January 6, 2020

Takeaways from the AICPA's 2019 Conference on Current SEC and PCAOB Developments

The annual AICPA Conference on Current SEC and PCAOB Developments has become a highly anticipated source of information on the latest issues and trends in financial reporting, accounting and auditing. The 2019 conference was held in Washington, D.C. on December 9-11, 2019 (the "Conference") and gathered speakers and panelists representing regulatory and standard-setting bodies as well as auditors, registrants, securities counsel and other industry experts. A prominent theme throughout the Conference was the importance of stakeholder engagement and communication in the delivery of high-quality financial reporting.

Set forth below are some of the key takeaways from the Conference, which highlight comments made by the SEC staff (the "Staff") regarding the points registrants should be mindful of as they prepare their next SEC disclosures.

Disclosure Effectiveness and SEC Rulemaking Initiatives

The Director of the SEC's Division of Corporation Finance (the "Division"), William Hinman, discussed several rulemaking initiatives, including disclosure effectiveness efforts, that the SEC hopes to finalize in the coming year. With respect to proposed amendments to S-X Rule 3-05 and Article 11 that would simplify the disclosure requirements relating to financial statements of businesses acquired or to be acquired, real estate operations and pro forma financial information, Mr. Hinman noted that the SEC received substantial feedback on the proposed requirement that pro forma financial information reflect "management's adjustments" — management's expectations for synergies and other plans that are both (i) reasonably estimable and (ii) reasonably expected to occur. As it prepares the forthcoming final rule, the Staff is considering modifications to the management's adjustments requirement. The Staff also highlighted an amendment to the definition of an accelerated filer aimed at reducing a number of registrants that are subject to the requirement to provide the auditor attestation report on internal control over financial reporting ("ICFR") under Section 404(b) of the Sarbanes-Oxley Act of 2002.

Non-GAAP Financial Measures

Non-GAAP financial measures continue to be a major area of focus for the SEC. During the Conference, Chairman Clayton and SEC Chief Accountant Sagar Teotia reminded registrants to exercise caution with respect to non-GAAP reporting. In particular, they noted that non-GAAP financial measures should be complete, accurate and consistent with the measures used by management to operate the business, rather than be prepared solely for disclosure to investors. Registrants were also reminded of the need to have appropriate disclosure controls and procedures in place to ensure that non-GAAP financial measures are not misleading and that they do not involve "individually tailored accounting principles" that may not be appropriate under Regulation G. The Staff's focus on individually tailored accounting principles represents a shift away from its historical approach of questioning how measures are presented to questioning the substance of the disclosures (*see* Compliance and Disclosure Interpretation on Non-GAAP Financial Measures, Question 100.4). The risk is that if the Staff is unpersuaded that the measures are appropriate, the presentational fix is not available; typically the use of the measure will be discontinued.

Chairman Clayton also stressed that calculations of non-GAAP financial measures should be made consistently from quarter to quarter, so that results are comparable over time. If any changes or adjustments to non-GAAP financial measures are made, registrants should provide clear explanations of the adjustments.

Another topic of concern was the practice of registrants using non-GAAP financial measures that rely on accounting principles that have now been superseded by new accounting standards, such as those relating to revenue recognition and credit losses. Staff members made clear that while allowance would be made as registrants transition to the new accounting standards for the purpose of facilitating comparison to prior periods, going forward, non-GAAP financial measures that continue to show legacy accounting would not be considered appropriate.

Emerging Disclosure Trends – LIBOR Transition, Brexit, Cybersecurity and Sustainability

At the Conference, a number of emerging disclosure trends were discussed by members of the Staff, including the phase-out of the London Interbank Offered Rate (LIBOR), cybersecurity and sustainability, among others. The Staff highlighted the anticipated phase-out of LIBOR and its replacement with a different benchmark in the coming years, a process commonly referred to as reference rate reform, as a significant emerging risk. In his remarks, Mr. Teotia noted that because LIBOR is used extensively in a wide range of commercial and financial contracts around the world, the move away from LIBOR could have a significant impact on financial markets. He referred to guidance from the Staff joint statement on LIBOR transition, which encourages market participants to consider the following questions, among others:

- Does the registrant have, or is the registrant or its customers exposed to, any contracts extending past 2021 that reference LIBOR? For registrants considering disclosure obligations and risk management policies, are these contracts, individually or in the aggregate, material?
- For each contract identified, what effect will the discontinuation of LIBOR have on the operation of the contract?
- For contracts with no fallback language in the event LIBOR is unavailable, or with fallback language that does not contemplate the expected permanent discontinuation of LIBOR, does the registrant need

to take actions to mitigate risk, such as proactive renegotiations with counterparties to address the contractual uncertainty?

- What alternative reference rate (for example, the Secured Financing Overnight Rate) might replace LIBOR in existing contracts? Are there fundamental differences between LIBOR and the alternative reference rate – such as the extent of or absence of counterparty credit risk – that could impact the profitability or costs associated with the identified contracts? Does the alternative reference rate need to be adjusted (by the addition of a spread, for example) to maintain the anticipated economic terms of existing contracts?
- For derivative contracts referencing LIBOR that are used to hedge floating rate investments or obligations, what effect will the discontinuation of LIBOR have on the effectiveness of any hedging strategy?
- Does use of an alternative reference rate introduce new risks that need to be addressed? For example, if the registrant has relied on LIBOR in pricing assets as a natural hedge against increases in costs of capital or funding, will the new rate behave similarly? If not, what actions should be taken to mitigate this new risk?

Chairman Clayton called upon stakeholders to avoid underestimating the risks involved with the anticipated phase-out of LIBOR, particularly with respect to registrants' legacy assets and liabilities. Chairman Clayton and Mr. Teotia stressed that registrants should be proactive and act quickly to assess the risks related to the transition away from LIBOR, plan for potential accounting implications and consult with the Staff as necessary.

The Staff also expressed concerns regarding the quality of Brexit-related disclosures, another issue that has evolved as a significant risk to registrants. As discussed in more detail in our earlier client alert, going forward, the SEC expects to focus more closely on registrants' Brexit disclosures and on Brexit's impact on market utilities and infrastructure. Notwithstanding the expected technical departure of the UK from the EU on January 31, 2020, substantial uncertainty remains over the future relationship between the UK and the EU, and there also remains the possibility that the UK ultimately could leave the EU at the end of the implementation period without a deal.

In the area of cybersecurity, the Staff continues to remind registrants of its ongoing focus on cybersecurity disclosures in light of the ever-increasing threat of cyber incidents. Our earlier client alert discusses the SEC's 2018 interpretive guidance on cybersecurity risks (CF Disclosure Guidance: Topic No. 2) as well as a report of investigation, which caution registrants to consider cyber threats when implementing and maintaining their internal controls.

In a panel session on sustainability matters, commenters addressed the need for more transparent sustainability disclosures, the current inconsistency among registrants when addressing such disclosures and the potential for an increased role of auditors to provide assurance over such sustainability information.

In another panel session on the topic of SEC comment letters, the Staff called upon registrants to make more transparent disclosures related to emerging risks – not only in respect of the topics mentioned above, but also those related to other areas of cross border risk, such as tariffs and civil unrest (*e.g.*, in Hong Kong). In evaluating whether these emerging risks are material, Chief of the Division's Office of Trade and Services Mara Ransom reminded registrants to consider including disclosures that discuss how management assesses and manages such risks, as well as the board's role in risk oversight. In addition, because these global developments are constantly evolving, registrants must continue to review and revise their disclosures to ensure that they are current.

New Accounting Standards

At several points during the Conference, members of the Staff generally praised the extensive and collaborative efforts of preparers, auditors and other stakeholders in the implementation of two significant new accounting standards in the past year, the revenue recognition standard (ASC 606) and the lease accounting standard (ASC 842). With respect to revenue recognition, the Staff noted during the comment letter panel session that comments have focused on areas of the new standard that involve the application of judgment in the selection of accounting policies – in particular, the identification of performance obligations, principal versus agent assessments and the timing of revenue recognition. With respect to lease accounting, the Staff acknowledged that it is too soon to identify themes or trends in SEC comments, but reminded registrants to avoid boilerplate disclosures and instead tailor disclosures to describe specific lease arrangements and the related assumptions used to apply the new accounting standard.

The Staff also commended stakeholders for significant progress in the implementation of the current expected credit losses accounting standard (ASC 326) that will become effective in 2020. Given that the effective date of this standard is fast approaching, Mr. Teotia suggested that registrants should aim to finalize their implementation of this standard soon, and invited stakeholders to consult with the Staff "as they turn their focus from adoption to the ongoing accounting for credit losses under the new guidance."

Critical Audit Matters

The implementation of the new requirement for auditors to discuss critical audit matters ("CAMs") (AS 3101, The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion) was discussed at length during the Conference, as it is now effective for audits of large accelerated filers. Mr. Teotia recognized the efforts made thus far by auditors, preparers, audit committees and the PCAOB with respect to the implementation of CAMs, and encouraged stakeholders to continue to take a "forward-looking and preventative mindset in CAM implementation and communication." In particular, Mr. Teotia highlighted the recent PCAOB staff guidance on the matter. The PCAOB's CAM guidance incorporates feedback from auditors, preparers and audit committees engaged in test runs of CAM implementation, which has helped make the guidance more practical and specific to particular questions that arose through the test run process. Mr. Teotia encouraged auditors to carefully consider this guidance as they move forward in the CAM implementation process. In addition, he encouraged accelerated and non-accelerated filers to learn from the implementation experiences of large accelerated filers and to continue test runs of the CAM implementation process.

Staff members also had a few additional recommendations for management and audit committees related to this process. For example, management and audit committees should review drafts of CAMs early in the audit process to ensure that they are internally consistent, as well as consistent with the registrant's financial statements and other disclosures (such as the MD&A). The Staff stressed that they will be reviewing CAMs for such consistency. Changes to the financial statements or other disclosures may be necessary during the drafting process, particularly if information necessary for the CAMs has not otherwise been made publicly available. Effective CAM implementation and reporting therefore requires early and open engagement among auditors, management and the audit committee.

Supplier Financing Programs

The Staff highlighted the increasing use by registrants of supplier financing programs involving trade payables; these are also referred to as vendor payable programs, supply chain financing, structured trade payables or reverse factorings. The Staff recommends that registrants consider including the following MD&A disclosures about supplier financing programs if their effects are material to their current liquidity or are reasonably likely to affect liquidity in the future:

- the material and relevant terms of the program;
- the general risk and benefits of the program;
- any guarantees provided by subsidiaries and/or the parent;
- any plans to further extend terms to suppliers;
- any factors that may limit the registrant's ability to continue using similar programs to further improve operating cash flows; and
- trends and uncertainties related to the extension of payment terms (such as variations in accounts payable) under the program.

The Staff noted the recent increase in incentive programs offered by entities that provide platforms that connect end users with suppliers. Sometimes these incentives programs are structured in a way that may require a judgment call as to whether the registrant is an agent or a principal, which could have a significant effect on the registrant's income statement. As a result, registrants should provide clear qualitative and quantitative disclosure regarding these incentive arrangements in their MD&A.

Auditor Independence and the Role of the Audit Committee

The importance of auditor independence was raised throughout the Conference. Chairman Clayton emphasized the responsibility of audit committees to ensure sure that auditors comply with the SEC's independence rules. In his speech, Mr. Teotia stressed that "strong, knowledgeable, experienced independent audit committees" should "continue to regularly challenge management and auditors about the accuracy and quality of an issuer's financial reporting." Moreover, given the number of new or forthcoming accounting and auditing standards, audit committees should be proactive about understanding these new standards and work closely with preparers and auditors throughout the implementation process.

Internal Control over Financial Reporting

With respect to ICFR, the Staff echoed similar comments from last year's Conference – the critical importance of ICFR generally, as well as the need for cooperation among audit committees, auditors and management in all ICFR areas (from risk assessment to design and testing of controls). While Mr. Teotia commended registrants on recent improvements with respect to ICFR, including proactive management engagement and discussions with auditors on ICFR matters, he noted that the Staff's "consultation experience and [SEC] enforcement actions suggest that there is additional room for improvement, including in the area of evaluating the severity of identified deficiencies." In addition, Mr. Teotia reminded registrants that transitions to new accounting standards may require changes to ICFR: "new accounting standards may require new processes, different information, and require the use of new or different individuals within the control process. Management should anticipate where controls may break down in the current environment and whether existing controls mitigate those risks. To the extent that current controls would not mitigate those risks, new or additional controls may be necessary."

EGC Transition Issues

Division Deputy Chief Accountant Lindsay McCord addressed the accommodation granted to emerging growth companies ("EGCs") under the JOBS Act to elect to defer compliance with new or revised accounting standards until private company adoption dates for as long as they qualify as EGCs. Calendar year-end EGCs that have elected to take advantage of the extended adoption period applicable to private companies for new or revised accounting standards but lose their EGC status before they would have adopted such standards must adopt the new accounting standards as of the beginning of the year they lose their EGC status. For example, if a registrant lost its EGC status in 2020, after the standard adoption date for the new credit losses standard (*i.e.*, January 1, 2020), it will not be permitted to delay the adoption of the standard by using the private company adoption date and must apply the new credit losses standard as of January 1, 2020.

Modifications and Waivers under Regulation S-X Rule 3-13

Division Chief Accountant Kyle Moffatt addressed financial statement waivers and modifications under Regulation S-X Rule 3-13, which are sought in instances where the strict application of the rules would result in a requirement to provide more information than the registrant believes is necessary to reasonably inform investors. Under Rule 3-13, the Staff has the authority to permit the omission or substitution of certain financial statements "where consistent with the protection of investors." While Mr. Moffatt acknowledged that there are several proposed rules to streamline disclosure requirements, he discouraged registrants to rely on proposed rules when seeking financial statement waivers and modifications under Regulation S-X Rule 3-13, making clear that until such proposed rules are finalized, the Staff will continue to grant waivers on the same basis they have historically.

* * *

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Mark S. Bergman
+44-20-7367-1601
mbergman@paulweiss.com

Securities practice management attorney Monika G. Kislowska and associate Sofia D. Martos contributed to this Client Memorandum.