

Segment disclosures

The DCF staff noted that many comments are still being issued about operating segments and, in some instances, the staff has objected to companies' operating segment presentations. It identified four areas of concern.

— **Identification of operating segments.** Registrants sometimes erroneously conclude that discrete financial information is not available. The DCF staff reminded companies that the allocation of shared costs is not required to meet the definition of discrete financial information in the standard.

— **Aggregation of operating segments.** The DCF staff has observed some registrants have not considered qualitative characteristics and still have only evaluated quantitative similarity when determining whether operating segments should be aggregated. Quantitative similarity may be coincidental, so a robust analysis of the qualitative similarities must also be performed.

— **Enterprise-wide disclosures.** Registrants do not always provide entity-wide disclosures, including reporting revenues from external customers for each product and service or each group of similar products and services;

[10] FASB Topic 280, Segment Reporting, available at www.fasb.org.

geographic information for revenues and long-lived assets; and information about its reliance on its major customers.

— **Miscellaneous disclosure points.** The DCF staff said the requirement to disclose the basis of organization would include how management has organized an entity (e.g. around different products, services, geographic areas or regulatory environments). The DCF staff also reminded registrants to disclose whether operating segments have been aggregated.

KPMG observations

The DCF staff addressed many issues around the interpretation of 'similar'. Registrants need to consider the scope of activities when evaluating similarity. The DCF staff provided an example of a conglomerate that has two to three food operating segments, which may be appropriate to aggregate because of the broad scope of the company's other activities. Conversely, a company may solely operate within the food industry with multiple food operating segments. In this case, the analysis would be qualitatively narrower making it inappropriate to consider the segments as similar.

There is no bright line for what constitutes similar, and the range of acceptably similar margins may be tighter in businesses with relatively lower margins or volatility in profitability. The likelihood that future margins are expected to be similar does not outweigh the dissimilarity of historic margins.

Finally, the DCF staff indicated that a company's operating segments are not necessarily defined by the financial information presented to the CODM; rather, this information should be considered as a data point to use when making the determination. Companies should look to a variety of information, including the manner in which management is organized, the budgeting process, and how compensation is determined when identifying their operating segments.

Customer incentive programs

The DCF staff said that companies are engaging in new types of incentive programs to attract customers, such as 'refer a friend' programs, where a customer might get a credit for a future purchase if they refer a friend. While these programs are typically recorded as a reduction in revenue, there is diversity in practice when an agent provides incentives to a principal's customer that is outside the traditional distribution chain. Because of this diversity, the DCF staff expects companies to disclose within MD&A incentives that are classified outside of revenue, together with a qualitative and quantitative discussion of the incentive programs.

KPMG observations

Classification of customer incentives could change under the new revenue standard, and companies are encouraged to carefully consider their programs as they adopt the new standard.

Loss contingencies

The DCF staff continue to focus on loss contingencies, including situations that suggest accruals or disclosures may not have been made in a timely manner or circumstances where the reasonably possible range of loss was omitted. The DCF staff discussed one situation where a registrant settled litigation very shortly after filing its Form 10-Q, which contained no disclosure of the contingency. After the DCF staff comment, the registrant concluded that the contingency should have been accrued in the prior period and amended its filing.

Income taxes

The DCF staff reminded companies that MD&A has disclosure requirements related to income taxes, which are especially important for multinational companies operating in jurisdictions with various tax regimes, risks and uncertainties. The DCF staff said that income tax disclosures have improved, but it expects to issue more comments if continuous improvement isn't seen in future Form 10-K disclosures. Current disclosures often do not provide adequate insight into the big picture tax situation for a company.

Required income tax disclosures – DCF staff

— The reasons for historical changes in the effective tax rate

— The reasons for changes in the reconciling items between the statutory tax rate and the effective tax rate

— Insight into the extent to which the past effective tax rate is indicative of the future

— Uncertainties related to a company's tax positions

— The effect of taxes on liquidity

— Information about trends and uncertainties and changes in unrecognized tax benefits, including cash in foreign jurisdictions that is subject to the indefinite reinvestment assertion

— The trends in income tax expense and cash taxes paid

The DCF staff also discussed situations when a company released a valuation allowance without providing any insightful information to investors to explain the reason for the change. The DCF staff expect to see robust disclosure about future sources of taxable income and uncertainties upon the release of a valuation allowance.

MD&A

A panel of preparers, auditors, users and securities counsel discussed topics including the importance of external communications, disclosure effectiveness and MD&A comment letter trends.

The areas of most frequent comment by the DCF staff related to MD&A include:

— **Non-GAAP** – equal or greater prominence and reconciliations from GAAP to non-GAAP performance measures

— **Segments** – the evaluation of segments and the key information used by the CODM to manage and operate the business

— **Cash balances** – offshore cash balances

— **Cybersecurity** – responsiveness to the potential impact of cybersecurity threats

— **Micro trends** – business trends that are not disclosed in MD&A

— **Critical accounting policies** – boilerplate disclosures not tailored to the registrant's business

The panel also discussed how registrants are streamlining their MD&A disclosures so they can provide clearer and more useful information to investors. These methods include removing stale information and replacing lengthy disclosures with tables, charts or graphics.

International reporting matters

Craig Olinger, Deputy Chief Accountant, DCF, noted that foreign private issuers (FPI) now predominately file either under IFRS or US GAAP with very few filers using home-country GAAP with a US GAAP reconciliation. Similar to US GAAP, frequent IFRS comment areas include segment reporting, non-GAAP measures, revenue recognition, income taxes, intangibles and goodwill, acquisitions and business combinations, commitments and contingencies, and fair value measurement.

Panel members also observed that pro forma financial statements and carve-out reporting often result in inconsistent reporting because there is no specific IFRS guidance. Mr. Olinger stated that the DCF staff were open to consultation on pro forma financial statements and carve-out reporting with respect to the applicable accounting framework.

Current accounting practice issues

The OCA staff discussed its consultations over the past fiscal year, which included 125 accounting consultations from a variety of sources, noting the top three consultation topics have been revenue recognition, business combinations and financial assets.

Mr. Bricker discussed OCA's process for accounting consultations on new accounting standards. The OCA staff first considers the nature, design and economic substance of a transaction. Mr. Bricker indicated that a clear understanding of the terms of the arrangement and the contract is the key starting point. With that understanding, questions are evaluated against the relevant guidance and interpretations, including:

— the language in the standard itself and the related basis for conclusions;

— implementation discussions, such as those at the Transition Resource Group; and

— general objectives expressed in the standard for consistency and comparability.

Revenue recognition

The OCA staff said that it is looking to the new revenue standard, and any subsequent amendments, as the starting point for all consultations related to implementation. SAB Topic 13 will continue to apply to registrants before they adopt the new revenue standard.[11] However, registrants should not be looking to the guidance in SAB Topic 13 when determining how to account for revenue transactions under the new revenue standard.

Payments to customers (new revenue standard)

The OCA staff provided observations from recent consultations related to accounting for payments made to customers under the new revenue standard. The OCA staff described scenarios where a company makes an up-front payment to a customer to secure an exclusive business relationship with that customer or as part of a marketing incentive plan.

The OCA staff provided questions that they consider to understand the nature and substance of a payment made to a customer:

- What are the underlying economic reasons for the transaction? Why is the payment being made?
- How did the company communicate and describe the nature of the payment to its investors?
- What do the relevant contracts governing the payments stipulate? Does the payment secure an exclusive relationship between the parties? Does the payment result in the customer committing to make a minimum level of purchases from the vendor?
- What is the accounting basis for recognizing an asset, or recognizing an up-front payment immediately in earnings?

Companies should first determine the purpose of the payment. After considering all the facts and circumstances and relevant accounting resources, a company should account for the payment using an accounting model that is consistent with the identified substance of the payment. A company should also consistently apply the relevant accounting literature to similar arrangements.

The OCA staff indicated that 'matching' is not a determinative factor to support asset recognition when a payment is made to a customer.

Definition of a contract (new revenue standard)

The OCA staff described a fact pattern in which a company had a loss leader pricing strategy in which it would sell initial products at a loss with the expectation that it would lead to the subsequent sale of other goods or services with higher volumes and/or greater profits. The OCA staff observed that while a future contract may be likely, or even compelled economically or by regulation, it would be inappropriate to account for a contract before it exists with both enforceable rights and obligations. As a result, the OCA staff objected to a view that the loss on the initial contract could be deferred. Anticipated future

---

[11] SEC Staff Accounting Bulletin No. 13, Revenue Recognition, available at www.sec.gov.

contracts for the subsequent sale of goods or services may not be considered part of an existing revenue arrangement.

Contract combination (new revenue standard)

The OCA staff described a fact pattern in which two contracts were entered into at the same time and met some of the criteria for contract combination. The criteria included being negotiated with a single commercial objective, and consideration paid in one contract was dependent on the pricing in the other contract. However, the contracts were not with the same customer or a related party of that customer. Therefore, the OCA staff objected to the registrant's view that the contracts could be combined because they did not meet the required criteria for contract combination.

Gross versus net revenue presentation and disclosures (new revenue standard)

The OCA staff said that over 30 percent of the revenue consultations it received relate to gross versus net revenue presentation and made the following observations.

OCA staff observations
Importance of information to investors
— The OCA staff said that the presentation determination informs investors with respect to (1) who the registrant believes is its customer; (2) which specified good or service the registrant is selling to the identified customer; and (3) the amount of revenue earned and the profit margins reported by the registrant on the transaction. — The related disclosures should help investors understand the accounting judgments that went into the gross or net revenue presentation and the transaction cash flows in the context of the relevant underlying contracts.
Moving from a 'risk and rewards' framework to a 'control' framework
— The accounting determination of whether a company is the principal or the agent under the new revenue standard could be different from a company's conclusion under US GAAP. — Registrants will need to revisit their current principal versus agent conclusions, and may need to look to the control indicators included in the new revenue standard. — Registrants must not view either gross or net reporting as a default or a safe harbor. The specific facts and circumstances of an arrangement must drive the final accounting conclusion.
Evolving business models
— The OCA staff said that evolving business models in conjunction with changes in the accounting framework will require management to stay focused when evaluating gross versus net revenue presentation.

KPMG observations

Companies will need to evaluate gross versus net presentation for each arrangement as part of the adoption of the new revenue standard, and there is no safe harbor in net presentation or the conclusions reached under current US GAAP.

Determining the interest cost component of net periodic benefit cost

The OCA staff followed up on last year's conference discussion related to approaches to determining the interest cost component of a sponsor's net periodic benefit cost for a defined benefit pension or other postretirement benefit plan.

The OCA staff discussed a recent consultation on the proposed use of the spot-rate approach to estimate interest cost using a hypothetical bond matching methodology for the benefit obligation. The OCA staff objected to this approach, because the yield curve data used to determine interest cost, even when derived from the prices of the bonds included in the hypothetical portfolio, was not the same data used to determine the benefit obligation, the latter of which is premised on the value of a selection of bonds. The OCA staff reiterated its views that the measure of the benefit obligation and determination of the interest cost are integrated concepts.

The OCA staff said that a company should first start with its balance sheet, measure the benefit obligation as required by GAAP, then attribute the change in benefit obligation to the various components of net periodic benefit cost, including interest cost. When computing interest cost, a company should use the same information that it used for the balance sheet measurement or the single weighted-average approach, which is explicitly allowed by US GAAP.[12]

KPMG observations

The measurement concepts of the benefit obligation and determination of the interest cost component are integrated, regardless of what approach is used to determine the benefit obligation. Therefore, a registrant should use discount rate information to compute interest cost on a basis consistent with its measurement of the benefit obligation.

Changes in accounting policies

The OCA staff discussed the judgment required to determine if a change a registrant makes to its accounting policies results in the adoption of a new accounting principle that should be evaluated for preferability. The occurrence of transactions or events that are clearly different in substance from previous transactions or events may require the adoption of a new accounting principle or modifying an existing accounting principle. Therefore they would not constitute a change in accounting principle that requires an evaluation of preferability.

[12] FASB paragraph 715-30-35-45, available at www.fasb.org.

The determination of whether transactions or events are clearly different in substance from those occurring in the past requires judgment. The OCA staff indicated that the starting point of that analysis is clearly documenting the nature of the transactions or events that resulted in the existing accounting policy. Identifiable differences between certain transactions or events does not necessarily equate to a clear difference in substance that necessitates a new or revised accounting principle.

Share-based payment awards: Establishing a grant date

The OCA staff discussed the challenges of determining whether there has been a grant date for share-based payment awards when there is a key term or provision that is subject to discretion. The OCA staff provided an example of an award with clawback features that would allow those with authority over compensation arrangements to apply broad discretion in determining whether and when awards could be clawed back.

The OCA staff made observations that when an award includes a key term or provision that is subject to discretion, registrants should carefully consider whether a mutual understanding has been reached and a grant date has been established. When making that determination, a registrant should also assess past practices exercised by those with authority over compensation arrangements and how those practices may have evolved over time.

The OCA staff also stressed the importance of appropriate ICFR to monitor those practices in order to support the judgment needed to determine whether a grant date has been established.

Financial instruments

Recognition and measurement

The OCA staff discussed implementation considerations related to the new recognition and measurement guidance for financial assets and liabilities.[13] Specifically, for financial liabilities recorded at fair value, the new standard allows companies to record the component of changes in fair value related to instrument-specific credit risk as other comprehensive income (OCI). The OCA staff discussed the scope of presentation and measurement of the amount of instrument-specific credit risk.

The new guidance permits OCI presentation for changes in instrument-specific credit risk for financial liabilities for which the fair value option has been elected pursuant to Topic 825.[14] The ability to record changes in fair value related to instrument-specific credit risk may be applied to hybrid financial liabilities recorded at fair value that contain an embedded derivative that would otherwise require bifurcation had the company not elected to record the entire instrument at fair value pursuant to Topic 815.[15] For example, changes in fair value related to instrument-specific credit risk for a debt instrument indexed to the price of gold

---

[13] FASB Accounting Standards Update No. 2016-01, Recognition and Measurement of Financial Assets and Liabilities, available at www.fasb.org.
[14] FASB Topic 825, Financial Instruments, available at www.fasb.org.
[15] FASB Topic 815, Derivatives and Hedging, available at www.fasb.org.

and whose repayment is required to be settled in cash would be eligible to be presented as other comprehensive income. The OCA staff noted that there is no requirement to apply the guidance in Topic 815, prior to electing the fair value option for financial liabilities in Topic 825. Consequently, the OCA staff observed that an election to record the financial liability at fair value pursuant to Topic 815 should not preclude applying the new presentation guidance.

In measuring instrument-specific credit risk, the new guidance does not prescribe the use of a specific method of measuring instrument-specific credit risk. However, the new guidance does provide a method ('Base Rate Method') that preparers may use for some instruments where any changes in fair value of the liability other than changes in fair value related to any changes in a benchmark interest rate would be determined to be changes in fair value related to instrument-specific credit risk. However, the OCA staff noted that the Base Rate Method is not appropriate for two types of financial instruments.

— **Non-recourse liabilities –** a financial liability whose payment is solely tied to the value or cash flows of an asset pledged as collateral and where there is no recourse to the debtor. As the risk of nonpayment, and the corresponding changes in the financial liability's fair value, is solely tied to the asset pledged as collateral, the OCA staff does not believe it is appropriate to ascribe any change in the fair value of the financial liability to instrument-specific credit risk. Therefore, no amounts would be recorded to OCI related to changes in instrument-specific credit risk.

— **Hybrid financial liabilities –** the OCA staff gave an example of a debt obligation that is indexed to the price of gold and requires cash settlement. The fair value of such instrument is impacted, in part, by the price of gold. Consequently, use of the Base Rate Method could result in changes in the fair value of gold being included in the measurement of instrument-specific credit risk.

The OCA staff observed that use of the Base Rate Method may not be appropriate in all circumstances, and as the terms of the financial liability become more complex, more judgment is needed to determine if an alternative method is required.

KPMG observations

Preparers are currently required to disclose the change in fair value of the financial liability changes in instrument-specific credit risk. We believe in many cases, preparers can use existing methodologies used to measure the change in fair value due to changes in instrument-specific credit risk for current disclosure purposes to measure amounts to record in OCI. Consequently, we would expect that preparers may not need to change current processes and controls related to measuring instrument-specific credit risk.

Additional KPMG observations are available in Financial Instruments: Q&As on recognition and measurement.

Debt and equity instruments

The OCA staff noted that it has observed several fact patterns in which registrants have not complied with the debt-equity guidance. The OCA staff provided one specific example where a registrant issued warrants on its common stock that included a put feature. This feature allowed the holder of the warrant to sell the warrant back to the registrant for cash equal to the fair value of the warrants. The OCA staff objected to equity classification of the warrants as they should be classified as a liability. Management and the audit committees of companies should continually assess whether they have resources with sufficient training available to appropriately account for these instruments.

Income taxes

The OCA staff noted that they continue to consult with DCF staff in evaluating certain judgments companies have applied in accounting for income taxes. The OCA staff gave an example of consultations related to the recognition of deferred taxes on undistributed earnings of a registrant's foreign subsidiary. The DCF staff have questioned registrants where disclosures made outside of the audited financial statements (e.g. MD&A) call into question or contradict assumptions relied upon in accounting for undistributed earnings of foreign subsidiaries. The OCA staff highlighted that in at least one instance it had objected to a registrant's assertion that remittance of a foreign subsidiary's earnings would be postponed indefinitely.

The OCA staff noted that the judgments applied in accounting for income taxes may require coordination among multiple business functions within a company's global organization, including accounting, treasury and other business functions.

Joint ventures and strategic alliances

Joint ventures and other forms of strategic alliances can raise issues across various accounting topics such as consolidation, gain recognition, revenue recognition, derivatives and leases. The OCA staff commented that these highly structured arrangements continue to increase in prevalence and complexity and that the assessment in each of the relevant areas should be based on the facts and circumstances of the specific arrangement. For arrangements in which activities are conducted partially or entirely within a legal entity, companies should first determine whether they should consolidate the entity. The OCA staff indicated that under both the voting and variable interest consolidation models conclusions with respect to decision-making authority should be consistent with the substance of the underlying arrangements and the objective of Topic 810.[16]

For arrangements where the entity is not consolidated or those arrangements that are outside of a legal entity, the OCA staff indicated that careful consideration should be given to the applicable accounting guidance. For example, an arrangement may meet the definition of a joint venture or a collaborative arrangement. Other arrangements may include a contract with a customer in the scope of the new revenue recognition standard. Finally, the OCA staff observed that it is important to distinguish between arrangements where the other party obtains the output of a company's ordinary activities, and arrangements where a company participates in an activity with another party and shares in the related risks and benefits (such as developing an asset in a collaboration arrangement).

[16] FASB Topic 810, Consolidation, available at www.fasb.org.

Definition of public business entity

The OCA staff commented on the interaction between the accounting and reporting for an equity method investment and the definition of a public business entity.

The definition of a public business entity includes, in part, business entities that file or furnish financial statements with the SEC. The definition also includes other entities whose financial statements or financial information are included in a filing with the SEC. Under this definition, some entities that are not SEC registrants, such as a registrant's equity method investees that are significant under Regulation S-X, are considered public business entities solely because their financial statements or financial information are included in a registrant's SEC filing. In those cases, the investee would be considered a public business entity solely for the purposes of the financial statements or financial information included in the SEC filing.

All entities that meet the definition of a public business entity should adopt new accounting standards using the effective dates for public business entities for the financial statements or financial information included in a filing with the SEC.

The OCA staff has received questions regarding the accounting for equity method investees that do not otherwise meet the definition of a public business entity and whose financial statements are not included in an SEC filing. The OCA staff indicated that amounts recognized by a registrant in applying the equity method of accounting would not by itself be considered financial information included in a filing with the SEC under the FASB's definition of a public business entity. Therefore, such equity method investees would not be required to use the effective dates of a public business entity solely for a registrant's equity method accounting. However, for equity method investees that meet the definition of a public business entity, the OCA staff expect the registrant's equity method accounting to be based on the investees' financial statements prepared using the public business entity effective dates.

KPMG observations

In certain cases, SEC registrants may be required to include the financial statements or financial information of an investee or acquiree in an SEC filing. For example, Rules 3-05, 3-09 and 4-08(g) of Regulation S-X require the inclusion of the separate financial statements or financial information of an investee or acquiree that is considered to be significant.

The inclusion of the financial statements or financial information of an investee or acquiree in an SEC filing would cause that company to meet the definition of a public business entity (PBE). Therefore, the investee or acquiree would be required to adopt the provisions of new accounting standards at the earlier effective dates provided for PBEs.

This might be a particular challenge to registrants that have numerous equity investees that meet the Rule 4-08(g) requirement solely as a result of the aggregation of the investees in the summarized financial information required by the Rule.

However, it is important to note that the transition method selected by an investee or acquiree would not be required to be the same as the SEC registrant, which is required to include its financial statements.

KPMG observations

Early consideration by management is imperative to ensure that the relevant implementation steps are planned, understood and performed, including adequate ICFR considerations.

Measurement period adjustments

An acquirer in a business combination is required to report provisional amounts if the initial accounting for the business combination is incomplete by the end of the period covering the business combination. The acquirer must recognize adjustments to those provisional amounts to reflect new information obtained within the measurement period about facts and circumstances that existed as of the acquisition date. The OCA staff reminded companies that the measurement period is not one year, but rather ends as soon as the acquirer receives the information it was seeking or learns more information is not obtainable, and shall not exceed one year.

In 2015 the FASB issued ASU 2015-16[17], which eliminates the requirement to retrospectively adjust the financial statements for measurement period adjustments. These adjustments are now recorded in the period identified and separately disclosed. However, this ASU does not impact the requirement to retrospectively reflect the correction of an error in the application of business combination accounting.

The OCA staff emphasized the importance of effective ICFR to ensure that measurement period adjustments and error corrections are appropriately identified and distinguished. When the accounting for a business combination is incomplete, disclosures regarding provisionally recorded amounts and unavailable information are required.

The OCA staff noted the importance of not misidentifying errors in business combination accounting as measurement period adjustments given the recent change in accounting for measurement period adjustments.

Implementation and monitoring of new auditing standards

The OCA staff reminded companies that having an effective implementation and monitoring strategy is equally important for new auditing standards. When a new standard is introduced by the PCAOB, audit committees are encouraged to have early and frequent conversations with management and the external auditors to promote successful implementation of the standard. These conversations should facilitate an in-depth understanding of the objective of the new standard and any potential changes to external filings. In addition, audit committees, through their discussions with management, are in a position to monitor best practices or potential unintended consequences, and are encouraged to share these observations with their auditors and regulators.

---

[17] FASB Accounting Standards Update No. 2015-16, Simplifying the Accounting for Measurement-Period Adjustments, available at www.fasb.org.

Standard setting

US consideration of IFRS

Mr. Bricker commended the FASB and IASB for their significant progress in recent years in reducing differences in key financial reporting areas such as revenue recognition, leases, fair value measurements and business combinations.

Mr. Bricker also emphasized the significance of IFRS to US investors and US companies. He noted that the quality of IFRS standards and their application is vitally important given the approximately 525 foreign-private issuers with total market capitalization of more than $7 trillion as of September 2016 that participate in the US capital markets. This does not include the numerous US companies that may have subsidiaries with separate IFRS filing requirements or acquisition targets, which may have reported historically under IFRS in other parts of the world.

Mr. Bricker noted the FASB and IASB's responsibility to continue their work to identify the needs of financial statement users and respond to those needs in a timely manner. He strongly encouraged that the two boards work together to eliminate differences between their standards where opportunities exist. He highlighted his belief that both the FASB and the IASB would benefit from this continued collaboration with a goal of further developing high-quality accounting standards in the United States and globally.

Hans Hoogervorst, IASB Chairman, shared a consistent viewpoint that IFRS remains relevant to investors in the United States due to the substantial amount of investments made in companies that report under IFRS. He also said that the IASB intends to keep IFRS as closely converged to US GAAP as possible.

On the question of possible further use of IFRS for US issuers, Mr. Bricker stated that "for at least the foreseeable future, the FASB's independent standard-setting process and US GAAP will continue to best serve the needs of investors and other users" of financial statements who rely on financial reporting by domestic public companies. While the SEC retains the ultimate standard-setting authority for registrants, Mr. Bricker emphasized the importance of a private sector standard setter. He noted that private standard setters are best positioned to develop standards free from undue influence, which allows investors to place a high level of confidence in the quality of accounting standards.

Mr. Bricker also recommended continued consideration of the suggestion of former Chief Accountant James Schnurr to allow US companies to provide IFRS-based information as a supplement to US GAAP financial statements.

FASB

Russell Golden, FASB Chairman, emphasized the importance of receiving input from as broad a constituency as possible to aid the FASB in continuing to issue high-quality accounting standards. Mr. Golden highlighted that the FASB has taken a more proactive outreach approach to support the development and implementation of its standards.

Update on new standards

Mr. Golden and Susan Cosper, FASB Technical Director and EITF Chairman, provided an overview of the significant progress that has been made over recent years with three new accounting standards – revenue recognition, leases and credit losses. The development of a Transition Resource Group for each of the revenue and credit losses standards has been very beneficial in assisting preparers with some of the challenges of implementation and in identifying areas where standard-setting action was necessary.

Disclosure framework

Mr. Golden and Ms. Cosper highlighted the ongoing disclosure framework project. It was emphasized that the objective of this project was to improve the relevance of disclosure requirements and was not to reduce the volume of required disclosures. The board has undertaken a thorough process to solicit input and feedback from both preparers and users of the financial statements in an effort to achieve this objective. Ms. Cosper provided an update on the initial focus areas of this project – inventory, income taxes, fair value measurement and pensions. An exposure draft on the disclosures for inventory is expected to be issued soon.

Project agenda and future activities

Ms. Cosper discussed the process the board undertakes to develop its agenda of future projects. The FASB has conducted an invitation to comment on its future agenda with practitioners, preparers, users and other advisory groups to identify and prioritize the issues that should be evaluated by the board.

Ms. Cosper highlighted the summary results of the comment letters received on its agenda, listed in the order of priority.

— **Distinguishing liabilities from equity** – respondents indicated that this area is overly complex and results in diversity in practice.

— **Performance reporting (measures of income and cash flows)** – respondents, in particular users of financial statements, have requested more comparable and useful information.

— **Intangible assets** – respondents specifically highlighted the inconsistent treatment of acquired and internally developed intangible assets.

— **Pensions and other postretirement benefits** – respondents noted this as an area in which differences between US GAAP and IFRS continue to exist.

Ms. Cosper highlighted that the final standard related to goodwill impairment testing is expected to be issued in early 2017, which would remove step two of the current impairment model for goodwill. Additionally, the final standard clarifying the definition of a business is expected to be issued in early January 2017.

IASB

The major standard-setting projects of the IASB include the Insurance Contacts and the Conceptual Framework expected to be issued in the first half of 2017. The insurance project is expected to reduce or eliminate substantial differences in accounting under different GAAPs and ensure that insurance accounting is more consistent among different jurisdictions as well as with other financial services sectors such as banking and asset management. The completion of the insurance project is expected to signal the end of major standard-setting initiatives, enabling the IASB to focus on improving existing standards over the next couple of years.

PCAOB

Martin Baumann, Chief Auditor, PCAOB, discussed the PCAOB's current standard-setting agenda[18] and the establishment of the research agenda. Selected standard-setting agenda highlights follow.

Auditor's reporting model

This standard would retain the pass/fail model in the existing auditor's report and would require auditors to communicate additional information, including critical audit matters (CAMs). CAMs would be limited to matters communicated or required to be communicated to the audit committee and include only those matters that involved especially challenging, subjective or complex auditor judgment. Therefore, only the most important matters with which the auditor dealt as part of the audit, worked through with management, and discussed with the audit committee would be communicated. Mr. Baumann highlighted that the expanded auditor's report would provide value to investors and "enable users to better consume the information in the financial statements through the auditor sharing the most challenging aspects of the audit and how they were addressed in the audit." The final standard on the auditor's reporting model is currently being drafted for Board action.

Going concern

For periods ending after December 31, 2016, management is required to evaluate whether there is substantial doubt about a company's ability to continue as a going concern.[19] The FASB defines substantial doubt as existing when it is probable that a company will be unable to pay its debts as they fall due within the next 12 months.

---

[18] PCAOB Standard-Setting Agenda, September 30, 2016, available at www.pcaobus.org.
[19] FASB Accounting Standards Update No. 2014-15, Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern.

Conversely, the auditor assesses going concern under the existing PCAOB standard, which was designed more qualitatively to be an early warning signal to investors of financial difficulty, in line with a legislative requirement of auditors.[20]

Mr. Baumann stated the PCAOB will be closely monitoring the effect of the accounting change on audits and will continue to evaluate the need to revise the existing PCAOB standard on the auditor's going concern evaluation in light of the new accounting requirements.

Research agenda

To create more discipline and focus in its standard-setting efforts, the PCAOB established a research agenda. Each project included on the research agenda has been identified as a potential need or problem to be addressed that necessitates further research, outreach and economic analysis prior to the PCAOB concluding a new or revised auditing standard is required, at which time it would be added to the standard-setting agenda.

Enforcement and other initiatives

Financial reporting enforcement matters

Mr. Ceresney and Michael Maloney, Chief Accountant, Division of Enforcement, discussed recent trends in enforcement actions, including a number of findings related to financial reporting and auditor violations.

Mr. Maloney highlighted cases that involved improper conduct around revenue and expense recognition, valuation and impairment decisions, recognition of accrued liabilities, management of earnings and other financial targets, evaluation of internal control deficiencies, and disclosure matters.

Enforcement also brought cases against auditors for various violations, including lack of professional skepticism and independence and over-reliance on management representations.

Several notable cases follow.

— An action against a company, including its CFO and CAO, a third party SOX consultant, and the audit engagement partner for improper deficiency evaluation as required in the 2007 Commission Guidance for Management on ICFR. This included mischaracterizing clear material weaknesses around insufficient accounting staffing as significant deficiencies.[21]

— An action against a company, its VP of tax and senior manager of tax, for fraudulently inflating net income, earnings per share, effective tax rate and other key financial information, and for not maintaining sufficient internal accounting controls to identify and properly account for income taxes.[22] In addition, an action related to this matter was brought against the audit

---

[20] Section 10A of the Securities Exchange Act of 1934, available at www.sec.gov.
[21] SEC Release No. 77345, March 10, 2016, available at www.sec.gov.
[22] SEC Release Nos. 10221 and 78944, September 27, 2016, available at www.sec.gov.

engagement and tax partners for lack of due professional care and professional skepticism.[23]

— A complaint was brought against two executives for purposely inflating a key non-GAAP financial measure used by analysts and investors to assess the company.[24]

Disclosures

Mr. Maloney noted that federal securities laws cover matters that are broader than the financial statements and related notes. For example, Mr. Maloney indicated that Enforcement has brought cases involving improper conduct relative to disclosure in MD&A, Form 8-Ks, press releases, proxy statements and earnings calls. Mr. Maloney emphasized that management, audit committees and auditors should all focus on their respective roles to ensure that investors receive accurate and complete information and comply with the respective securities regulations.

> The sufficiency of the company's disclosure controls and procedures should receive close and ongoing attention by management and the audit committee to ensure that proper disclosures are made.
>
> Michael Maloney, Chief Accountant, Division of Enforcement, SEC

Cybersecurity panel

A panel discussion emphasized that as cybersecurity threats rapidly evolve and diversify, companies need to be equally adaptive in establishing and changing controls on a daily basis to react to the risks. Panelists referenced five areas of a framework that should be established and monitored to aid in effective risk mitigation: identify, detect, protect, respond and recover. Too often, panelists found companies will go after the last attack, and focus on respond and recover elements, without proactively addressing the first three components of the framework. It is important for senior management to be engaged in understanding and allocating resources to the top cyber risk priorities.

The panelists encouraged the board of directors to embrace the focus on cybersecurity as it becomes a much larger part of companies' overall risk management strategy. They should continue to educate themselves on the matter and engage in frequent conversations with management because investors are increasingly interested in how companies are managing this risk.

---

[23] SEC Release No. 79109, October 18, 2016, available at www.sec.gov.
[24] US District Court Southern District of New York, SEC vs. Brian S. Block and Lisa Pavelka McAlister, 16 Civ. 7003, September 8, 2016, available at www.sec.gov.

Data and analytics panel

A panel discussion emphasized that the expanded use of data and analytics (D&A) impacts all stakeholders. While the use of big data and innovative technologies presents tremendous opportunities for companies and auditors, these advances are accompanied by critical challenges. The panel discussed four key focus areas:

— risk assessment,

— continuous monitoring,

— audit efficiency, and

— business advisory role.

Additionally, the panel discussed how the SEC is using D&A to analyze companies' filings, looking for correlations in data, using text analytics to analyze free-form text, and identifying pre-defined patterns that may identify emerging issues.

Sustainability panel

Panelists discussed the increased interest in sustainability measures, including environmental matters and data privacy, by the investment community. They also highlighted measures that companies are taking to provide the relevant information to the public. Panelists also discussed future guidance that was expected to be issued by the Sustainability Accounting Standards Board on a path to standardizing these disclosures.

Appendix: Index of published speeches

The text of speeches can be accessed using the links below.

SEC
Wesley R. Bricker, Chief Accountant
Julie A. Erhardt, Deputy Chief Accountant, OCA
Jenifer Minke-Girard, Assistant Deputy Chief Accountant, OCA
Marc Panucci, Deputy Chief Accountant, OCA

SEC OCA staff speakers	Topics
Sylvia E. Alicea, Professional Accounting Fellow	Revenue Recognition; Transition Disclosures
Sean May, Professional Accounting Fellow	Current Expected Credit Loss Model (CECL); Changes in Accounting Policies; Share-Based Payment Awards: Establishing a Grant Date
Brian Staniszewski, Professional Accounting Fellow	Financial Instruments; Income Taxes
Jennifer L. Todling, Professional Accounting Fellow	Implementation and Monitoring of New Auditing Standards
Ruth Uejio, Professional Accounting Fellow	Revenue Recognition; Determining the Interest Cost Component of Net Periodic Benefit Cost
Jonathan Wiggins, Associate Chief Accountant	Joint Ventures and Strategic Alliances; Definition of Public Business Entity; Measurement Period Adjustments

AICPA/CAQ
Cynthia M. Fornelli, Executive Director, CAQ

FASB/IASB
Russell G. Golden, Chairman, FASB
Hans Hoogervorst, Chairman, IASB

PCAOB
James R. Doty, Chairman, PCAOB
Claudius B. Modesti, Director of Enforcement, PCAOB

Acknowledgments

This is a publication of KPMG's
Department of Professional Practice
212-909-5600

Contributing authors
John D. Brown
Shane P. Burak
Jeanine L. Daily
Melanie F. Dolan
Mark D. Eller
Ryan P. Evans
Jonathan R. Guthart
Erin L. McCloskey
Paul H. Munter
Christopher D. Semesky
Ryan N. Vaz
Rob J. Werling

www.kpmg.com/us/frn

Legal–The descriptive and summary statements in this newsletter are not intended to be a substitute for the potential requirements of any proposed or final standards or any other potential or applicable requirements of the accounting literature or SEC regulations. Companies applying US GAAP or filing with the SEC should apply the texts of the relevant laws, regulations, and accounting requirements, consider their particular circumstances, and consult their accounting and legal advisors.

kpmg.com/socialmedia