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Heads Up

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Making Disclosures, Checking Them Twice

Highlights of the 2014 AICPA Conference on Current SEC and PCAOB Developments

by Deloitte & Touche LLP's National Office Departments of Professional Practice

Introduction

The annual AICPA[1] conference features insights from numerous speakers on current accounting, reporting, and auditing practice issues. Below are brief highlights of remarks made by selected speakers and panelists[2] at this year's conference, which took place December 8–10 in Washington, D.C.

IFRSs

With anticipation building in the weeks preceding the conference about whether news would be forthcoming regarding the incorporation of IFRSs into the U.S. financial reporting system, James Schnurr, chief accountant in the SEC's Office of the Chief Accountant (the OCA), discussed a possible fourth alternative[3] for consideration. Indicating that "some domestic issuers may, now or in the near future, prepare IFRS-based financial information in addition to the U.S. GAAP based information" in their filings, Mr. Schnurr spoke about a plan to consider whether U.S. companies should be permitted to voluntarily provide IFRS-prepared financial information as a supplement to their U.S. GAAP financial statements. The information from this fourth alternative could range from selected IFRS financial information to full IFRS financial statements. Mr. Schnurr further noted that "[u]nder this line of thinking, issuers that do not believe IFRS-based information would be beneficial to investors would not be forced to undertake what we understand to be, in some cases, significant implementation costs."

In addition, Mr. Schnurr indicated that the goals of providing investors with comparable and high-quality decision-useful information remain paramount and recognized that "any continued uncertainty around IFRS results in uneasiness for investors across the globe. Therefore, it is a priority . . . to bring a recommendation to the Commission in the near future with the hope of resolving, or at least lessening, this uncertainty."

Members of the following Deloitte teams contributed to this issue of *Heads Up*: Accounting Standards and Communications, Audit and Assurance Services, and SEC Services.

To our colleagues at Deloitte, our clients, and our other friends, we wish each of you a joyous and peace-filled holiday season and a happy new year.

[1] Abbreviations and short forms used in this publication are defined in Appendix B.
[2] For a list of panelists and selected sessions, see Appendix C.
[3] Alternatives already under consideration by the SEC regarding the use of IFRSs in the United States include (1) adopting IFRSs outright, (2) giving U.S. registrants the option of filing IFRS financial statements, and (3) using the so-called "condorsement" approach.

New Revenue Recognition Standard

Other speakers provided their views on practice issues related to current and future GAAP, including implementation issues arising from the new revenue recognition standard, and acknowledged the efforts of the FASB and IASB — particularly of their joint transition resource group (TRG)[4] on revenue recognition — to address questions that have been raised by domestic and foreign constituents. Noting that monitoring the implementation of the new revenue recognition standard is a high priority for the OCA, Mr. Schnurr stated that "the Staff respects reasoned judgments, but where significant diversity in practice exists, [the OCA seeks] to eliminate that diversity." He also reiterated the importance of achieving comparability and reducing practice differences by addressing "potential diversity in practice on the front end of the implementation effort" to avoid what are likely to be significant post-implementation costs.

In addition, FASB Chairman Russell Golden noted that on the basis of feedback received from the TRG, the FASB has instructed its staff to conduct research related to a potential agenda project. He indicated that the project would take into account application issues and the need for additional (or clarified) guidance on (1) intellectual property transactions (i.e., licenses), (2) identifying performance obligations, and (3) determining whether an entity is a principal or an agent (i.e., whether an entity should present revenues on a gross or net basis). Mr. Golden stated that he anticipates that the revenue TRG "will serve as a prototype for other such groups as [the FASB prepares] to issue major standards." Further, as it announced at the October 2014 revenue TRG meeting, the FASB is researching whether to delay the effective date of the new revenue standard and expects to decide by mid-2015.

SEC Staff Speeches

Professional accounting fellows in the OCA spoke at the conference this year for the first time in several years. They addressed a number of topics, including (1) identification and reporting of material weaknesses in ICFR, (2) errors in the statement of cash flows stemming from less complex topics in accounting guidance, (3) amendments to or exchanges of equity-classified preferred stock, (4) derivatives and hybrid financial instruments, (5) business combinations and pension accounting, (6) determination of the primary beneficiary in variable interest entities (VIEs) for consolidation purposes, and (7) revenue recognition — primarily regarding principal-agent assessments in arrangements with more than two parties.

Mr. Murdock cautioned registrants against overreliance on SEC staff speeches in setting their accounting policies because U.S. GAAP changes, and SEC staff views tend to evolve over time.

Referring to what has been commonly called "speech GAAP," Dan Murdock, deputy chief accountant in the OCA, stated that speeches by members of the SEC staff are meant to provide transparency into how the staff analyzes complex accounting matters rather than "absolute answers" to accounting questions because accounting conclusions are based on a transaction's particular facts and circumstances. Further, Mr. Murdock cautioned registrants against overreliance on SEC staff speeches — as well as on any other nonauthoritative guidance — in setting their accounting policies because U.S. GAAP changes, and SEC staff views tend to evolve over time. He further expressed his view that a staff speech has a shelf life that expires in, perhaps, five years, noting that there is no substitute for thoughtful analysis that takes into account the principles in authoritative guidance and reflects an understanding of what standard setters sought to achieve.

Disclosure Effectiveness

In addition to fulfilling the SEC's mandated rulemaking activities under the Dodd-Frank Act and the JOBS Act, the SEC staff in the Division of Corporation Finance (the "Division") has been focusing on its disclosure effectiveness initiatives. The Division staff recapped the activities planned for its disclosure effectiveness project,[5] stating that it is currently evaluating Regulations S-K and S-X[6] for improvements and that it hopes to issue a concept release (as part of what may be a series of concept releases) in

[4] The joint TRG on revenue recognition was formed to discuss and analyze potential issues that preparers may face when implementing the boards' new revenue standard.

[5] In December 2013, in a report provided under the JOBS Act, the Division staff indicated that the SEC would commence a broad effort to modernize and streamline its rules and regulations (also called its "disclosure effectiveness project"). For additional information, see Deloitte's August 26, 2014, *Heads Up*.

[6] For the full titles of standards and other literature cited in this publication or links to them, see Appendix A.

the near future. Representatives from the FASB and IASB also provided updates on their disclosure effectiveness efforts — including their conceptual framework projects and other simplification projects — which may reduce differences between U.S. GAAP and IFRSs.

In addition, the staff indicated that it would focus on proxy reporting in a later phase of the project. Further, Mr. Schnurr noted that he has devoted a significant amount of time on audit committee reporting since assuming his role in October 2014, and that the "OCA staff has been working closely with staff from [the Division] and others throughout the Commission to consider [the SEC's] existing disclosure requirements, current audit committee disclosure practices, and publicly available observations and commentary."

As did other presenters at the conference, the Division staff discussed how, in the absence of specific requirements, registrants can improve their disclosure documents in the near term and how they can better focus their disclosures on matters that are material and relevant to their operations, liquidity, and financial condition.[7] The Division staff noted that whether they are about critical accounting estimates, results of operations, or other matters, effective (and compliant) MD&A disclosures are those that appropriately identify and explain material known trends and uncertainties.[8] The staff cited material operations in Venezuela, recent updates to mortality tables, and decreasing oil and gas prices as examples of items that may represent material trends and uncertainties requiring analysis in a registrant's MD&A.

Audit and Auditor Considerations

As part of its plan to increase transparency and improve audit quality, the PCAOB expects to continue to (1) analyze the effectiveness and results of inspections, (2) enhance the usefulness of its inspection reports, and (3) work to advance its standard-setting agenda. Addressing concerns from SEC representatives about how standards have been prioritized because of standard-setting delays, a PCAOB staff member highlighted that the PCAOB has strived to ensure that it undertakes full due process — including performing extensive cost-benefit analyses — in its standard-setting efforts and noted that such activities are time-consuming.

The PCAOB staff indicated that it has made progress conducting international inspections and that it continues to work with its foreign counterparts to gain access to additional countries, and it identified deficiencies in approximately one-third of its inspections of prior-year audits that were referred to foreign auditors. Despite citing improvements in domestic inspections, the PCAOB staff stated that it has continued to identify deficiencies associated with audits — including revenue recognition, inventory, goodwill and intangible assets, and business combinations. In addition, it has identified deficiencies in auditors' testing of ICFR and of management estimates.

Brian Croteau, deputy chief accountant in the OCA, also stressed the importance of auditor independence to auditors, management of companies, and audit committees. He stated that nonaudit services should be monitored to avoid "scope creep" and noted that scope creep can occur during the delivery of otherwise permissible nonaudit services when engagement activities deviate from the intended scope and thus become impermissible, impairing auditor independence. Representatives from the PCAOB also cited their efforts to educate audit committees, namely by developing audit quality indicators.

Many of these topics, as well as others from this year's conference, are discussed in the sections below.

7 The SEC staff has discussed this topic in various speeches over the past year. For more information about the staff's remarks, see Deloitte's October 16, 2014, March 20, 2014, and December 16, 2013, *Heads Up* newsletters.

8 Under Regulation S-K, Item 303(a)(3), registrants are required to disclose in MD&A material known trends or uncertainties that may affect future performance (whether favorable or unfavorable).

Accounting and Financial Reporting Topics

Business Combinations

Definition of a Business

A panelist from the session on current accounting practice issues discussed the difference between the definition of an asset and the definition of a business, reminding participants that the definition of a business under U.S. GAAP is different from that in Regulation S-X, Article 11. The panelist noted that in practice, registrants may have difficulty determining whether certain transactions constitute an asset acquisition or a business combination.

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Citing an example seen in the real estate industry, another panelist noted that a registrant's acquisition of a residential apartment building with rental lease agreements in place (i.e., a process capable of generating an output) would be indicative of a business combination. The panelist also noted that a single asset acquisition (e.g., ship, airplane, or power plant) combined with customer contracts that generate outputs at the time of acquisition may qualify as a business combination and that it may therefore be difficult to determine whether arrangements are part of an acquisition or are separate from the acquisition.

Blackline Expense Presentation

The OCA staff discussed whether it is appropriate to exclude certain expenses incurred in a business combination from the predecessor and successor income statement periods when pushdown financial statements are presented. While the staff acknowledged that a registrant needs to consider its specific facts and circumstances, it observed that registrants sometimes exclude expenses that are contingent on a change-in-control event from the predecessor and successor periods and record those expenses on the "blackline" separating the two periods. The staff noted that it would not object to such presentation "provided that transparent and disaggregated disclosure of the nature and amount of such expenses was made."

Consolidation

Evaluating Joint Power

The OCA staff discussed how a registrant should determine the primary beneficiary of a VIE if the power to direct the entity's significant activities is shared by multiple unrelated parties, particularly when decisions related to all significant activities do not require joint consent. To illustrate, the staff provided an example in which decisions regarding two of the three significant activities require the joint consent of two unrelated parties while decisions related to the third significant activity are unilaterally directed by one of the parties.

In commenting on the example, the OCA staff noted that "while certain significant activities do require joint consent, it does not appear that shared power as described in [ASC] 810 exists." The staff indicated that for shared power to exist under the consolidation guidance in ASC 810, each party sharing power would be required to consent to all decisions related to the significant activities of the VIE. The staff noted that "[t]his is the case even when it is determined that the significant activities that require joint consent more significantly impact the economic performance of the entity than the significant activities that do not." The staff cautioned that determining which activities most significantly affect the economic performance of a VIE is a crucial first step in the primary beneficiary analysis and often requires the use of a significant amount of judgment.

Evaluation of Power When Decision Maker Is Acting as an Agent

The OCA staff also discussed how registrants should evaluate the power criterion when a decision maker is acting in the capacity of an agent. The staff noted that when a registrant has determined that a fee paid to a decision maker is not a variable interest, the registrant may need to continue the consolidation analysis by evaluating whether the substance of the arrangement identifies a party other than the decision maker as the party with power. The staff noted that "[w]hile this [assessment] can require a great deal of judgment, additional scrutiny may be necessary if a decision maker is acting as an agent and one variable interest holder is absorbing all or essentially all of the variability that the VIE is designed to create and pass along." The staff indicated that in such situations, "stated power may not be substantive, and it may be appropriate to attribute the stated power of the decision maker acting as an agent to the variable interest holder absorbing the variability of the VIE." In addition, the staff noted that although the guidance in ASC 810 provides that the level of a reporting entity's economic interest in a VIE is not determinative of the primary beneficiary's identity, the staff believes that the level of a reporting entity's economic interest is an important factor in the determination of whether power held by an entity acting as an agent is substantive.

Related-Party Tiebreaker Test

The OCA staff discussed whether related parties under common control are always required to perform the related-party tiebreaker test to determine whether stated power is substantive. The staff noted that while entities must carefully consider situations involving related parties under common control to determine whether stated power is substantive, "the staff does not believe there is a requirement to consider the related party tie-breaker guidance or that [such] guidance is necessarily determinative unless no party in the common control group individually meets both characteristics of a primary beneficiary."

Equity

The OCA staff discussed registrants' (1) evaluation of whether amendments to or exchanges of equity-classified preferred stock constitute an extinguishment or modification and (2) accounting for equity-classified preferred stock modifications.

The staff noted that in practice, registrants may use any one of the following approaches in determining whether an amendment or exchange is a modification or extinguishment:

- *Qualitative approach* — A registrant would evaluate (1) the significance of additions, removals, and changes to existing contractual terms, (2) the business purpose for the changes, and (3) "how the changes may influence the economic decisions of the investor." If the registrant determines that these changes are significant, "the amendments or exchange would be treated as an extinguishment; otherwise, the changes are considered a modification to the preferred stock."
- *Fair value approach* — A registrant would compare pre- and post-amendment fair values of the preferred stock to determine whether the preferred stock is substantially different. If the difference in fair values is 10 percent or greater, the preferred stock is considered substantially different and the amendment or exchange would be accounted for as an extinguishment. Otherwise, the preferred stock would only be considered modified.
- *Cash flow approach* — A registrant would use an approach that is similar to the fair value approach except that rather than analyzing fair value, it would evaluate the contractual cash flows. The staff noted that "this approach may only be reasonable, however, when the preferred stock has well-defined periodic contractual cash flows."
- *Legal form approach* — A registrant would account for any exchange that results in issuance of new preferred stock as an extinguishment. Any other "change in terms (regardless of significance) that does not result in the legal exchange of the preferred stock would be captured as a modification." The staff cautioned registrants that the legal form is merely one factor in the evaluation of whether an amendment or exchange is a modification or extinguishment, and that the form of the change in and of itself should not be determinative of the accounting outcome.

The OCA staff indicated that if a registrant determines that amendments to or exchanges of equity-classified preferred stock are a modification, then it is appropriate for the entity to analogize to the modification guidance in ASC 718-20, which addresses modifications to equity-classified share-based payment awards. The staff noted that if the postmodification fair value of the instrument exceeds its premodification fair value, the entity should recognize the additional fair value to reflect the modification. The staff indicated that it would not object to an entity's recognition of the additional fair value in retained earnings as a deemed dividend from the entity to the preferred stockholders. The staff also noted that in certain unique circumstances, it may be appropriate to recognize the additional fair value as a charge to earnings (e.g., if facts and circumstances indicate that it is reflective of compensation for agreeing to restructure the preferred stock).

The staff would not object to an entity's recognition of the additional fair value in retained earnings as a deemed dividend from the entity to the preferred stockholders.

The OCA staff noted that while it has accepted both methods, the appropriate method for recognizing the additional fair value would depend on "the underlying purpose for and circumstances surrounding the modification."

Fair Value

The Division staff remarked that it continues to comment on fair value measurements and that its comment trends have been consistent with those in prior years. The staff noted that it often asks registrants about the initial fair value measurements in business combinations (i.e., related to the purchase price allocation) and testing for impairments of many types of assets. Specifically, the staff noted that it may ask about fair value measurements and inputs when impairment indicators (or other "red flags") exist but no impairment charge has been recorded.

The Division staff also noted that in addition to considering the propriety of the classification of assets and liabilities within the fair value hierarchy, it evaluates the consistency and completeness of the related disclosures because the disclosures are largely driven by such classifications. The staff reminded registrants to continue disclosing information about recurring fair value measurements but not to omit the required disclosures for nonrecurring fair value measurements.

For additional information, see Deloitte's *SEC Comment Letters — Including Industry Insights: A Recap of Recent Trends*, which discusses recent SEC comments related to fair value measurements and other topics.

Financial Instruments

Impact of Derivative Novations on Hedge Accounting

The OCA staff noted that under ASC 815, a novation of a derivative contract designated in a hedging relationship, in which one counterparty is replaced by another, typically would trigger discontinuation of hedge accounting because the novation would be viewed as the legal termination of the original derivative instrument. However, the SEC staff indicated that it will not object if an entity continues its existing hedging relationship despite the derivative instrument's novation in any of the following circumstances, provided that (1) no other critical terms of the derivative are changed and (2) the hedging relationship continues to be highly effective:

- The reporting entity's derivative counterparty merges with and into a surviving entity that assumes the same rights and obligations that existed under a preexisting derivative instrument of the merged entities;
- The reporting entity's derivative counterparty novates a derivative instrument to an entity under common control with the derivative counterparty; or
- At the inception of the hedging relationship, the reporting entity knows and contemporaneously documents that all or part of the derivative will be novated to a new counterparty during the hedging relationship.

These are additional circumstances in which the SEC staff will not object to continuation of a hedging relationship after a novation. Other circumstances are enumerated in the staff's 2012[8] guidance.

See Deloitte's May 15, 2012, Financial Reporting Alert for additional information.

[8] May 11, 2012, letter from the Office of the Chief Accountant to the International Swaps and Derivatives Association.

The staff emphasized that registrants should not attempt to analogize other fact patterns to these circumstances; registrants that have a different set of facts are encouraged to consult with the OCA.

Hybrid Financial Instruments

The OCA staff discussed allocation of proceeds from the issuance of a hybrid instrument (e.g., issued convertible debt) when the fair value of a liability such as a bifurcated conversion feature is greater than the proceeds from issuance. The staff noted that in these unique circumstances, a registrant should do the following:

- Verify that the fair values of the financial liabilities required to be measured at fair value are appropriate under ASC 820.
- Evaluate whether the transaction was conducted on an arm's-length basis and assess whether the parties involved are related parties under ASC 850.
- If the transaction is at arm's length between unrelated parties, evaluate all elements of the transaction to determine whether there are any other rights or privileges received that meet the definition of an asset under other applicable guidance.

The OCA staff indicated that if no other rights or privileges that require separate accounting recognition as an asset could be identified, the financial liabilities that are required to be measured at fair value (e.g., embedded derivatives) should be recorded at fair value, and the excess of the fair value over the net proceeds received should be recognized as a loss in earnings. The staff indicated that given the unique nature of these transactions, registrants should clearly and robustly disclose the nature of the transaction, including reasons why the entity entered into the transaction, and the benefits received. Lastly, the staff observed that entities must use significant judgment if such transactions were not at arm's length or were entered into with a related party. The staff encouraged registrants to consult with the OCA in those situations.

Goodwill Impairment

The OCA staff discussed whether it should continue to view a change in the annual goodwill impairment testing date as a change in accounting principle that would generally require a preferability letter. The staff noted that ASC 350 requires the annual goodwill impairment test to be performed on the same date each year but does not impose a similar requirement for indefinite-lived intangible assets. For this reason, it has historically requested a preferability letter upon a change in a registrant's annual goodwill impairment testing date unless goodwill was not material.

While the OCA staff noted that the FASB may consider amending its guidance on this topic as part of its simplification project, registrants in the meantime may be able to demonstrate that a change in the goodwill impairment testing date is an immaterial change in the application of an accounting principle. In reaching this conclusion, a registrant may determine that a change in the goodwill impairment testing date does not have a material effect on the registrant's internal controls or on its assessment of goodwill impairment because of the requirement under ASC 350 to test goodwill for impairment upon the occurrence of certain triggering events. The staff indicated that it will no longer request a preferability letter in such instances if the change is prominently disclosed in the registrant's financial statements. However, the staff may request information to understand the registrant's specific facts and circumstances, particularly if there are frequent changes to the testing date.

Income Taxes

The Division staff reiterated that it continues to issue the types of comments it has discussed in the past, which include those related to disclosures about (1) the potential tax and liquidity ramifications regarding the repatriation of foreign earnings, (2) valuation allowances, (3) rate reconciliation, and (4) unrecognized tax benefits. In addition, the staff noted that disclosures about income taxes can be improved, particularly disclosures related to tax provision amounts. In this regard, the staff stated that boilerplate language should be avoided and that approaches more conducive to effective disclosure would include:

- Using the income tax rate reconciliation as a starting point and describing the details of the material items.
- Discussing significant foreign jurisdictions, including statutory rates, effective rates, and the current and future impact of reconciling items.

- Providing meaningful disclosures about known trends and uncertainties, including expectations regarding the countries where registrants operate.

See Deloitte's *SEC Comment Letters — Including Industry Insights: A Recap of Recent Trends* for a more detailed discussion about trends identified in the SEC staff's comment letters on this topic.

In addition, the OCA staff foreshadowed that it is currently assessing the reporting of income taxes — in a manner similar to its focus on the statement of cash flows in 2014 — to better understand the causes of recent restatements and that the OCA will most likely be discussing its findings in 2015. Consequently, registrants can expect income taxes to be a topic of increased SEC staff focus.

Materiality

Financial Statement Disclosures

Disclosure effectiveness was a frequent topic of discussion at this year's conference, with many presenters reiterating that registrants can improve the effectiveness of their current disclosures by emphasizing matters that are material and relevant and deemphasizing or removing disclosures that are not.

During a Q&A session, the OCA staff elaborated on remarks it made at a recent banking conference about assessing materiality for financial statement disclosures. The staff referred to two approaches that it has heard and is considering in evaluating the materiality of disclosures: the "all-in" and "piecemeal" approaches. Under the all-in approach, an entity would be within the scope of an ASC topic's disclosure requirements if the financial statement balances were material, and omitted disclosures would generally be considered errors. Alternatively, under the piecemeal approach, an entity would consider disclosure requirements on a line-item basis, and if the entity concluded that a disclosure was immaterial, its decision not to make that disclosure generally would not be considered an error.

The OCA staff indicated that no conclusions have been reached regarding these approaches and that the staff will continue to analyze them.

See Deloitte's October 16, 2014, *Heads Up* for more information about the SEC staff's disclosure effectiveness initiative.

Materiality for MD&A

Regulation S-K, Item 303, requires disclosure in MD&A of known trends and uncertainties that are reasonably likely to have a material impact on a registrant's liquidity, capital resources, or results of operations. The Division staff noted that this disclosure requirement is among the most important in MD&A and provided additional insight into the requirements of Item 303 by discussing the SEC's two-prong test. Under the two-prong test, disclosure in MD&A is required unless a registrant is able to conclude either (1) that it is not reasonably likely that the trend or uncertainty will occur or (2) that a material effect is not reasonably likely to result. The staff explained that the two-prong test should be performed in situations in which forward-looking information is required in MD&A and that this test is different from the probability and magnitude test for materiality that was approved by the Supreme Court.

Editor's Note: Paragraph 9220.11 of the Financial Reporting Manual outlines the two-prong test in its entirety.

Pensions and Other Postretirement Benefits

The OCA staff reminded registrants that mortality is a key assumption in defined benefit obligation measurement and that under ASC 715-30 and ASC 715-60, each individual assumption should reflect the entity's best estimate. The staff noted that in light of the updated mortality tables and improvement scale issued by the Society of Actuaries (SOA) in October 2014, which reflect improved longevity, there has been some discussion by entities related to ignoring the new data for the current year. However, the staff does not believe that the new data can be disregarded in the development of this year's best estimate of mortality since entities have historically used the data issued by the SOA. Also, the staff expects entities to disclose any significant effect on the benefit obligation resulting from a change in the mortality assumption.

A panelist in a later discussion on current practice issues remarked on the SEC staff's comments about using the updated mortality tables and improvement scale, indicating that this new information could result in significant increases in the benefit obligation. The panelist described possible scenarios in which an entity's mortality assumption may be different from the SOA's tables and noted that in such cases, the entity would need to demonstrate that its estimate of mortality was based on the specific merits of its plan's population. The panelist also mentioned that there are divergent views among actuaries about the SOA's future longevity projection (updated improvement scale) and that other equally reasonable projections are possible. The panelist advised entities to discuss their longevity improvement assumption with their external auditor early in the process. Further, the panelist also noted that the downward trend (since December of last year) in discount rates will, like the mortality assumption, contribute significantly to actuarial losses.

For more information on the mortality assumption, see Deloitte's December 2, 2014, Financial Reporting Alert.

Revenue Recognition

Principal Versus Agent Considerations

The OCA staff discussed challenges related to determining whether an entity is a principal or an agent under ASC 605-45 when the guidance is applied to emerging business models, such as digital advertising. The staff observed that this analysis should generally begin with the identification of a "deliverable" in the transaction and the party ultimately responsible for its fulfillment. In this regard, the staff may scrutinize the deliverable identified by a registrant and consider all available information (e.g., MD&A, Web sites, marketing materials, contractual arrangements) in evaluating the reasonableness of this determination. Further, the staff noted that the deliverable that is ultimately identified for ASC 605-45 application purposes should be consistent with the deliverable that is subsequently evaluated for revenue recognition purposes.

In addition, the OCA staff indicated that it is likely to focus on a registrant's assessment of the primary obligor and general inventory risk indicators under ASC 605-45. If the identity of the primary obligor is unclear, the staff may focus its analysis on other factors, such as latitude in establishing pricing. The staff also observed that since general inventory risk may be applicable in a services environment (e.g., inventory risk may be present if an entity is obligated to compensate a service provider regardless of customer acceptance), the staff may consider which party is economically at risk. Further, the staff observed that latitude in establishing pricing should be evaluated in the context of any "economic constraints" in accordance with ASC 605-45.

Analysis should generally begin with the identification of a "deliverable" in the transaction and the party ultimately responsible for its fulfillment.

Panelists from the session on current accounting practice issues elaborated on the OCA staff's discussion of the complexities of applying ASC 605-45 to emerging business models, particularly the "ad tech" industry, in which numerous entities may be involved in a transaction to facilitate the sale of Web-based advertising to a customer. In remarks consistent with those of the OCA staff, a panelist indicated that entities should determine the primary obligor by considering all available information, including marketing materials, and that even when they do so, it may be difficult to make a conclusive determination. Further, the panelist noted that a consideration of fulfillment and economic risks may indicate the principal in the arrangement. Finally, panelists echoed the staff's emphasis on clearly defining a deliverable and cautioned entities to perform the analysis under ASC 605-45 by carefully applying the guidance to the specific facts and circumstances of individual transactions.

For additional considerations related to determining whether an entity is a principal or an agent under ASC 605-45, see the Technology section of Deloitte's *SEC Comment Letters — Including Industry Insights: A Recap of Recent Trends*.

Observations on the New Revenue Recognition Standard

Use of Judgment

The OCA staff acknowledged the greater use of judgment required of entities under the new revenue recognition standard. In particular, the staff referred to the measurement — and potential constraint — of variable consideration as significantly increasing the judgment required of management in accounting for contracts with customers. The staff also observed that the new standard requires substantial disclosure of the judgment an entity uses in recognizing revenue and noted that entities may need to adjust their systems, processes, and controls to support such judgment.

Process to Address Implementation Issues

The FASB staff provided an overview of the role of the joint TRG on revenue recognition created by the FASB and IASB. The staff noted that the TRG has received a total of 28 submissions of questions about the new standard, a large portion of which the TRG has already discussed or will discuss in the near future. The staff also indicated that the TRG is primarily focusing on questions that could potentially result in future standard setting, such as application of the license implementation guidance and the principal-agent analysis. Further, the staff highlighted that entities have the opportunity to submit an issue to the TRG and that if the issue does not meet the TRG's criteria for responding, entities should use the FASB's Technical Inquiry Service.

A registrant that presents less than five years on the basis of the new revenue standard would need to disclose the method it used.

For more information about the TRG, see Deloitte's *TRG Snapshot*.

In a separate panel on the new standard that included both preparers and auditors, panelists discussed and provided a status update regarding the progress of various other working groups currently discussing implementation issues related to the new revenue guidance, such as the AICPA's 16 industry task forces. Panelists discussed the degree to which the use of judgment would be challenged in the application of the standard, particularly when entities reach different conclusions about how to account for similar transactions with similar fact patterns.

Transition Considerations Related to Financial Reporting

The Division staff reminded conference participants that it would not object if a registrant uses the same basis to reflect its adoption of the new revenue standard in selected financial data (as required by Regulation S-K, Item 301) that it uses to adopt the new revenue standard in its financial statements. If a registrant presents less than five years on the basis of the new revenue standard, it would need to disclose the method it used and that the prior years in the selected financial data disclosure are not comparable.

See the September 12, 2014, *Deloitte Accounting Journal* entry for more information.

Editor's Note: The Division staff noted that it will accept less than five years of revenues presented on the basis of the new revenue standard in selected financial data (i.e., it would not require a registrant to retrospectively adjust the earliest two years), which would encourage registrants to use the full retrospective method of adoption because that method would yield information that is more useful to financial statement users.

Further, the Division staff indicated that it is currently considering how transition affects certain financial reporting matters, including:

- The interplay between the new revenue standard's transition methods and emerging growth company (EGC) accommodations that allow EGCs to adopt new accounting standards on a delayed basis.
- The impact of the new revenue standard's transition methods on determining significance and the financial statements required for other entities in a registrant's filings (e.g., for significant business acquisitions, significant equity method investments, and guarantor financial statements).
- The nature of disclosures to be included in MD&A.

Segment Reporting

The OCA staff noted that segment reporting disclosures may be among the most important financial statement disclosures, and it explained how the SEC staff's views on them have been evolving over the last several months. Specifically, the staff provided the following insights about a registrant's considerations related to (1) identifying the entity's chief operating decision maker (CODM), (2) identifying operating segments, and (3) aggregating operating segments:

- *Identifying the CODM* — The term CODM refers to a function of the entity that is responsible for the key operating decisions within the organization rather than a specific person.[9] The staff reminded registrants of the need to identify the key operating decisions and who is making them. While registrants often default to the CEO as their CODM, such a conclusion may not be appropriate if the CEO focuses on strategic decisions while the key operating decisions are more "day-to-day" decisions made by a different person (e.g., the chief operating officer).

- *Identifying operating segments* — When identifying operating segments under ASC 280, entities should consider the manner in which they organize the segments for assessing performance and making operating decisions. Reviewing the internal organization structure and the CODM report are two important data points for entities to consider among other factors in the identification of operating segments, such as the overall management structure, the basis on which budgets and forecasts are prepared, and the basis on which executive compensation is determined.

- *Aggregating operating segments* — Two or more operating segments can be aggregated together into one segment if (1) aggregation is consistent with the objective and basic principles of ASC 280, (2) the segments have similar economic characteristics, and (3) the segments are similar in each of the qualitative areas specified in ASC 280-10-50-1. The quantitative thresholds for satisfying the aggregation criteria are meant to be high, and entities should base their determination on well-reasoned judgment rather than specific, bright-line guidance. The staff observed that historically, when concluding on whether operating segments should be aggregated, the staff and registrants have placed more emphasis on the economic similarity of operating segments than on the qualitative factors in ASC 280. Accordingly, the staff reminded entities that while it is important to consider economic similarity, it is equally important to consider the qualitative factors.

In closing, the OCA staff (1) encouraged registrants to have a refreshed mindset when providing operating segment disclosures because the SEC staff's approach will be similarly refreshed when it reviews them, (2) advised registrants to consider the accounting principles in ASC 280 when determining their operating segments rather than placing too much emphasis and reliance on the CODM package, and (3) noted that registrants will generally have more than one reportable segment but less than ten.

See Deloitte's November 10, 2014, *Financial Reporting Alert* for additional information on segment reporting.

The Division staff noted that segment reporting continues to be a common topic of comment and that its objections to a registrant's segment presentation may result in prospective changes to segment disclosures in future filings rather than amendments to previously filed financial statements. However, such a determination will be made on the basis of the registrant's facts and circumstances. For example, because reporting units are operating segments (or one level below) for goodwill impairment testing purposes, the staff is likely to require an amendment if changes in operating segments result in the impairment of a reporting unit.

In addition, the staff noted that comments have commonly resulted from omissions of required segment disclosures, including those related to:

- The basis of the segment presentation organization (e.g., products and services, geographic locations).
- Aggregation of operating segments.
- Revenue by products and services, unless including them is impracticable.

See Deloitte's *SEC Comment Letters — Including Industry Insight: A Recap of Recent Trends* for a more detailed discussion about trends identified in the SEC staff's comment letters on this topic.

[9] Under ASC 280, the CODM is not required to have the ultimate decision-making authority but must be the individual or individuals responsible for evaluating the entity's operating results to assess performance and allocate resources.

Statement of Cash Flows

Staff Observations About Recent Restatements

The OCA staff discussed the recent trend of restatements resulting from errors in the statement of cash flows. The staff noted that restatements often occur as a result of the application of less complex U.S. GAAP guidance and identified several actions entities could take when preparing the statement of cash flows to potentially reduce the likelihood of errors. The actions include:

- Evaluating the completeness and accuracy of the information collected for preparation of the statement.
- Standardizing and automating required reports and other information.
- Separately considering the effect of nonrecurring transactions in the statement.
- Preparing the statement earlier to allow for adequate review.
- Selecting employees with the appropriate expertise and providing sufficient training on the accounting requirements for the statement.
- Incorporating risk assessment and monitoring controls, in addition to control activities, over the preparation of the statement.

Current Consultation Topics

A panelist from the session on current practice issues noted that entities should present cash flows from transactions for a noncontrolling interest (NCI) in a manner consistent with cash flow activity of owners, which are generally presented within financing activities. However, a sale that results in the loss of control of an entity with an NCI should be presented within investing activities. The panelist observed that there is diversity in practice related to recording transaction costs for NCI transactions. Some entities expense the costs as incurred through net income, which is analogous to business combination cost guidance. Others record the costs as contra-equity, which is consistent with costs incurred on equity transactions. The panelist's recommendation for the cash flow presentation of these costs was for entities to be consistent with the recognition of the costs and provide appropriate disclosures. Thus, entities that recorded the costs through net income as incurred would reflect the cash flow effect within operating activities, and entities that recorded the costs as contra-equity would reflect the cash flow effect within financing activities.

A panelist observed that there is diversity in practice related to recording transaction costs for NCI transactions.

The panel also discussed:

- Presenting changes in restricted cash within investing activities and that determining whether cash is restricted requires the use of judgment in the assessment of the contractual consequences of accessing the cash.
- Presenting cash payments and receipts separately (i.e., gross presentation) unless "the turnover is quick, the amounts are large, and the maturities are short" (in accordance with ASC 230-10-45-8), in which case net presentation is appropriate.
- Disclosing capital equipment acquired but not paid for during the period (i.e., a trade payable has been recorded at period-end) as noncash investing activities. The cash flow statement effect of these transactions occurs in the period in which the cash is paid to the equipment seller (this point was also made by an SEC staff member in his speech at the conference).

Other Accounting and Financial Reporting Matters

Accounting for Spin-Off Transactions

The OCA staff discussed the accounting for spin-offs, particularly the determination of whether a proposed transaction should be accounted for as a forward spin or a reverse spin. The staff indicated that a registrant should perform an assessment of the accounting spinnor on the basis of the following indicators in ASC 505-60: (1) the relative size of the entities, (2) the relative fair value of the entities, (3) which entity will retain the majority of the senior management of the current reporting entity, and (4) the length of time each entity will be held after the spin-offs. In addition, the staff noted that while tax planning strategies are mentioned in ASC 505-60, they are not explicitly identified as an indicator.

The OCA staff also observed that when a transaction is determined to be a reverse spin, some registrants have presumed that the accounting conclusion is determinative of the financial statements that are presented in the registration statement (i.e., the financial statements of the existing registrant can be used to satisfy the financial statement requirements of the entity being spun). Even when the transaction is determined to be a reverse spin, there may be instances in which carve-out financial statements (i.e., financial statements for the accounting spinnor/legal spinnee) are required in the registration statement. The staff noted that to reach a conclusion regarding the appropriate financial statements, entities should carefully evaluate the facts and circumstances specific to the transaction. The staff encouraged entities conducting spin-off transactions, and particularly those accounted for as reverse spins, to consult with specialists.

Financial Statements Included in Initial Public Offerings

The Division staff suggested that an increase in the volume and complexity of IPO transactions (e.g., spin-off, put-together, and drop-down transactions) has led to more questions about the appropriate financial statements to include in an IPO registration statement. For example, the operations of the entity filing the IPO may represent a portion of a larger entity or investment group and a reorganization may be contemplated in connection with the IPO transaction. Depending on the circumstances, businesses or individual assets may be (1) transferred into the registrant, (2) transferred out of the registrant, or (3) some combination of both.

In addition, the Division staff noted that determining what financial statements to include in the registration statement can be complex in these types of situations and that registrants need to use judgment, particularly because there may not be accounting or SEC guidance directly on point. Registrants should also consider the context of their Description of Business section and MD&A and whether that information, along with the financial statements, will provide a full picture for investors. To resolve any complex issues in advance of filing the IPO and potentially avoid having to address them during the SEC's review of their filing, registrants were encouraged to submit a pre-filing letter to the Division staff.

The Division staff also noted that it has observed an increase in IPO transactions that contemplate the formation of a master limited partnership. Recent examples include situations in which assets that function as internal services have been contributed by the sponsor but operations have not had historical revenue streams. Registrants need to carefully analyze the facts and circumstances to determine what historical financial statements to include, if any, in these circumstances. Again, the staff encouraged registrants to submit a pre-filing letter to help resolve these unique and complex issues.

Further, the Division staff also observed that registrants often use a "Recent Developments" section in the registration statement to add financial or operational information that is more current than the financial statements they are required to include in the filing. The staff reminded registrants to consider disclosing other material additional information to ensure that the disclosures are not misleading in these circumstances.

Editor's Note: While the Division staff's remarks referred to IPO transactions, since registrants may include Recent Developments sections in filings other than IPOs, the same guidance would apply. Rule 12b-20 of the Securities Exchange Act contains guidance on when additional information may be necessary in these circumstances.

Pre-IPO Valuations of Stock for Share-Based Compensation Arrangements

In the session on current accounting practice issues, a panelist described situations in which an entity's valuation of pre-IPO employee share-based awards is significantly lower than the prices observed in certain transactions occurring shortly before the IPO (commonly referred to as "cheap stock" considerations). The panelist provided specific examples of when a price paid during a stock repurchase transaction is higher than the pre-IPO valuation of employee share-based awards. That "higher price" is most likely indicative of the fair value of the stock, but there may be situations in which the differences do not represent fair value but include components of employee compensation or dividends paid to shareholders.

A panelist discussed situations in which observable transactions are available in a secondary market.

The panelist also discussed situations in which observable transactions are available in a secondary market as well as the presumption that such transactions are at fair value. However, the panelist noted an increase in transactions between investors, particularly in the technology sector, that have been identified by entities as disorderly and not representative of fair value. The panelist encouraged entities to engage their valuation specialists to consider those transactions and to sufficiently document their assessment of the impact of the transactions on their pre-IPO stock valuation.

See Deloitte's April 28, 2014, *Heads Up* for information about guidance on cheap stock disclosures in MD&A.

Definition of a Joint Venture

The OCA staff discussed joint venture formation transactions and noted that the lack of guidance in U.S. GAAP on accounting for the formation of a joint venture has resulted in significant diversity in accounting for these transactions (i.e., joint venture registrants recognize either (1) full or partial step-up in basis or (2) predecessor basis).

The OCA staff noted that in accounting for a joint venture formation transaction, a registrant should determine "whether the purpose of the transaction is consistent with the definition of a joint venture as described in [ASC] 323 or whether the substance of the formation transaction is a merger or put-together transaction that should be accounted for as a business combination under [ASC] 805." In addition, the staff noted that the FASB should consider (1) clarifying the definition of a joint venture under ASC 323 and (2) providing guidance on the appropriate accounting in the stand-alone financial statements of a joint venture for assets and businesses contributed to the joint venture.

Software Development Costs

A panelist from the session on current accounting practice issues discussed the differences between accounting for software developed for internal use (ASC 350-40) and accounting for software developed for sale (ASC 985-20), highlighting that the pattern of amortization and when an entity starts and stops capitalization may differ depending on which model is used. The panelist noted that if an entity later decides to sell software that was developed for internal use, it would be required under ASC 350-40 to apply any consideration received from the sale against the carrying value of the software before recognizing any revenue.

Oil and Gas Industry Observations

The Division staff reminded registrants in the oil and gas industry to consider the recent declines in oil and gas prices and the related potential impact on exploration, development, and production levels.

Specifically, the staff highlighted that such changes may:

- Represent a known trend or uncertainty that should be discussed in a registrant's MD&A.
- Represent a risk that should be discussed in a registrant's risk factor disclosures.
- Affect the determination of estimated proved reserves.

The Division staff referred registrants to Regulation S-X, Rule 4-10(a), and Question 131.04 of the SEC's C&DI of the definition of proved undeveloped oil and gas reserves and the interaction of that definition with a registrant's development plan. The staff noted that the mere intent to develop reserves does not constitute adoption of a development plan, which would require a final investment decision. A registrant's scheduled drilling activity should reconcile to its investment plans that have been approved by management.

Standard Setting

Remarks of Russell Golden, FASB Chairman

Mr. Golden stressed that the FASB's first priority is to improve U.S. GAAP; he spoke about the FASB's simplification initiative and reducing complexity in U.S. GAAP. He also admitted the need for a complete conceptual framework to bridge gaps and minimize inconsistencies. These priorities have helped align the guidance of U.S. GAAP and IFRSs on some topics (e.g., the measurement of inventory, development-stage enterprises, and extraordinary items), although sometimes the simplification of U.S. GAAP has resulted in conclusions different from those of the IASB on various topics (e.g., leases, impairment, classification and measurement, and insurance). Consequently, the FASB continues "to collaborate and cooperate with the IASB and national standards setters with an eye toward agreeing on and adopting standards that either are converged or [have] the fewest possible differences."

In addition, Mr. Golden stated that the FASB staff is currently researching an agenda project to address revenue recognition issues raised by the TRG that are related to (1) intellectual property transactions, (2) the determination of whether certain performance obligations are distinct within the context of the contract, and (3) gross versus net presentation determinations.

See Deloitte's October 2014 *TRG Snapshot* for a more detailed discussion about the TRG's October meeting on revenue recognition issues.

Remarks of Ian Mackintosh, IASB Vice-Chairman

In his prepared remarks, Mr. Mackintosh discussed the global success of IFRSs and noted the increasing relevancy of IFRSs to many American companies. Further, he discussed the success of the FASB's and IASB's convergence efforts and stated, "Convergence was not a perfect process but it was a good one and we achieved a great deal. The similarities between the two sets of Standards are bigger than the differences." In closing, he stated that the relationship between the FASB and IASB needs to remain strong to further the convergence of standards and minimize differences in the future.

During a Q&A session, Mr. Mackintosh discussed the remarks of James Schnurr, chief accountant in the OCA, on the possibility of permitting voluntary supplementary use of IFRSs in the United States. While he stated that he was pleased that the topic is back on the agenda, he cautioned that renewed discussion of the topic has only begun and that the success of the voluntary supplemental-use approach would depend on how many registrants volunteer to provide the supplemental IFRS information.

FASB and IASB Standard-Setting Update

The FASB and IASB staffs outlined the boards' progress on their respective projects. The FASB staff discussed the status of the significant FASB projects, and the IASB staff provided an overview of the IASB's standard-setting process and outlined several research initiatives and major projects, including the conceptual framework project. For more information about the boards' current projects, refer to the FASB's technical agenda and the IASB's work plan.

Auditing and PCAOB Developments

In his keynote address, PCAOB Chairman James Doty emphasized the importance of high-quality, independent audits, referring to them as the "linchpin" of the financial markets. Mr. Doty indicated that while he believes that the auditing profession has a bright future, it must not take this period of calm for granted and give in to "temptations to scale back on doing what good audit requires."

In 2014, the PCAOB continued to advance three key initiatives to enhance the reliability and relevance of financial statement audits: (1) using robust economic analysis to evaluate and enhance the role of an audit, (2) developing effective standards, and (3) facilitating the work of audit committees.

Recent Developments

The PCAOB continues to seek ways to improve its inspection process and reporting model as well as increase its transparency with investors, auditors, and audit committees. In the current year, the PCAOB expanded its inspection findings report to include links to applicable auditing standards for each deficiency identified.

Increased Global Cooperation

The PCAOB staff noted that although the PCAOB made progress internationally with inspections in many jurisdictions, it continues to work with its foreign counterparts to gain access to certain countries to increase transparency and investor protection. The staff also indicated that there were significant findings in one-third of the referred work the PCAOB reviewed in the prior year, that many deficiencies were associated with the testing of revenue and inventory, and that the Board will increasingly focus on controls in a global network.

Inspection Staff Results and Common Findings

Reiterating its statement from last year that the PCAOB primarily takes a risk-based approach in selecting engagements for inspection, the staff indicated that the Board will continue to focus on the areas it believes represent the greatest risk. The staff noted that the findings in this inspection season were frequently related to revenue recognition, inventory, goodwill and intangible assets, and business combinations.

The PCAOB continues to seek ways to improve its inspection process and reporting model as well as increase its transparency with investors, auditors, and audit committees.

Further, the PCAOB staff commented that ICFR continues to be a challenge to auditors in the current-year inspection cycle and discussed the most common findings related to internal controls, which include failure to (1) obtain a sufficient understanding of the flow of transactions to identify and to test the controls that mitigate the risks, (2) management review controls, and (3) test the completeness and accuracy of the data used in the performance of controls. The staff also discussed other challenges, including testing fair value measurements and management estimates as well as not effectively responding to the assessed risk of material misstatement, particularly with respect to revenue.

Looking Ahead to 2015 — Areas of Focus

The PCAOB staff noted that some newer areas of PCAOB focus will include (1) environmental risk (including environmental developments, which will have a significant effect on financial reporting risks), (2) M&A activity (including cash flow projections used to support valuations and controls related to business combinations), (3) income taxes (specifically undistributed earnings and cash held overseas, and controls related to income tax accounting and disclosure), (4) investment returns, (5) falling oil prices, (6) statement of cash flows, and (7) cybersecurity.

The PCAOB staff also referred registrants to the PCAOB's Rule 4010 Report and Staff Audit Practice Alert No. 11, *Considerations for Audits of Internal Control Over Financial Reporting*, which it indicated were valuable resources that warrant another read.

Standard Setting

Increasing the quality of audits through effective standard setting remains a focus of the PCAOB. Jay Hanson and Martin Baumann outlined recently completed, current, and upcoming standard-setting projects.

See Deloitte's December 5, 2014, *Heads Up* for a table that lists these projects.

Two key proposed auditing standards of interest to investors, audit committees, and auditors are:

- *Auditor's reporting model* — In August 2013, the PCAOB proposed revisions to the auditor's reporting model in response to investor demands for a more informative and meaningful auditor's report. The revisions would require auditors to include in their reports a discussion of "critical audit matters," often described as matters related to the audit that "keep the auditor up at night." After analyzing the comments received on this proposal, the PCAOB plans to repropose the standard in early 2015 to further define critical audit matters.
- *Improving transparency through disclosure of engagement partner and certain other participants in the audit* — A supplement to this proposed standard is expected to be issued in the first quarter of 2015. The supplement would address the mechanics of the disclosure, with the goal of striking a balance between investors' need for information about the names of the engagement partner and other firms participating in the audit and auditors' concerns about increased liability.

Mr. Hanson reported that the PCAOB's standard-setting program now explicitly incorporates economic analysis, which aims to weigh the benefits of meeting investors' and other stakeholders' needs against the costs to the audit. Eventually the PCAOB expects to expand its economic analysis model to all of its activities.

Audit Committee Outreach Activities

Mr. Doty and Mr. Hanson highlighted the PCAOB's continued efforts to engage with audit committees in support of their oversight of the auditors by equipping them with relevant and timely information about recent inspection findings, audit trends and risks, and other audit quality hot topics.

A critical aspect of these efforts is the PCAOB's audit quality indicator (AQI) project, which will establish a portfolio of quantitative measures of audit quality that audit committees can use to evaluate auditors. A concept release that will include a list of potential AQIs is expected to be issued in early 2015. In addition, the CAQ issued a paper on audit quality indicators in April 2014 that is currently being field tested by audit firms with select audit committees. A key objective of both of these projects is to give audit committees valuable information about matters that contribute to an audit firm's delivery of a high-quality audit.

Editor's Note: The OCA staff stressed the importance of auditor independence, noting that nonaudit services should be monitored by management and the audit committee to avoid "scope creep." The staff indicated that scope creep can occur during the delivery of otherwise permissible nonaudit services when engagement activities deviate from the intended scope and thus become impermissible, impairing auditor independence. The staff also emphasized that since audits of broker-dealers registered with the SEC must satisfy SEC independence requirements under Regulation S-X, the auditor cannot both prepare and audit the broker-dealer's financial statements.

Internal Control Over Financial Reporting

As it did at last year's conference, the OCA staff questioned whether all material weaknesses in internal controls are being properly identified, evaluated, and disclosed. The staff attributed inadequate identification and disclosure of material weaknesses to either (1) not identifying deficiencies initially or (2) not appropriately evaluating the severity of the deficiencies.

At this year's conference, the OCA staff elaborated on its previous comments, noting that understanding and accurately defining control deficiencies are key to management's evaluation of the severity of such deficiencies. The staff observed that a consideration of various factors may be helpful to understanding and describing a control deficiency, including but not limited to (1) the nature of the control deficiency,

(2) the impact of the deficiency on financial reporting and ICFR, (3) the cause of the deficiency, (4) how the deficiency was identified, and (5) what remediation procedures are likely to be performed. The OCA staff also noted that the cause of a control deficiency in the control activities COSO component may indicate a deficiency in another COSO component, which may be overlooked if such cause is not appropriately understood. For example, a deficiency in the design of a control activity may indicate a deficiency in management's risk assessment component, and a deficiency in the operating effectiveness of a control activity may indicate a deficiency in management's monitoring component.

After discussing the relationship of the various COSO components, the OCA staff reminded management to identify and consider financial reporting risks in their annual ICFR evaluations, noting that it is critical to consider the nature and extent of any changes in the risks to reliable financial reporting.

Editor's Note: In a discussion about COSO's *Internal Control — Integrated Framework* (the "2013 Framework"), the OCA staff reminded participants that COSO will no longer support the 1992 Framework as of December 15, 2014. The staff indicated during a Q&A session that it does not expect companies to receive questions from the SEC staff about why a company did not use the 2013 Framework. However, companies may begin to receive questions from others (e.g., the Division) as time passes asking why a company would use an outdated framework. The staff also remarked that it is important for companies to disclose to investors which framework they used.

The OCA staff also expressed hope that the improved organization and structure of COSO's 2013 Framework will lead to improved evaluations of the components outside of control activities.

For more information on the 2013 Framework, see Deloitte's September 5, 2014, and June 10, 2013, *Heads Up* newsletters.

The OCA staff also discussed the identification of material weaknesses, noting that management appears to be focused on what happened (i.e., the actual error) rather than on what *could happen* (i.e., the "could factor") when evaluating the severity of deficiencies. The staff explained that such an evaluation requires management to consider the nature and amount of the transactions exposed to the deficiency as well as the current and future volume of activity.

See Deloitte's *SEC Comment Letters — Including Industry Insights: A Recap of Recent Trends* for excerpts of SEC staff comments and Deloitte's analysis on evaluating the potential severity of errors and deficiencies to determine whether there is a material weakness in ICFR.

Other Topics

Conflict Minerals

At the session on conflict minerals reporting, a panelist provided an update on the status of legal challenges to the SEC's conflict minerals rule. After (1) highlighting that the U.S. Court of Appeals for the D.C. Circuit will soon rehear the case challenging the constitutionality of the rule and (2) noting that in a recent case dealing with similar issues, that same court ruled that the government is able to require disclosure of country-of-origin information, the panelist indicated that most registrants are proceeding "full speed ahead" with their implementation of the rule. The panelist also reminded registrants that the contested portions of the rule will not affect their obligation to obtain an independent private sector audit (IPSA) in certain circumstances, notwithstanding the guidance issued by the SEC in April 2014.

During the session, panelists also (1) reviewed observed trends and noted difficulties faced by preparers in the rule's first year of adoption and (2) emphasized that registrants should challenge the auditability of their conflict minerals reports.

See Deloitte's July 21, 2014, *Heads Up* for more information about the history of the legal action, findings from Deloitte's analysis of registrants´ first filing under the rule, and insights for registrants as they consider conflict minerals compliance and reporting improvements for future filings in anticipation of an IPSA. Further, see Deloitte's *Conflict Minerals — Frequently Asked Questions*, which addresses many questions that have arisen related to conflict minerals, including reporting considerations.

Integrated Reporting

A panelist discussing integrated reporting matters noted that to make investment decisions in today's changing markets, investors need strategic insights from management and not just historical financial numbers. Therefore, the panelist explained, companies should communicate the full range of factors that affect the organization's ability to create value over time, including not only traditional financial or manufactured capital but also human, intellectual, social and relationship, and natural capital. Specifically, companies should communicate factors such as (1) the entity's key strategy and business model to build value, (2) whether the entity is on top of its risks and opportunities, and (3) how changing patterns in consumer behavior are exploited and reflected in the entity's future strategy and business model. The panelist also noted the importance of both applying integrated thinking within the organization and demonstrating in the integrated report the extent to which integrated thinking is used.

In addition, the panelist observed that integrated reporting is not a new creation; rather, the panelist said, it is building on current forms of reporting. The panelist dismissed myths about integrated reporting (e.g., the view that an integrated report is an executive summary, or just a report that combines the financial statements or annual report and any separate corporate responsibility or sustainability report into one report) and suggested that integrated reporting is an umbrella for the organization's communication and reporting.

The panelist also indicated that integrated reporting is not a fad but a reality. In discussing the efforts of the International Integrated Reporting Council (IIRC), the panelist noted that more than 100 companies from various regions and industries worldwide took part in its pilot program for integrated reporting.

Another panelist spoke about assurance on integrated reporting and noted that the IIRC published two discussion papers on the topic in July 2014 and that it plans to issue a summary of the responses to those papers in early 2015. In addition, the panelist emphasized the role of internal audit and discussed the benefits of providing assurance on integrated reporting. The panelist also discussed related technical and implementation challenges (e.g., the nature and levels of assurance and methodology issues, including materiality); however, such challenges are nothing new.

Appendix A: Glossary of Standards and Regulations

The standards and literature below were cited or linked to in this publication.

FASB Literature

For titles of *FASB Accounting Standards Codification* references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

See the FASB's Web site for the titles of citations to:

- Accounting Standards Updates.
- Proposed Accounting Standards Updates.

SEC Literature

- Regulation S-K:
  - Item 301, "Selected Financial Data"
  - Item 302, "Supplementary Financial Information"
  - Item 303, "Management's Discussion and Analysis of Financial Condition and Results of Operations"
- Regulation S-X:
  - Rule 4-10, "Financial Accounting and Reporting for Oil and Gas Producing Activities Pursuant to the Federal Securities Laws and the Energy Policy And Conservation Act of 1975"
  - Article 11, "Pro Forma Financial Information"
- Division of Corporation Finance's Financial Reporting Manual, Topic 9, "Management's Discussion and Analysis of Financial Position and Results of Operations (MD&A)"
- Securities Exchange Act of 1934 Rule 12b-20, "General Requirements as to Contents: Additional Information"
- Compliance and Disclosure Interpretation: Securities Act Rules, Section 131. Rule 144(c), "Current Public Information"

PCAOB Literature

- Staff Audit Practice Alert No. 11, *Considerations for Audits of Internal Control Over Financial Reporting*
- Release 2012-006, *Observations From 2010 Inspections of Domestic Annually Inspected Firms Regarding Deficiencies in Audits of Internal Control Over Financial Reporting* [Rule 4010 Report]

Appendix B: Abbreviations

Abbreviation	Description
AICPA	American Institute of Certified Public Accountants
AQI	audit quality indicator
ASC	FASB Accounting Standards Codification
C&DI	SEC Compliance and Disclosure Interpretation
CAQ	Center for Audit Quality
CEO	chief executive officer
CODM	chief operating decision maker
COSO	Committee of Sponsoring Organizations of the Treadway Commission
Division	SEC's Division of Corporation Finance
EGC	emerging growth company
EITF	FASB's Emerging Issues Task Force
FASB	Financial Accounting Standards Board
FCPA	Foreign Corrupt Practices Act
FinREC	AICPA's Financial Reporting Executive Committee
GAAP	generally accepted accounting principles

Abbreviation	Description
IASB	International Accounting Standards Board
ICFR	internal control over financial reporting
IFRS	International Financial Reporting Standard
IIRC	International Integrated Reporting Council
IPO	initial public offering
IPSA	independent private-sector audit
MD&A	Management's Discussion and Analysis
NCI	noncontrolling interest
OCA	SEC's Office of the Chief Accountant
PCAOB	Public Company Accounting Oversight Board
Q&A	question and answer
SAB	SEC Staff Accounting Bulletin
SEC	Securities and Exchange Commission
SOA	Society of Actuaries
TRG	transition resource group
VIE	variable interest entity

The following is a list of short references for the Acts mentioned in this publication:

Abbreviation	Act
Dodd-Frank Act	The Dodd-Frank Wall Street Reform and Consumer Protection Act
JOBS Act	Jumpstart Our Business Startups Act
Securities Exchange Act	Securities Exchange Act of 1934

Appendix C: Selected Sessions and Speakers

The table below lists sessions and information about speakers on selected topics at the conference. The full text of conference speeches that are publicly available can be viewed by clicking the speaker's name.

Sessions/Speakers

Remarks of the SEC Chief Accountant

- James Schnurr, Chief Accountant, SEC's Office of the Chief Accountant

OCA Policy Initiatives

- Brian Croteau, Deputy Chief Accountant — Professional Practice, SEC's Office of the Chief Accountant
- Julie Erhardt, Deputy Chief Accountant — International, SEC's Office of the Chief Accountant
- Dan Murdock, Deputy Chief Accountant — Accounting, SEC's Office of the Chief Accountant

OCA Current Projects

- T. Kirk Crews, Professional Accounting Fellow, SEC's Office of the Chief Accountant
- Steve Mack, Professional Accounting Fellow, SEC's Office of the Chief Accountant
- Christopher Rogers, Professional Accounting Fellow, SEC's Office of the Chief Accountant
- Hillary Salo, Professional Accounting Fellow, SEC's Office of the Chief Accountant
- Kevin Stout, Senior Associate Chief Accountant, SEC's Office of the Chief Accountant
- Carlton Tartar, Associate Chief Accountant, SEC's Office of the Chief Accountant

A Conversation With Commissioner Daniel Gallagher — Hosted by Barry Melancon

- Daniel Gallagher, Commissioner, SEC
- Barry Melancon, President, AICPA

Keynote Address — PCAOB

- James Doty, Chairman, PCAOB

Current Practice Issues

- Jeff Jones, Partner, KPMG LLP
- Sandie Kim, Partner, Deloitte & Touche LLP
- Joe McGrath, Partner, Ernst & Young LLP
- Beth Paul, Partner, PricewaterhouseCoopers LLP

Developments in the Division of Corporation Finance

- Keith Higgins, Director, SEC's Division of Corporation Finance
- Mark Kronforst, Chief Accountant, SEC's Division of Corporation Finance
- Cicely LaMothe, Associate Director, SEC's Division of Corporation Finance
- Craig Olinger, Deputy Chief Accountant, SEC's Division of Corporation Finance
- Nili Shah, Deputy Chief Accountant, SEC's Division of Corporation Finance

Sessions/Speakers

FASB and IASB Chair Addresses

- Russell Golden, Chairman, FASB
- Ian Mackintosh, Vice-Chairman, IASB

FASB and IASB Accounting Standard-Setting Update

- Susan Cosper, Technical Director and EITF Chairman, FASB
- Hugh Shields, Executive Technical Director, IASB

Disclosure Reform/Effectiveness Panel

- Neri Bukspan, Partner, Ernst & Young LLP
- DawnDee Hankel, External Reporting Controller, Intel Corporation
- Tom Kim, Partner, Sidley Austin LLP
- Mark Kronforst, Chief Accountant, SEC's Division of Corporation Finance

PCAOB Auditing Standard-Setting Update

- Martin Baumann, Chief Auditor and Director of Professional Standards, PCAOB
- Jay Hanson, Board Member, PCAOB

SEC Enforcement Division Update

- Andrew Ceresney, Director, SEC's Division of Enforcement
- Michael Maloney, Chief Accountant, SEC's Division of Enforcement

Revenue Recognition

- Kenny Bement, Director of Financial Reporting, Raytheon Company
- Mark Crowley, Director, Deloitte & Touche LLP
- Jim Dolinar, Chairman, FinREC, and Partner, Crowe Horwath LLP
- Liesl Nebel, Accounting Policy Controller, Intel Corporation

PCAOB Registration, Inspection, and Enforcement Updates

- Claudius Modesti, Director, Division of Enforcement and Investigations, PCAOB
- Helen Munter, Director, Division of Registration and Inspections, PCAOB

Conflict Minerals Reporting

- Dorsey Baskin, Partner, Grant Thornton LLP
- Lacey Elberg, Senior Counsel and Assistant Corporate Secretary, Johnson & Johnson
- Kristen Sullivan, Partner, Deloitte & Touche LLP

The Future of Financial Reporting — Including Integrated Reporting

- Paul Druckman, CEO, International Integrated Reporting Council
- Amy Pawlicki, Director, Business Reporting, Assurance and Advisory Services, AICPA

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