

SEC in Focus

Quarterly summary of current SEC activities

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Regulators discuss implementation of standards, disclosures

Regulators and standard setters discussed a broad range of financial reporting topics and emerging issues at the annual AICPA Conference on Current SEC and PCAOB Developments (Conference) in Washington, DC.

The speakers and panelists included representatives of the Securities and Exchange Commission (SEC or Commission), the Financial Accounting Standards Board (FASB), the International Accounting Standards Board and the Public Company Accounting Oversight Board (PCAOB) who shared their views on various accounting, financial reporting, auditing and regulatory issues.

New accounting standards – The staffs of the FASB and the SEC commended the successful implementation of the major new accounting standards on revenue recognition and leases and said they anticipate the successful implementation of the credit losses standard. The SEC staff emphasized that it has consistently accepted well-reasoned judgments applied by registrants adopting the new accounting standards. The FASB staff said that it continues to provide implementation support and will evaluate whether reporting under the new standards is meeting the FASB’s objectives.

Critical audit matters – PCAOB and SEC officials expressed appreciation for the efforts of auditors to implement the PCAOB requirement to discuss critical audit matters (CAMs) in the auditor’s report. The PCAOB noted that it is proactively monitoring auditors’ initial reports with CAMs by performing selected reviews and publishing observations and additional staff guidance. Representatives of company management and audit committees noted that auditors’ reporting of CAMs has resulted in companies challenging and improving the quality of their own disclosures.



EY resources

- ▶ [2019 AICPA Conference on Current SEC and PCAOB Developments: compendium of significant accounting and reporting issues](#)

Areas of focus – The SEC staff highlighted the risks and complexities associated with phasing out the London Interbank Offered Rate (LIBOR). Because LIBOR is a reference rate that is widely used in loans and commercial contracts, the SEC staff is actively monitoring transition activities to address financial reporting and disclosure issues that might arise. The FASB expects to issue final guidance in early 2020 to temporarily ease the accounting burden for entities changing the reference rate in contracts if they meet certain criteria.

Non-GAAP financial measures – The SEC staff encouraged registrants to engage in “responsible” non-GAAP reporting by, among other things, making sure these measures are calculated consistently period to period. SEC staff members also discussed non-GAAP financial measures calculated using accounting principles that have been superseded by new standards (e.g., the new credit losses standard). The SEC staff believes that measures that exclude the effects of the new standard will be inappropriate because they are considered to have been prepared using “individually tailored accounting principles” that cause them to be misleading.

How we see it

While participants in the Conference discussed a variety of topics, the overall theme of their remarks was how regulators, standard setters, preparers and auditors are increasing stakeholder engagement to achieve consistent, high-quality financial reporting, which is the bedrock of the US capital markets.

NYSE revises proposal to amend direct listing rules

The New York Stock Exchange (NYSE) submitted a **revised proposal** to the SEC to amend its rules to allow a company conducting a direct listing to also raise capital by selling new shares to the public as part of the transaction. In a direct listing, a company’s current shares are listed for resale by its existing shareholders, and the company does not raise capital. If adopted, these changes would likely increase the appeal of direct listings.

Under the proposal, a company that has not previously had its common equity securities registered under the Securities Exchange Act of 1934 would be allowed to sell new shares to the public if either:

- ▶ The market value of the new shares sold to the public in the direct listing is at least \$100 million.
- ▶ The market value of the company’s shares prior to the direct listing, together with the market value of the new shares sold to the public, is at least \$250 million.

The SEC rejected the NYSE’s original proposal, which included significantly higher qualification thresholds for companies seeking to undertake such transactions.

SEC officials emphasize audit committee responsibilities

SEC Chairman Jay Clayton, SEC Chief Accountant Sagar Teotia and William Hinman, Director of the SEC Division of Corporation Finance, issued a **public statement** highlighting the important oversight role that audit committees play in the financial reporting system. They said audit committees should focus on, among other things:

- ▶ Tone at the top, with the objective of supporting the integrity of the financial reporting process and the independence of the audit
- ▶ Compliance with auditor independence rules

- ▶ Reviewing the presentation of non-GAAP financial measures and metrics, including understanding how management uses the measures, period-to-period consistency and related disclosure controls and procedures
- ▶ Understanding management's plans to identify and address the risks associated with the transition from LIBOR, commonly referred to as reference rate reform, and its accounting and financial reporting effects
- ▶ The auditor's discussion of CAMs in the auditor's report

Messrs. Clayton, Teotia and Hinman said these reminders are intended to help audit committees carry out their year-end work and promote constructive dialogue among audit committees, management and independent auditors.

Other SEC rulemaking and implementation

SEC proposes amending 'accredited investor' definition

The SEC proposed amending the definition of accredited investor to:

- ▶ Permit natural persons to qualify as accredited investors based on certain professional certifications and designations
- ▶ Allow a "knowledgeable employee" of a private fund to qualify as an accredited investor for the purpose of investing in that fund
- ▶ Add certain limited liability companies, registered investment advisers and rural business investment companies (RBICs) to the list of entities that may qualify as accredited investors
- ▶ Allow any entity owning investments in excess of \$5 million that was not formed for the purpose of investing in the securities offered to qualify as an accredited investor
- ▶ Add family offices with at least \$5 million in assets under management, as well as their family clients, to the list of entities that may qualify as accredited investors
- ▶ Allow spousal equivalents to pool their finances for the purpose of qualifying as accredited investors

The proposed amendments also would change the definition of qualified institutional buyer (QIB) in Rule 144A. Limited liability companies and RBICs, as well as all institutional accredited investors under Rule 501(a), would become eligible for QIB status.

Comments on the proposal are due 60 days after its publication in the Federal Register.

How we see it

Chairman Clayton has said the Commission would take a fresh look at expanding access to the private capital markets while preserving investor protection. The proposed amendments represent the Commission's first rulemaking in this area and follow the SEC's June 2019 concept release that sought input on whether changes should be made to the framework for securities offerings that are exempt from registration.

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The [current] accredited investor definition stands between millions of Americans and opportunities to invest their wealth in private offerings.

— Commissioner Elad Roisman

SEC proposes amendments to auditor independence rules

The SEC **proposed** changes to the auditor independence rules that are intended to focus the independence analysis on relationships and services that are more likely to pose threats to an auditor's objectivity and impartiality. Among other things the proposed amendments would:

- ▶ Change the definition of a common control affiliate in Rule 2-01(f) of Regulation S-X to include only sister entities that are material to the common controlling entity
- ▶ Revise the business relationship rule in Rule 2-01(c) of Regulation S-X to replace the term "substantial stockholder" with "beneficial owners of the audit client's equity securities where such beneficial owner has significant influence over the audit client"
- ▶ Clarify the Loan Rule to focus the analysis on whether the beneficial owner has significant influence over the entity being audited
- ▶ Expand the group of audit clients that use the Investment Company Complex definition to determine their affiliates to include private (unregistered) funds and investment advisers
- ▶ Reduce the look-back period for compliance with the SEC auditor independence rules to one year prior to the year of the first filing of the initial public offering (IPO) registration statement by a domestic entity

Comments on the proposal are due 60 days after publication in the Federal Register.

SEC proposes changes to shareholder proposal and proxy solicitation rules

The SEC proposed **amendments** to the rule that governs the process for including shareholder proposals in a company's proxy statement and **changes** to its proxy solicitation rules to enhance the accuracy and transparency of the information that proxy advisory firms provide to their clients. The amendments to the shareholder proposal rule would:

- ▶ Update the criteria that a shareholder must satisfy to be eligible to have a proposal included in a company's proxy statement
- ▶ Clarify that a single person may not submit multiple proposals to be considered at the same shareholder's meeting, whether the person submits a proposal as a shareholder or as a representative of a shareholder
- ▶ Increase the levels of shareholder support a proposal must receive to be eligible for resubmission at a future shareholder meeting

The proposed changes to the proxy solicitation rules would allow companies and other soliciting parties to review a proxy advisory firm's voting advice before it is issued and request that the advice direct recipients to a written statement setting forth the views of the company or other soliciting party, among other things. The proposal would also codify recent Commission guidance on the proxy process and require enhanced disclosure of material conflicts of interest.

Comments on the proposals are due 3 February 2020.

SEC proposes resource extraction disclosures

The SEC **proposed** rules that would require resource extraction issuers to make annual disclosures about payments to foreign governments or the US Federal Government for the commercial development of oil, natural gas or minerals.

The rules were mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act, but the Commission's attempts to adopt rules in 2012 and 2016 were nullified by court and Congressional actions. Chairman Clayton said the latest proposal was designed to address both the Dodd-Frank mandate and the issues raised in challenges to the earlier rules.

Among other things, the proposal would require a registrant to disclose its payments by project. The disclosures would include payments made by subsidiaries and entities that a registrant controls.

Comments are due 60 days from publication in the Federal Register.

Other SEC activities and current practice matters

SEC staff issues SAB on new credit losses standard

The SEC staff issued [Staff Accounting Bulletin \(SAB\) 119](#) to provide interpretive guidance on applying the new credit losses standard for registrants engaged in lending activities. These registrants should consider the new guidance when documenting their methodology for estimating credit losses and evaluating the sufficiency of their controls over allowances for credit losses recorded under Accounting Standards Codification (ASC) 326, *Financial Instruments – Credit Losses*. Until they adopt the new standard, registrants should continue to apply the guidance in SAB 102.

CAQ – SEC Regulations Committee meeting highlights

At the Center for Audit Quality (CAQ) SEC Regulations Committee meeting in September 2019, the SEC staff provided guidance on the amounts that must be presented in the contractual obligations table upon adoption of the new leases accounting standard. All registrants except smaller reporting companies are required to present a contractual obligations table in their annual reports, registration statements and proxy statements. The table should include all contractual obligations as of the registrant's latest fiscal year-end balance sheet date in a tabular format.

The SEC staff clarified that the presentation of cash outflows in the contractual obligations table should be consistent with US GAAP disclosures. However, the staff also said that registrants should consider additional footnote disclosures if they do not believe that the table itself adequately captures liquidity needs and expected future cash outflows.

Conference remarks by the staff of the Division of Corporation Finance

Implications of the FASB's deferral of certain effective dates of major standards

SEC staff members in the Division of Corporation Finance discussed questions the staff has received about the FASB's recent deferral of certain effective dates for major accounting standards.

With Accounting Standards Update 2019-10, the FASB created a "two-bucket approach" for adopting major accounting standards under which SEC filers other than smaller reporting companies adopt a major new accounting standard at least two years before all other entities. The SEC staff told registrants that the definition of an SEC filer used in ASU 2019-10 excludes:

- ▶ An entity whose financial statements are included in another entity's SEC filing (e.g., Items 3-05 and 3-09 of Regulation S-X)
- ▶ An entity that is preparing to conduct an IPO, because it would not become an SEC filer until its registration statement is declared effective

EY resources

- ▶ To the Point, [FASB defers certain effective dates for major standards](#)

The staff clarified that because entities conducting IPOs become SEC filers when their registration statements are declared effective, they must adopt the new credit losses standard as of the Bucket 1 adoption date in their next SEC filing. For example, a calendar-year company that becomes an SEC filer in June 2020 must adopt the new credit losses standard as of 1 January 2020 in its calendar second-quarter Form 10-Q, unless it is an emerging growth company (EGC) that retains the ability to adopt new accounting standards using private company adoption dates.

How we see it

Unless they are an EGC that retains the accounting changes relief, an entity that submits IPO registration statements should consider using the effective dates for SEC filers when adopting new standards to avoid the complexity of having to retrospectively apply the new accounting and revise previously issued financial statements immediately after the IPO.

Even though ASU 2019-10 states that companies should determine whether they are smaller reporting companies on 15 November 2019, the SEC staff has said that it would not object to a newly public company that qualified as a smaller reporting company at the time of its IPO deferring adoption of the credit losses standard until the Bucket 2 effective date (i.e., 2023 for a calendar-year company).

How we see it

The SEC staff's position levels the playing field for companies that go public and qualify as smaller reporting companies after 15 November 2019, which is the determination date set by the FASB in ASU 2019-10.

Finally, the SEC staff said that an EGC that has elected to use the private company effective date for a new or revised accounting standard but loses its EGC status before it would have adopted the new guidance must adopt the new guidance as of the beginning of the year it loses its EGC status. That is, a company that loses its EGC status during 2021 would have to adopt the new credit losses standard as of 1 January 2021 in its 2021 Form 10-K.

Consistent with guidance previously provided by the SEC staff, an EGC that loses its status in 2020 would apply the new credit losses standard as of 1 January 2020 in its 2020 Form 10-K.

EY resources

- ▶ SEC Reporting Update, [Highlights of trends in 2019 SEC comment letters](#)
- ▶ [SEC Comments and Trends: an analysis of current reporting issues](#)
- ▶ Technical Line, [Spotlight on non-GAAP financial measures](#)

Non-GAAP financial measures

The SEC staff's remarks on non-GAAP financial measures focused on companies using such measures to present financial results prepared using accounting principles that have been superseded by new standards such as ASC 326, which public companies will begin adopting in 2020.

While companies may contemplate using non-GAAP measures to make it easier for investors to compare their current results with those of previous periods when a new standard has been adopted without full retrospective application, SEC staff members reminded registrants that, in many cases, these measures will be inappropriate because they are considered to have been prepared using individually tailored accounting principles that cause them to be misleading.

The SEC staff believes that it will not be appropriate for companies that adopt ASC 326 this year to present a non-GAAP measure that excludes the effect of the new standard, as well as a measure that excludes the effect of a company's allowance for credit losses in its entirety.

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[Rebekah’s]
understanding of
our financial
markets and
international
experience will
benefit the PCAOB
as it oversees the
audits of public
companies and
brokers and dealers

— Sagar Teotia,
SEC Chief Accountant

How we see it

Preparers need to consider carefully the SEC rules and staff guidance on the use of non-GAAP financial measures when they adopt a new accounting standard. Although the SEC staff encourages a detailed discussion in management’s discussion and analysis that facilitates period-to-period comparability, the staff typically considers a non-GAAP financial measure that unwinds the effect of a newly adopted accounting principle to be misleading, even when presented for the purposes of discussing comparability with prior periods, unless similar information is required by the standard.

The SEC staff also discussed the presentation of contribution margin or similar measures by companies. The staff noted that such measures are considered to be non-GAAP financial measures and that gross margin would be considered the most directly comparable GAAP measure. Accordingly, companies that present contribution margin (or other similar measures) must provide the appropriate non-GAAP disclosures and a reconciliation to gross margin calculated in accordance with GAAP, even if gross margin cannot be calculated directly from amounts in its income statement.

How we see it

Although Rule 5-03 of Regulation S-X requires the presentation of revenue and cost of revenue, SAB Topic 11.B allows companies to exclude depreciation and amortization from cost of revenue. Companies that apply the SAB and present a non-GAAP margin must allocate depreciation and amortization to cost of revenue to calculate GAAP gross profit for purposes of the non-GAAP reconciliation.

Stock buyback disclosures

Mr. Hinman discussed stock buybacks and observed that they are frequently perceived as a way for management to unfairly increase executive compensation that is tied to stock price or earnings-per-share targets.

He noted that most compensation committees have considered the effect of stock buybacks and adjusted the targets accordingly. He suggested companies include additional compensation discussion and analysis disclosures about how the compensation committee takes stock buybacks into account in the targets it sets for incentive compensation for executives.

Personnel changes

SEC appoints new PCAOB board member and announces coordination effort

The SEC **announced** the appointment of Rebekah Goshorn Jurata as a member of the PCAOB for a five-year term through October 2024. Ms. Jurata, a former SEC official and Special Assistant to the President for Financial Policy, filled the PCAOB seat that was **vacated** by Kathleen M. Hamm at the end of her term.

In addition, the SEC said SEC Commissioner Hester Peirce will lead the agency’s coordination efforts with the PCAOB along with the SEC’s Office of the Chief Accountant (OCA). The SEC oversees the PCAOB and appoints its members.



**Rebekah Goshorn
Jurata¹**

SEC appoints new Deputy Chief Accountants

The SEC named John Vanosdall and Paul Munter as Deputy Chief Accountants in OCA.

Mr. Vanosdall, who was a partner at PricewaterhouseCoopers LLP and previously served as a professional accounting fellow at the SEC, leads the OCA's Accounting Group, which consults with stakeholders about the application of accounting standards and financial disclosure requirements.

Mr. Munter, who recently retired from KPMG LLP's National Office and has been teaching at the University of Colorado, leads OCA's activities on international matters. Mr. Munter was an SEC academic fellow earlier in his career.

Enforcement activities

SEC's Division of Enforcement issues its 2019 annual report

The SEC's Division of Enforcement said in its annual report for fiscal year 2019 that it brought 862 enforcement actions, including 526 standalone actions, and returned \$1.2 billion to harmed investors.

The report noted that 108 of the enforcement actions involved financial reporting, accounting or auditing issues, including instances in which companies were charged in connection with weaknesses in internal controls, misleading investors to meet performance targets, or making other false and misleading statements.

The Division's other cases involved a wide range of issues, including those related to investment advisors, securities offerings, market manipulation, insider trading and broker-dealer misconduct.

SEC charges life insurer for internal control failures

The SEC charged a major life insurance company with violating the books and records and internal controls provisions of the federal securities laws.

According to the order, the company improperly released reserves for annuity benefits, thus overstating income. For more than 25 years, the company's practice was to assume annuitants had died or would never be found if they did not respond to two mailing attempts made approximately five and a half years apart. The company later determined that its processes for locating and contacting unresponsive annuitants were insufficient to justify the release of the reserves and, therefore, restored reserves of \$510 million to correct the error. The order also states that the company recorded a reserve decrease of \$896 million to correct a separate error caused by data mistakes during the same year.

Without admitting or denying the order's findings, the company agreed to pay a civil penalty of \$10 million.

SEC charges biotech company and executives with fraud

The SEC charged a biotech company and its former chief executive officer (CEO), chief operating officer (COO) and chief financial officer (CFO) with accounting fraud.

According to the complaint, the company prematurely recognized revenue from sales to distributors, given undisclosed side arrangements entered into by the former CEO and COO. The side agreements allowed the distributors to return the product or conditioned their payments on sales to end users. The company's former CEO, COO and CFO allegedly misled the company's auditors, audit committee members and outside lawyers for years.

Without admitting or denying the order's findings, the company agreed to a settlement and to pay a \$1.5 million penalty. The SEC complaint seeks permanent injunctions, disgorgement plus interest, penalties and officer-and-director bars against the former CEO, COO and CFO, as well as the clawback of bonuses and other incentive compensation from the former CEO and CFO.

Cryptocurrency-related enforcement activities

The SEC charged an entrepreneur and his company with defrauding investors in an initial coin offering (ICO) that raised more than \$42 million. The complaint alleges that the entrepreneur repeatedly lied to investors and never created the shopping platform that the ICO proceeds were intended to fund. It also alleges that the entrepreneur misappropriated at least \$500,000 of investor funds for his personal use.

In other recent enforcement actions related to digital assets, the SEC:

- ▶ Filed an emergency action and obtained a temporary restraining order against two entities conducting an unregistered digital token offering that has raised more than \$1.7 billion
- ▶ Settled charges against a company for conducting an unregistered ICO that raised nearly \$13 million, in return for a \$250,000 penalty

What's next at the SEC?

The SEC continues to focus on finalizing amendments aimed at simplifying disclosure and other reporting requirements to facilitate capital formation while protecting investors. At the Conference, SEC staff said the Commission is expected to adopt final amendments in 2020 to streamline disclosure requirements for certain registered debt offerings and acquired businesses and to reduce the number of companies subject to the auditor attestation requirement for internal control over financial reporting.

Endnote:

¹ Photo from LinkedIn.

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