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2010 AICPA National Conference on Current SEC and PCAOB Developments

Regulators and Standard-Setters Address Investor Trust, Convergence, and Accounting and Financial Reporting Developments

Representatives of the SEC, PCAOB, FASB, IASB, and AICPA addressed accounting, reporting, and regulatory matters at the 2010 AICPA National Conference on Current SEC and PCAOB Developments (the Conference) held December 6–8, 2010, in Washington, D.C. The major Conference themes were restoring investor trust, convergence of U.S. GAAP and IFRS, audit quality, and the effect of the Dodd-Frank Wall Street Reform and Consumer Protection Act on the accounting profession. Other areas of focus included accounting and auditing standard-setter priorities and reporting observations identified during reviews of registrants' filings.

As stated, speakers' views did not necessarily reflect the official views of their respective organizations—as a matter of policy, the SEC, PCAOB, FASB, and IASB disclaim responsibility for any private publication or statement made by any of their members or staff.



Executive Summary

Restoring Investor Trust

Reversing investor skepticism will require collaboration among regulators and accountants.

Senior SEC officials stressed restoring investor trust and the importance of collaboration among accounting professionals. SEC Chairman Mary Schapiro discussed the important role of the accounting profession and the need for regulators, preparers, and auditors to work together to restore investor confidence. She indicated that past events have led to investor skepticism and lack of confidence in the U.S. capital markets and regulators alone cannot protect the capital markets. She spoke about a number of SEC initiatives to restore investor trust but said, “[I]n our quest to restore confidence, [investor skepticism] is one barrier in particular that we cannot dismantle without your help—one barrier against which you have to lead the fight.” Ms. Schapiro urged the profession to have the courage to challenge answers and the willingness to elevate judgments about the quality of disclosures to management and the audit committee. SEC Chief Accountant James Kroeker echoed the theme of restoring investor trust and said auditors can and should do more to emphasize the importance of auditor independence and the auditor’s duty to shareholders and the public.

Deputy Chief Accountant Mike Starr said that in 2011 the Office of the Chief Accountant (OCA) will hold multidisciplinary public roundtable discussions with standard-setters, preparers, investors, and other stakeholders to promote collaboration in the profession. Executive Director of the Center for Audit Quality (CAQ) Cynthia Fornelli said collaboration in the profession also is needed to advance fraud detection. The CAQ has partnered with Financial Executives International, the National Association of Corporate Directors, and the Institute of Internal Auditors to focus on further understanding conditions that contribute to fraud, to find ways to increase professional skepticism, to identify ways to moderate the risk of focusing only on short-term results, and to explore how information technology can facilitate fraud deterrence and detection.

Convergence of U.S. GAAP and IFRS

Discussions about whether the United States will incorporate IFRS into the U.S. reporting system continued as a hot topic at the Conference this year. “[T]here is a window of opportunity...if we blow this, I suspect the world will disintegrate as far as global standards are concerned.... It won’t simply be U.S. vs. IFRS...we will be back to where we were a long time ago,” said IASB Chairman Sir David Tweedie. Mr. Tweedie and FASB Acting Chairman Leslie Seidman discussed the status of global accounting standards convergence. The FASB and IASB are focusing their efforts on higher priority joint projects that have target completion dates of June 2011. Ms. Seidman spoke about the importance of obtaining feedback from all constituents on major projects prior to finalizing the standards and indicated both the FASB and IASB have increased their efforts to solicit input from constituents.

Convergence also continues as a top priority of the SEC, Ms. Shapiro said, but resulting standards “must be high quality improvements over current standards.” Ms. Schapiro spoke about the status of the SEC Work Plan for the Consideration of Incorporating International Financial Reporting Standards into

The SEC expects to make a decision about IFRS in 2011, and the transition period would likely be at least four years.

the Financial Reporting System for U.S. Issuers (IFRS Work Plan), and she is “pleased” with the progress to date.¹ She also stated that the SEC intends to make a decision during 2011 on whether to incorporate IFRS into the U.S. reporting system, possibly not by June 2011, however. Deputy Chief Accountant Paul Beswick discussed the possibilities if the SEC decides on some form of incorporation of IFRS in the United States. Mr. Beswick presented the idea of a combination of convergence of existing U.S. GAAP and IFRS and endorsement of future international standards. Under the approach suggested by Mr. Beswick, legacy U.S. GAAP would continue to be authoritative, and the FASB would primarily undertake new projects intended to converge U.S. GAAP with IFRS. Ms. Schapiro addressed concerns about the timing of a potential transition to IFRS and said that if the SEC decides on some form of incorporation of IFRS in the United States, the transition period would likely be a minimum of four years.

Staff from the SEC’s Division of Corporation Finance (DCF) spoke about their process for evaluating the application of IFRS as part of the IFRS Work Plan. The Staff is reviewing financial statements prepared using IFRS for a large number of entities across various jurisdictions and industries, including non-registrants. The Staff is analyzing accounting and disclosure policies and practices and focusing on both the initial selection and the application of those policies.

Audit Quality—Serving the Public Good

Officials reminded the profession that restoring investor trust can only be accomplished if reliable financial reporting is backed by quality audits. Mr. Starr, like Mr. Kroeker, spoke about the role of audit firms and the need for auditors to demonstrate a high degree of objectivity and to focus on serving investors as their number one priority. Deputy Chief Accountant Brian Croteau spoke about the recently effective auditing standard that provides a framework for engagement quality reviews. Mr. Croteau stressed the importance of the standard and said “it provides for an important element of quality control before an audit opinion is issued.” Mr. Croteau also spoke about the importance of determining the root causes of audit deficiencies identified by PCAOB inspections and noted that the Staff is working with the PCAOB and others to determine how root causes can be identified and evaluated.

Financial reporting supply chain participants all have a role in fraud deterrence and detection.

Fraud detection is an important element of audit quality. Chief Accountant of the SEC’s Division of Enforcement Howard Scheck identified common themes in recent SEC accounting fraud cases and spoke about how all accountants can be vigilant in preventing and detecting fraud. Ms. Fornelli discussed the CAQ’s anti-fraud initiative. She noted that all members of the “financial reporting supply chain,” including management, boards of directors and audit committees, and internal and external auditors have a unique role to play in deterring and detecting fraud—but that all parties need to work together. Among the key themes Ms. Fornelli expressed were mitigating fraud risk, which includes the need for a strong and highly ethical tone at the top; strong communication among “financial reporting supply chain” participants; and professionals who exercise professional skepticism and objectivity.

¹ [SEC Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers.](#)

Dodd-Frank Wall Street Reform and Consumer Protection Act

Dodd-Frank will have a significant impact on corporate governance and disclosures despite implementation challenges.

Significant changes to corporate governance and disclosures are expected as a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), including changes resulting from the PCAOB's new comprehensive oversight authority over audits of broker-dealers. More than 300 rules and numerous studies need to be completed by the SEC, said AICPA Chair Paul Stahlin. Interestingly, Congressional staff members noted that the full impact of Dodd-Frank will not be known for some time because many of the provisions were not subject to public hearings and the full extent of the implementation challenges is not yet known. SEC officials did indicate, however, that Dodd-Frank will not slow Staff efforts on the IFRS Work Plan or filing reviews, because most of the rules and required studies are the responsibility of other departments or divisions within the SEC.

Director of the SEC's DCF Meredith Cross spoke about a number of proposed or contemplated rules related to Dodd-Frank, including "say on pay" and "say on frequency" rules under which securities holders will be entitled to nonbinding votes on the compensation of executives; rules prohibiting uninstructed broker voting; new compensation committee independence rules; and rules requiring additional disclosures relating to "pay equity" and "pay-to-performance" ratios. Director of the SEC's Enforcement Division Robert Khuzami discussed the whistleblower provisions of Dodd-Frank and the related rule proposed by the SEC. This proposal would reward individuals who provide the SEC with high-quality and original tips that lead to successful enforcement actions.

Remarks of Senior SEC Officials

SEC Chairman (Mary Schapiro)

The accounting profession plays an important role in restoring investor trust.

Chairman Schapiro discussed the important role of the accounting profession in restoring investor trust as well as international auditing and accounting matters. She said past events such as restatements, cases of “window dressing” an entity’s financial position in quarterly and annual reports, misleading “off balance sheet” exposures, and misappropriation of investor assets have led to investor skepticism and lack of confidence in the U.S. capital markets. Ms. Schapiro stressed that regulators alone cannot protect the capital markets and restore investor confidence; rather, coordination between regulators and accountants is necessary to achieve these goals.

Ms. Schapiro spoke about a number of accomplishments and current topics on the SEC agenda to restore investor trust and prevent future scandals. SEC rules now require independent public accountants to perform annual surprise examinations of adviser-held accounts, which serve as a “second set of eyes” in support of the SEC’s investment adviser examinations.² Also, any registered investment adviser or affiliate who serves as a custodian of client assets is required to obtain a written report from an accounting firm registered with and subject to inspection by the PCAOB to verify that appropriate internal controls are operating effectively to protect the assets of investors.

Ms. Schapiro challenged the accounting profession, including both preparers and auditors, to ask “tough questions” to ensure financial results are accurate and present a true portrait of the financial condition of the company, to establish whether red flags are evident and need to be addressed, and whether additional disclosures are necessary to paint a “fair” picture. She urged the profession to have the courage to challenge answers and the willingness to elevate judgments about the quality of disclosures to the highest levels of management and the audit committee.

Ms. Schapiro said the SEC is continuing to support PCAOB efforts to remove obstacles that prevent them from inspecting non-U.S. registered audit firms, and that the SEC’s search for a new chair and two new board members of the PCAOB is in the final stages. Convergence continues to be a top priority for the SEC, she said, but the goal of convergence is not only uniformity but resulting standards that “must be high quality improvements over current standards.” She is “pleased” with the progress to date on the IFRS Work Plan, and said the SEC still plans to decide whether to incorporate IFRS into the U.S. reporting system sometime during 2011, but not necessarily by June 2011. If the SEC decides on some form of incorporation of IFRS in the United States, Ms. Schapiro said the transition period would likely be a minimum of four years.

Chief Accountant (James Kroeker)

SEC Chief Accountant Jim Kroeker also spoke about restoring investor trust. He “challenged” accounting professionals to improve their objectivity and integrity in everything they do, to continue identifying strong leaders in the

² [SEC Custody of Funds or Securities of Clients by Investment Advisers.](#)

Transactions structured solely to achieve an accounting outcome should be avoided.

profession who have a record of acting in the best interest of investors and the public, and to explore ways that accounting professionals may show leadership in enhancing investor trust.

Mr. Kroeker suggested auditors begin to refer to their “clients” as the shareholders or investors rather than the companies they audit, and he stressed the importance of acting independently in fact and in appearance. Mr. Kroeker also addressed the role of accountants who prepare financial statements and emphasized that they “must not let complexity stand in the way of transparent financial reporting.” He said that it is important for transactions to have economic substance and suggested that a change in culture in the profession to avoid structuring complex transactions to achieve an accounting outcome could “go a long way in enhancing the public trust.”

Mr. Kroeker also reiterated Chairman Schapiro’s point that the result of convergence must be improvements to existing requirements. He believes converging accounting standards will be successful only with adequate due process and field testing.

Deputy Chief Accountant, Accounting (Paul Beswick)

Paul Beswick discussed the IFRS Work Plan and his ideas about a potential method of incorporating IFRS into the U.S. capital markets. He noted that very few jurisdictions look directly to the IASB to provide authoritative support for the standards they follow. Instead, many incorporate IFRS using some kind of endorsement or other approval mechanism that maintains a level of national sovereignty over accounting standards in case exceptions are warranted. In this light, Mr. Beswick discussed a possible future approach for the incorporation of IFRS into the U.S. financial reporting system involving a combination of convergence of existing U.S. GAAP and IFRS and endorsement of future international standards, which he termed “condorsement” as follows:

- Legacy U.S. GAAP would continue to be authoritative.
- The FASB and IASB would finish the major projects on their convergence agenda.
- The FASB would work to converge existing U.S. GAAP and IFRS over a period of time for standards that are not on the IASB’s agenda.
- The FASB would consider and investigate new standards proposed by the IASB and determine whether those standards would be appropriate to incorporate into U.S. GAAP.

In further support of his “condorsement” approach, Mr. Beswick noted that there is a great deal of consistency in the objectives of U.S. GAAP and IFRS and that many differences are primarily in the method of application. This general congruity in objectives and principles calls into question whether the significant costs associated with incorporating all of IFRS at one time (i.e., a “big bang” approach) are justifiable or whether a more gradual approach such as the one he outlined would be superior.

A “big bang” approach of incorporating all of IFRS at one time may not be necessary or cost effective.

Mr. Beswick cautioned that his views on “condorsement” were his, and that the SEC commissioners themselves would make any final decision regarding incorporation of IFRS. The Staff’s efforts to complete the IFRS Work Plan will consider ways to lessen the burden of converting to IFRS while protecting the interests of investors, and future work may indicate other possible paths to incorporation.

Deputy Chief Accountant, Professional Practice (Brian Croteau)

Brian Croteau discussed a variety of matters related to PCAOB’s standard-setting and inspection developments. He said he likes PCAOB Auditing Standard No. 7³ because the standard “provides for an important element of quality control before an audit opinion is issued and affords engagement teams the opportunity to address significant engagement deficiencies in a timely way to help ensure that a high quality audit is performed.” Mr. Croteau also commented that the PCAOB’s current standard-setting agenda and timeline is “very ambitious, but appropriate.”

Mr. Croteau shared his views about certain aspects of the PCAOB’s standard-setting approach. He said he is skeptical about overly prescriptive requirements that can cause audits to become “mechanical exercises,” highlighting that the PCAOB’s proposed auditing standard on confirmations contains almost double the number of requirements in their existing audit standard.

Annually refreshing the approach to evaluating internal controls is critical.

Mr. Croteau noted that annually refreshing the approach to evaluating internal controls is “critical to maintaining the value to investors of the SOX 404 efforts.” A refreshed approach “must go well beyond” a roll-forward of testing the same list of controls each year. He also said evaluating the design of controls should include an assessment of whether appropriate changes have been made to address current economic or business conditions or changes in financial reporting requirements.

Mr. Croteau provided a reminder that SEC and AICPA independence rules differ and that auditors must be independent for all years in which their audit report is included in a registration statement. He suggested private companies and their auditors should consider the implications of non-audit services on the auditor’s independence if a company intends to raise public capital by filing a registration statement, such as an initial public offering (IPO) or an exchange of newly issued public debt for restricted or controlled securities. Mr. Croteau also reminded the profession that the prohibition against providing non-audit services extends beyond an audit client to include affiliates of audit clients. For venture capital and private equity firms, this includes upstream affiliates and brother-sister companies that are controlled by the venture capital or private equity firm. He also noted that auditors of broker-dealers are required to follow SEC independence rules, but there are certain aspects of the independence rules that apply only to issuers (e.g., rotation rules).

³ [PCAOB Auditing Standard No. 7, Engagement Quality Review.](#)

The Staff will hold roundtables in 2011 to identify issues and trends pressuring the financial reporting system.

Deputy Chief Accountant, Policy Support and Market Monitoring (Mike Starr)

Mike Starr discussed a new OCA undertaking for 2011. The Staff will hold multidisciplinary public roundtable discussions with standard setters, preparers, investors, and other stakeholders that will seek to identify the latest issues and trends pressuring the financial reporting system. He also cited investor feedback related to the independent auditor's report, which expressed a desire for qualitative data such as the type of information shared with audit committees under professional standards. Mr. Starr said the profession should be receptive to new ideas about how the audit report can be made more useful in order to maintain and extend the profession's relevance to financial reporting.

Director, Division of Corporation Finance (Meredith Cross)

Meredith Cross spoke about DCF developments during 2010, including changes in proxy disclosure rules, changes in proxy access rules (which have been delayed pending court review), and redeployment of staff to focus on large financial institutions and asset-backed securities. Ms. Cross also commented on some possible future DCF developments, including potential changes in the filing review process to focus on high risk areas and to perform continuous reviews of certain issuers. Ms. Cross noted that Dodd-Frank requires the SEC to adopt many new rules, including:

- "Say on pay" and "say on frequency" rules under which stockholders will be entitled to nonbinding votes on the compensation of executives, including severance and other related matters
- Compensation committee rules that will require committee member independence similar to audit committees under the Sarbanes-Oxley Act of 2002 (SOX)
- Rules on disclosure of a "pay equity ratio," which is a ratio of the compensation of a company's CEO to the median compensation of all employees, and a "pay-to-performance ratio," which is a ratio of senior executive compensation to a measure of the company's performance
- Rules on disclosure of any hedging of the equity securities of a company by its executives
- Rules directing stock exchanges to prohibit the listing of companies that do not comply with compensation "clawback" rules under which incentive compensation will be retroactively adjusted in the event of an accounting restatement
- Rules related to asset-backed securities offerings, including a requirement that securitizers retain some risk related to offerings of many securities.

Ms. Cross said the rulemaking for Dodd-Frank will be complex and unusual and that relevant public comments will be very beneficial to the Staff.

The SEC is required to adopt a large number of rules under Dodd-Frank. Many of the rules will affect corporate governance, compensation, and other areas. Further, the Division of Trading and Markets and other offices and divisions will write rules related to derivatives trading and the regulation of credit rating agencies. While the SEC has noted that some rulemaking will be delayed due to capacity constraints, the pace of rulemaking over the near term will be fast and furious. During a separate legislative update panel, members of the legal profession highlighted that certain requirements of Dodd-Frank, such as the “pay equity ratio,” will be challenging to implement in a consistent manner and may present cost-benefit challenges to public companies. Companies can monitor the progress of SEC rulemaking related to Dodd-Frank and learn how they can participate in the rulemaking process on the SEC’s [Web site](#).

Chief Accountant, Division of Corporation Finance (Wayne Carnall)

Wayne Carnall described a number of the Staff’s communication and outreach activities during 2010, including updates to the Financial Reporting Manual (FRM) and “Dear CFO” letters related to foreclosures and to sale and repurchase transactions (“repos”).⁴ He noted that the Staff plans to update the FRM on a quarterly basis and posted the most recent version to the SEC Web site on December 6, 2010. Staff views that were previously communicated at joint meetings with the CAQ’s SEC Regulations Committee now are incorporated into the FRM. Further, in 2011 the Staff will undertake to include views expressed in meetings with the International Practices Task Force. Recent updates to the FRM include updates to the section on non-GAAP measures to reflect changes in Staff interpretation that permit more types of non-GAAP measures in SEC filings and updates related to disclosures of stock-based compensation in registration statements for companies undertaking an IPO.

Mr. Carnall remarked that observations from filing reviews in 2010 were very similar to those encountered in the past. However, Mr. Carnall specifically commented that there was increased Staff focus on disclosures about contingencies and short-term borrowings. He also noted that many recent comment responses appeared to be directly copied from responses filed by other registrants and that such a practice is not appropriate.

Mr. Carnall encouraged financial statement preparers to consult upfront on complex reporting matters to avoid having to address such matters through the comment process after the financial statements are published. Registrants seeking pre-clearance from the Staff on accounting matters should consult OCA while pre-clearance issues related to reporting matters should be directed to DCF.

The Staff plans to update the Financial Reporting Manual every quarter and encourages preparers to consult upfront on complex reporting matters.

⁴ [SEC Division of Corporation Finance Financial Reporting Manual](#).

Director, Division of Enforcement (Robert Khuzami)

Robert Khuzami provided an update on the five specialization groups within the Division of Enforcement that were created in 2009 and discussed at last year's Conference. He said these groups in combination with a flattened management structure allow the Division of Enforcement to identify and conduct enforcement actions more efficiently and effectively. Mr. Khuzami also highlighted the creation of an Office of Market Intelligence to analyze complaints and assign resources to those tips or complaints presenting the greatest risk.

Proposed "whistleblower" rules would reward individuals providing original tips that lead to successful enforcement actions.

Mr. Khuzami also discussed the whistleblower provisions of Dodd-Frank and the related rules proposed by the SEC, which would reward individuals who provide the SEC with high-quality and original tips that lead to successful enforcement actions.⁵ Some constituents have raised concerns that the SEC's proposed rule could diminish the effectiveness of existing internal governance programs by providing incentives for whistleblowers to bypass such programs and go directly to the SEC. Mr. Khuzami addressed these concerns and said the SEC proposal would treat an employee who first reports a matter internally as if he or she had reported it to the SEC on the same date, provided they subsequently report the matter to the SEC within 90 days. Further, the proposal would allow the SEC to consider higher awards for whistleblowers who first report through their company's compliance programs. However, whistleblowers would not be eligible if they receive information from a company's internal compliance programs.

Chief Accountant, Division of Enforcement (Howard Scheck)

Howard Scheck indicated that fraud often starts "small" as individuals react to pressures from internal and external forces and rationalize that the fraudulent activity will be a "one time" only event, but as time passes, the fraud grows bigger. He said fraud is not limited to small companies and typically is perpetrated by senior members of management who have access to the financial records of the company—chief financial officers, chief accounting officers, and controllers. Motives for fraud typically are to smooth earnings or mask the true economic condition of a company. Mr. Scheck also observed that companies often fail to include relevant qualitative factors beyond those identified in SEC Staff Accounting Bulletin No. 99 when evaluating the materiality of errors.⁶

Mr. Scheck suggested a number of ways accounting professionals can be vigilant in preventing and detecting fraud, including resisting the pressure to rationalize improper accounting treatments and lack of disclosure; considering the appropriateness of alternative accounting conclusions; and meaningful auditor fraud risk assessments and use of fraud specialists. He also believes audit professionals should continue to exercise professional skepticism by being inquisitive and standing firm despite pressures from external and internal forces.

⁵ [SEC Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934.](#)

⁶ [SEC Staff Accounting Bulletin: No. 99-Materiality.](#)

Accounting Standard-Setting

Overview

Acting FASB Chairman Leslie Seidman and IASB Chairman Sir David Tweedie discussed the status of convergence of global accounting standards and other priorities of the FASB and IASB. Both expressed the continued need for a single set of high quality globally accepted accounting standards.

Today's globalized capital markets continue to be hindered by differences in national accounting standards, said Mr. Tweedie. He believes having a single set of high quality globally accepted accounting standards will open doors to many benefits, including lower cost of capital, easier consolidation for global companies, and increased access to capital overseas. More than 120 countries use IFRS as of 2010, and that number is expected to grow to more than 150 countries in 2013. Mr. Tweedie shared his view that there is a narrow "window of opportunity" to achieve global accounting standards. International standards can exist without U.S. incorporation of IFRS but global standards cannot occur without the United States, he said.

Ms. Seidman and Mr. Tweedie noted that the FASB and IASB modified the strategy to converge U.S. GAAP and IFRS to focus their efforts on higher priority joint projects that include financial instruments,⁷ fair value measurement,⁸ revenue recognition,⁹ and leases.¹⁰ The target completion date for these projects remains June 2011. Ms. Seidman spoke about the importance of obtaining feedback from constituents. She noted the FASB and IASB recently issued papers seeking input from stakeholders about the effort involved to adopt the upcoming standards and that information about transition methods also will help the FASB and IASB determine effective dates for the final standards.¹¹ In addition to reviewing comment letter responses, the standard-setters have obtained constituent input through field testing, field visits, workshops, interviews, and roundtables with preparers, investors, and auditors.

The same overall objectives were reiterated by FASB Board member Russ Golden and IASB Director of Technical Activities Alan Teixeira, who provided a status update on each of the higher priority projects. Both Mr. Golden and Mr. Teixeira commented that the timeline is ambitious but has been effective in focusing the FASB and IASB's efforts. They emphasized that the standard-setters are committed to quality in the resulting standards even if that means the projects extend beyond their targeted completion dates. Mr. Golden and Mr. Teixeira also summarized the steps taken over the past year to work in a collaborative manner, including monthly joint meetings and joint outreach programs.

Ms. Seidman said another FASB priority is increasing the number of FASB Board members from five to seven as a result of the decision made by the trustees of the Financial Accounting Foundation, which is intended to facilitate

IFRS can exist without the United States but truly global standards cannot.

⁷ [FASB Proposed Accounting Standards Update, Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities.](#)

⁸ [FASB Proposed Accounting Standards Update, Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs.](#)

⁹ [FASB Proposed Accounting Standards Update, Revenue from Contracts with Customers](#), and [IASB Exposure Draft ED/2010/6, Revenue from Contracts with Customers](#).

¹⁰ [FASB Proposed Accounting Standards Update, Leases](#), and [IASB Exposure Draft ED/2010/9, Leases](#).

¹¹ [FASB Discussion Paper, Effective Dates and Transition Methods](#), and [IASB Request for Views on Effective Dates and Transition Methods](#).

additional outreach to constituents. In addition, Ms. Seidman highlighted that in response to recommendations from the SEC Advisory Committee on Improvements to Financial Reporting, the Financial Accounting Foundation will be performing post-implementation reviews of recently issued accounting standards.¹²

Revenue Recognition

Members of the FASB and IASB staffs provided an update on the joint revenue recognition project. The project aims to create a single standard for revenue recognition that would converge U.S. GAAP and IFRS and apply across a broad range of industries and transactions. The FASB and IASB proposed a new standard in June 2010. The comment period closed on October 22, 2010, and the FASB and IASB received over 1,000 comment letters.

Comments support core principles of the revenue recognition proposal but concerns remain about certain requirements.

Comment letters generally supported the objectives of the joint project, and there was broad support for the proposed core revenue recognition principles. However, concerns remain about how companies would apply specific aspects of the proposal, including the following key items that are likely to be addressed in redeliberations:

Control—The principle and indicators for determining when goods or services are transferred need to be clarified. In particular, commenters have noted that the control principle is difficult to apply to construction and service arrangements.

Distinct Performance Obligations—The guidance for identifying separate performance obligations needs clarification. Many construction contractors are particularly concerned the standard would result in the identification of more distinct performance obligations than would be useful for their investors.

Variable Consideration—Some of the guidance on estimating variable consideration relating to probability-weighted estimates, collectibility, and time value of money may be difficult to implement. The standard-setters have been encouraged to identify practical approaches that would lower the burden of complying with the proposed standard.

Other areas of frequent comment they discussed related to the costliness of proposed disclosure requirements, the difficulty of proposed full retrospective transition, and concerns about the proposed accounting for warranties, exclusive licenses, and onerous performance obligations.

The FASB and IASB expect to begin redeliberation of the proposed revenue standard in January 2011 and hope to release a final standard in the second quarter of 2011. This is an aggressive timeline, and we expect that frequent FASB and IASB meetings will be necessary to fully consider the many detailed comments received from constituents. A full discussion of the proposed standard can be found in [KPMG Issues In-Depth No. 10-3](#).

¹² [Financial Accounting Foundation Announces Post-Implementation Review Process](#).

Lessees would recognize a right of use asset and financing liability for every lease.

Lease Accounting

The FASB staff gave an overview of the lease accounting proposal that was jointly released with the IASB in August 2010. If the proposal is adopted, companies would face significant changes in how they account for leasing transactions. In particular, lessees would no longer classify each lease as operating or capital, but would instead recognize a right of use asset and financing liability for every lease. The proposed model also would affect lessor accounting, including the pattern of revenue recognition for many lessors.

As part of their presentation, the staff highlighted several key areas they expect to address in redeliberations, including the expense recognition pattern for operating leases, accounting for “build-out” allowances and other lease incentives, accounting for month-to-month leases and leases with terms less than twelve months, and accounting for leases between related parties.

The FASB staff noted that the proposal is a key step to developing comprehensive, converged guidance on lease accounting by mid-2011. Comments on the proposal were due by December 15, 2010. The FASB and IASB will hold public roundtable meetings in December 2010 and January 2011 to discuss the proposal with a wide variety of stakeholders, including preparers, auditors, investors, and other users of financial statements. A final standard is expected in the second quarter of 2011. A full discussion of the proposal can be found in [KPMG Issues In-Depth 10-5](#).

Financial Instruments

A panel of preparers and investors discussed the joint financial instruments project, primarily focusing on the FASB’s proposal. Because the FASB’s proposal requires most financial instruments to be carried at fair value on the balance sheet, some preparers expressed concern that the model might result in a presentation of financial instruments that is not reflective of the business purpose of the transactions in some cases. They also indicated their belief that the proposed impairment model for loans and other financial assets needs clarification. The FASB and IASB staffs did not participate in the panel.

The FASB will reconsider its proposed decisions on financial instruments over the near term.

Despite divergence to date, the FASB and IASB are jointly redeliberating their proposals on impairment of financial instruments, and the FASB intends to consider the IFRS requirements in redeliberating classification and measurement over the near term. Further, the FASB will consider feedback received on the IASB’s upcoming proposal on hedge accounting as it redeliberates its own hedging proposals.

The FASB is still targeting June 2011 for release of a final standard on financial instruments. See [KPMG Issues In-Depth No. 10-2](#) for a full discussion of the FASB’s proposed guidance. A discussion of the current status of redeliberations can be found on the FASB [Web site](#).

PCAOB Developments

Representatives from the PCAOB and SEC discussed various developments in PCAOB inspections, standard-setting, and enforcement activities as well as recent guidance related to broker-dealer audits.

PCAOB Inspections

PCAOB Acting Chairman Daniel Goelzer said the September 2010 PCAOB report on inspection observations related to areas of audit risk affected by the economic crisis does not indicate audit deficiencies caused the financial crisis or that better auditing could have prevented it.¹³ Mr. Goelzer believes, however, that audit firms must do a better job of adjusting to emerging audit risks as economic conditions change. George Diacont, Director, PCAOB Division of Registration and Inspections, also discussed inspection observations and said he was surprised by the reappearance of inspection findings in areas such as revenue and inventory, where inspectors had previously observed a decline in the number of findings. As in prior years, 2011 PCAOB inspections will focus on issues such as fair value measurements, impairment of goodwill and long-lived assets, allowance for loan losses, and revenue recognition. Both Mr. Goelzer and Mr. Diacont said the PCAOB also will focus on the effect of audit fee pressures on audit quality.

Mr. Goelzer spoke of the challenges the PCAOB continues to face when conducting inspections of registered firms in certain foreign jurisdictions: "Robust oversight of audit work done in other countries is critical to the protection of U.S. investors, given that significant operations of many U.S. public companies are located beyond our shores." Currently, the PCAOB is unable to conduct inspections in jurisdictions such as China, Switzerland, and the European Union. Mr. Goelzer indicated that the PCAOB is in various stages of negotiation, and he is hopeful that the barriers will be removed in all countries where there are firms that audit U.S. public companies.

The PCAOB is considering measures to address its inability to inspect certain foreign registered firms.

The PCAOB responded to the foreign inspection challenge by implementing a disclosure regime that includes posting information about the PCAOB inspection status of foreign registered firms on its Web site so that investors understand the limitations. The PCAOB also no longer routinely approves new registrations for firms in countries where it has been unable to conduct inspections. Mr. Goelzer said alternative measures to address foreign inspection challenges under consideration include measures that would:

- Require a principal auditor relying on work performed by another firm that has not yet been inspected because of foreign-jurisdiction restrictions to disclose that fact and other information useful to investors in SEC-filed audit reports
- Require firms that cannot be inspected to arrange for their audit work on U.S. registrants to be supervised by a registered and inspected firm.

PCAOB Standard-Setting

Martin Baumann, PCAOB Chief Auditor, discussed recent PCAOB standard-setting activities and highlighted PCAOB Auditing Standard No. 7,

¹³ [PCAOB Report on Observations of PCAOB Inspectors Related to Audit Risk Areas Affected by the Economic Crises.](#)

Investors hunger for more insight into the audit process and the company's financial reporting.

Engagement Quality Review, and PCAOB Auditing Standards No. 8 through 15, collectively known as the “risk assessment standards,” which the PCAOB recently adopted. Mr. Baumann believes that engagement quality reviews should improve audit quality and significantly benefit investors, and he expects the 2010 engagement quality review process to be conducted in “substantially greater depth” than the concurring partner review of 2009. Mr. Baumann said the eight new risk assessment standards are designed to improve the auditor’s assessment of and response to risks. He provided highlights of the standards, which include enhanced requirements for planning, integration of fraud considerations throughout the audit, and increased focus on financial statement disclosures.

PCAOB auditing standards must be approved by the SEC before they become effective. Although the PCAOB adopted the eight “risk assessment standards,” no SEC action has been taken. During his prepared remarks, Brian Croteau, SEC Deputy Chief Accountant, commented that he expects the SEC to take action by the end of 2010.

Mr. Baumann discussed the status of the current standard-setting agenda and indicated he expects the PCAOB to act on proposed standards for communications with audit committees and confirmations as well as concept releases related to failure to supervise and engagement partners signing the audit report in the first-half of 2011.¹⁴ Mr. Baumann also indicated that the PCAOB is monitoring the increase in non-audit services by audit firms and is considering the impact non-audit services could have on auditor independence.

Mr. Goelzer and Mr. Baumann both discussed the PCAOB’s project related to the auditor’s reporting model. Mr. Goelzer said, “It is clear that there is considerable investor hunger for more insight from the auditor into the audit process and the company’s financial reporting.” He noted that other standard-setters outside the United States are studying ways the auditor’s report can be expanded. Mr. Goelzer said the PCAOB is exploring reporting-model alternatives and that this issue “should be a priority of the profession and the Board.” Mr. Baumann said he expects to present the results of his staff’s research to the PCAOB in early 2011.

PCAOB Enforcement

Claudius Modesti, Director of the PCAOB’s Division of Enforcement, discussed the PCAOB’s enforcement process and said that the non-public nature of their disciplinary proceedings, required by SOX, is the most critical issue facing the PCAOB’s enforcement program and its ability to protect the public. Mr. Modesti expressed his concern and said confidential proceedings have “serious adverse consequences for the investing public, audit committees, the accounting profession, the Board, and other interested parties, such as Congress.” Mr. Goelzer shares this concern and said that the PCAOB has asked Congress to amend SOX to make their enforcement actions public.

¹⁴ [PCAOB Current Standard-Setting and Related Rulemaking Activities.](#)

Broker-Dealer Audits

Dodd-Frank gives the PCAOB comprehensive oversight of broker-dealer auditors.

Dodd-Frank granted the PCAOB comprehensive oversight authority over broker-dealer auditors; auditors of broker-dealers that previously were required only to register with the PCAOB are now subject to PCAOB inspection, standard-setting, and enforcement.

Mr. Goelzer expects the new responsibility to have a significant impact on the PCAOB's work. He said that in the near-term, PCAOB broker-dealer oversight will focus on developing a broker-dealer funding system, auditing standards applicable to broker-dealer financial statement audits, attestation standards applicable to their compliance reports, and a broker-dealer audit inspection program. Mr. Goelzer said the great diversity in size and types of services provided by broker-dealers raises questions about whether resources should be devoted to all broker-dealer auditors or whether some auditors can be exempted from PCAOB oversight without compromising investor protection.

At an open meeting on December 14, 2010, the PCAOB proposed rules to establish an interim inspection program for registered firms' audits of broker-dealers and rules related to assessing and collecting a portion of its accounting support fee from broker-dealers to fund PCAOB oversight of audits of broker-dealers. The PCAOB expects, subject to SEC approval, to begin inspections of audits of broker-dealers and expects to propose rules for a permanent inspection program after no more than two years. The proposed funding rules, if approved by the SEC, would be in effect for the 2011 funding cycle.

The PCAOB also proposed amendments to its issuer funding rules to include all classes of voting and non-voting common equity rather than just common stock when calculating issuers' market capitalization and to increase the market capitalization threshold for equity and investment company issuers. The proposed issuer funding rules are expected to be effective for the 2012 issuer funding cycle.

Further details about the PCAOB's proposal are available on the PCAOB's [Web site](#).

John Offenbacher, SEC Senior Associate Chief Accountant, highlighted that the SEC recently provided transitional guidance that indicates references to "GAAS" in SEC rules, Staff guidance, and Federal securities laws as they relate to non-issuer broker-dealers, should continue to be understood to mean the auditing standards of the AICPA and not the PCAOB.¹⁵

Until the SEC completes the rulemaking required to update the audit and attestation requirements for broker-dealers under the Federal securities laws, auditors have a responsibility to comply with existing laws and professional standards. He highlighted that in addition to the financial statement audit, broker-dealer auditors perform a review of the accounting system, internal controls, and procedures for safeguarding securities, and that SEC rules require the "scope of the audit and review...shall be sufficient to provide reasonable assurance that any material inadequacies existing at the date of the examination...would be disclosed."

¹⁵ [Commission Guidance Regarding Auditing, Attestation, and Related Professional Practice Standards Related to Brokers and Dealers](#).

SEC Accounting Matters

The Staff discussed several specific accounting issues as follows:

Consolidation of Variable Interest Entities (Paul Beswick and Wesley Bricker)

Mr. Beswick and Mr. Bricker discussed consolidation of variable interest entities (VIEs), which remains an area of Staff focus. They reminded registrants that U.S. GAAP indicates a reporting entity has a controlling financial interest in a VIE if it has both the power to direct the most significant activities of the VIE and rights or obligations in the VIE that could be significant. This analysis requires qualitative judgment based on the total mix of information, not a purely quantitative approach, and they cautioned against failure to consider all relevant facts and circumstances in the evaluation.

Significant powers should not be arbitrarily excluded from VIE analysis.

The Staff noted that a group of activities may be most significant to the VIE, and that power over such influential activities could be embedded in various arrangements and at various levels of an entity's structure (e.g., Board of Directors, management, servicing contracts, and financing arrangements). Significant powers should not be arbitrarily excluded from the analysis. In one Staff example, a VIE was designed to fund holdings of long-term assets by rolling over short-term debt on a periodic basis, but the registrant limited its assessment of activities only to those associated with the initial debt financing, without considering the activities associated with rolling over the debt or ultimately liquidating the assets. The Staff objected to excluding those activities from the analysis. However, only activities that are part of the VIE or with which the VIE has involvement should be considered. The Staff has objected to conclusions where the registrant attributed activities to a VIE that were not part of the entity, were performed by parties that had no involvement with the entity, and were not related parties or agents of any party involved.

Finally, the Staff said they continue to bring a healthy dose of professional skepticism to shared-power assertions. To qualify for shared-power whereby none of the investors consolidate the entity, two or more unrelated parties together must be able to direct the significant activities of the VIE, each with the consent of the other. If shared-power provisions are not present, or the blocking powers of one or more parties are more like protective rights, the Staff will object to shared-power assertions. Further, shared-power conclusions are not appropriate if the parties are related. In those cases, one member of the related party group must consolidate if the group as a whole has a controlling financial interest.

Accounting for Foreclosed Real Estate Involving Loan Participations (Lisa Watson)

Ms. Watson discussed the accounting for loan participations when the lead bank forecloses on collateral property as a result of borrower default on a loan. In these situations, portions of the original loan have previously been sold to several banks and the lead bank often retains only a portion of the financial asset on its balance sheet pursuant to the transfers and servicing guidance in U.S. GAAP. Ms. Watson noted that the transition from financial asset accounting to real estate accounting in foreclosure requires careful analysis.

Accounting for foreclosure of real estate involving loan participation agreements requires careful analysis.

Depending on the facts and circumstances, one of the following accounting outcomes could be appropriate:

- The lead bank records the entire property on its books with a liability to participating banks for their proportionate share.
- The lead bank and the participating banks each record their respective interests using the equity method.
- The lead bank and the participating banks each record their pro-rata share in the real estate asset itself.

Ms. Watson noted that there may be alternative ways to approach the analysis, but any approach should consider the manner in which legal title in the foreclosed property is held and the terms of the participation agreement. If legal title is held in a separate legal entity, the guidance on accounting for real estate ventures may apply. In cases in which no accounting literature is directly on point, it may be appropriate to analogize to related guidance.

For example, the contract may specify that title to foreclosed property be held by the participating banks as tenants in common or in trust for the benefit of each bank. This might suggest that each bank holds an undivided interest in the underlying property and that equity method accounting for each respective interest is appropriate. On the other hand, there may be some level of joint control over the foreclosed real estate specified in the participation agreement independent of how title is held, which may suggest a similar outcome. In other cases, the Staff noted it may be appropriate to analogize to the accounting guidance for sales of real estate, which permits recognition of partial sales of property if certain conditions are met. Under such an approach, the lead bank would record only its portion of the real estate in foreclosure.

The accounting for foreclosure of real estate can depend on a number of factors, including whether the real estate is held in a legal entity, the rights of the various interest holders, and title provisions. In addition, this area can involve the interaction of multiple pieces of accounting guidance, including the guidance on consolidation of VIEs, investments in real estate ventures, and real estate sales. The Staff also highlighted that the Emerging Issues Task Force (EITF) is currently discussing Issue 10-E, *Accounting for Deconsolidation of a Subsidiary That Is In-Substance Real Estate*. The outcome of discussions of that issue may affect the accounting in this area and the Staff's views will continue to be informed by the EITF's efforts. Careful consideration of each of these factors and the status of EITF deliberations are important for companies that face these issues.

Sales of Businesses Not in Legal Entities (Lisa Watson)

To evaluate whether control has passed in a sale of a business that is not housed in a legal entity, Ms. Watson noted that although there may not be prescriptive guidance on how to assess control in all cases; an evaluation should be performed and should not be limited to whether title in the underlying assets has been transferred.

Ms. Watson discussed an example whereby a company sold one of its businesses not held in a separate legal entity to a third party. As part of the arrangement, the buyer was given the right to sell the business back to the

seller at a later date for the same amount paid at closing. Further, prior to the option exercise date, the seller would continue to operate the business under a management agreement. In this example, the seller's analysis of whether the business should be derecognized consisted only of analyzing whether the registrant should consolidate the third party to which the business was sold. Once the seller concluded that it should not consolidate the buyer, it derecognized the business and recognized a gain on the sale.

Ms. Watson observed that the analysis appeared deficient under the consolidation guidance in U.S. GAAP, which stipulates that a group of assets that constitutes a business should be derecognized only when the seller ceases to have controlling financial interest in that group of assets. This would require looking not only at whether the buyer should be consolidated but also looking at whether there has ceased to be a controlling financial interest over the transferred business. In the Staff example, it is possible the seller may continue to control the business despite the transfer of legal title to the assets.

Debt Extinguishment with Related Parties (Sagar Teotia)

The Staff has recently received questions regarding the treatment of debt extinguishment transactions when the lender is a related party. The questions focused on accounting guidance that indicates these transactions may in essence be capital transactions. Mr. Teotia emphasized the need to carefully consider the nature and substance of debt extinguishment transactions between related parties, especially when an accounting gain is indicated. Key considerations include obtaining an understanding of the role of the related party in the transaction and why the related party would accept less value from the company than the stated value of the debt.

Mr. Teotia provided an example where a registrant had nonconvertible debt with an executive of the company who was also a significant shareholder. The two parties reached an agreement to extinguish the debt by issuing shares of the registrant to the executive, the value of which was substantially lower than the carrying value of the nonconvertible debt at the time of extinguishment. The Staff believed the substance of the transaction was in essence a capital contribution from a related party. Therefore the difference between the fair value of the equity issued and the carrying value of the debt was recorded as a contribution to equity from the shareholder, not as a gain on extinguishment.

Debt versus Equity Evaluation of Warrants and Convertible Debt (Todd Hardiman)

Mr. Hardiman emphasized that the Staff continues to encounter registrants who fail to appropriately apply the guidance on distinguishing equity from liabilities, particularly for equity based warrants and embedded conversion features in debt instruments. In particular, the Staff noted a common failure to consider all settlement provisions contained in such instruments (including contingent adjustments to settlement calculations). For example, some warrants and convertible debt instruments include "down-round" protection that specifies that the strike price or conversion price will be adjusted downward if the company subsequently issues stock at a lower price than the strike price or conversion price of the instrument due to declining market prices. Such a provision often will result in a conclusion that the instrument or feature should be presented as a derivative liability at fair value through earnings.

The Staff often can detect errors in evaluating equity-based instruments by reviewing documents on EDGAR.

The Staff often can detect errors in evaluating equity-based instruments by reviewing electronic documents or agreements on EDGAR. Given the complexity of evaluating equity based instruments, such as convertible debt, warrants, and preferred stock, it is critical for companies to have a well-documented evaluation of all terms and features of an instrument prior to concluding on the appropriate accounting. The accounting requirements in this area are highly rules based, often do not allow for “common sense” judgments based on probability, and can hinge on technicalities that do not appear to have a significant effect on the economic substance or fair value of the arrangement.

Allocation of Goodwill in Disposal of a Portion of a Reporting Unit (Sagar Teotia)

Mr. Teotia discussed the disposal of a portion of a reporting unit, highlighting that in some cases judgments must be made regarding the portion of the unit retained and the portion sold. The example used to illustrate this point was a transaction in which a previously wholly-owned set of stores was franchised to a third party. At the time of the disposal transaction, in addition to the receipt of upfront proceeds for the existing assets of the locations, a franchise agreement was executed which required the buyer/franchisee to make royalty payments at a market rate to the seller/franchisor based on future sales volume.

U.S. GAAP requires that upon partial disposal of a reporting unit, goodwill associated with the disposed business should be derecognized based on the relative fair value of the business to be disposed of and the portion of the reporting unit retained. In the franchise example, a contemporaneous agreement executed at the time of the disposal transaction resulted in the seller retaining a portion of the economics of the transferred operations (via ongoing royalty payments). Based on the facts presented, the Staff did not object to including the fair value of the franchise agreement in the portion of the reporting unit retained for purposes of determining the gain or loss to be recognized on sale. That is, because the seller/franchisor retained a portion of the economics of the disposed stores via the franchise agreement, only a portion of the goodwill associated with the disposed stores would be derecognized in the transaction.

SEC Reporting Developments

The Staff discussed various reporting matters, many of which pertain to observations from their filing reviews.

IFRS Work Plan and Staff Reviews of IFRS Filings

The Staff continues to gain experience reviewing financial statements prepared under IFRS.

The Staff discussed their process for evaluating the application of IFRS in practice as part of the IFRS Work Plan and common themes identified during filing reviews of financial statements prepared using IFRS. Under the IFRS Work Plan, the Staff is reviewing financial statements prepared using IFRS for a large number of entities from more than 20 jurisdictions and more than 30 industries, including non-registrants. The Staff is analyzing accounting and disclosure policies and practices and is focusing on both the initial selection of accounting policies (i.e., policy choices among alternatives permitted by IFRS, policy choices when IFRS relies on application of management judgment, and policy choices when IFRS does not provide specific guidance) and the application of those policies. The Staff is interested in how those choices affect the comparability of financial statements across jurisdictions and industries.

The Staff also reviews financial statements prepared using IFRS for foreign private issuers the same way they review financial statements prepared using U.S. GAAP for domestic issuers. Staff comments often related to insufficient disclosure about why key accounting judgments had been made and how they were implemented. The areas that received frequent Staff comment during reviews of financial statements prepared under IFRS were similar to those under U.S. GAAP and included comments requesting expanded disclosures in areas such as contingencies, revenue recognition policies, operating segments, asset impairments, and fair value measurements.

Similar to DCF's process for reviewing IFRS filings, OCA staff said their process for evaluating an accounting issue is generally consistent whether the interpretive question concerns U.S. GAAP or IFRS. Although not a required step in reaching a conclusion, OCA staff said they may discuss IFRS application questions with other foreign securities regulators or informally with the IASB staff, as they sometimes do with the FASB staff and other regulatory bodies for U.S. GAAP interpretations.

Significance Tests for Acquisitions and Equity Method Investments

The Staff highlighted recent changes of interpretation of the test for determining when separate financial statements must be furnished for acquired businesses and equity method investees as well as the test for measuring the significance of a disposed business as follows:

Five-year averaging and loss considerations—If a registrant's pretax income for the most recent year is at least 10 percent lower than the average for the last five fiscal years, then the five-year average should be used as the denominator of the income test. The Staff historically interpreted the term "income" to refer solely to positive income, precluding five-year averaging for a registrant with a pretax loss in the current fiscal year. The Staff revised its interpretation to allow a registrant to average even though it incurred a loss in the most recent year. This change is expected to reduce the number of entities considered significant under such tests when an entity has a recent

The Staff relaxed its interpretation of rules for determining when separate financial statements of investees are required.

loss-making year. The Staff also said the new interpretation can be applied retroactively to previous acquisitions and equity investees.

Example of the impact of the change in interpretation:

A registrant's pretax income over the last five years follows:

Year 1	Year 2	Year 3	Year 4	Year 5
\$100	\$250	\$175	\$125	\$50

Because the registrant's pretax income from continuing operations of \$50 in the most recent fiscal year (Year 5) is at least 10 percent lower than the \$140 average of the pretax income from continuing operations for the last five fiscal years $[(100+250+175+125+50)/5]$ years], the average income of \$140 would be used as the denominator in performing the income test under existing rules and interpretations.

In contrast, assume the same facts as above, but instead of pretax income for Year 5, assume a pretax loss of \$50. Under the previous interpretation, the registrant would not be permitted to utilize income averaging and would have been required to utilize the current period pretax loss of \$50 as the denominator in the income test.

However, under the Staff's revised interpretation, five-year averaging would be required because the registrant's pretax loss of \$50 is more than 10 percent less than the \$130 average for the five-year period $[(100+250+175+125+0)/5]$. Therefore, the computed average of \$130 would be used as the denominator in the income test.

Equity Method Investees—The Staff revised the FRM to clarify the numerator in the income test when assessing the significance of an equity method investee should be pretax income of the investee adjusted for any basis differences recognized by the investor at acquisition. This may differ from the effect of the equity method investee on the registrant's financial statements during the period for a variety of reasons. While not an exclusive list, items impacting net income of the registrant that should be excluded from the numerator of the test include impairment charges at the investor level, gains/losses from stock sales by the registrant, dilution gains/losses from stock sales by the investee, and preferred dividends.

Discontinued Operations—The Staff also said that the FRM has been revised to clarify that when determining the significance of a disposed business, the denominator in the income test should include the effects of disposed businesses in the determination of income from continuing operations unless the disposed business was previously reported as a discontinued operation. Because the income test only reflects amounts for the most recently completed fiscal year prior to the disposal date, the accounting in the period of disposal has no effect on the income test.

Non-GAAP Financial Measures

While the Staff is not encouraging the use of non-GAAP financial measures, they acknowledged that non-GAAP financial measures can be an effective component of communications with investors. Recent Staff interpretations allow for more non-GAAP financial measures in SEC filings, potentially allowing management to improve consistency between filings and other

When using non-GAAP financial measures, the story inside and outside the financials should be the same.

communications to investors, but the Staff reminded registrants that such disclosures should comply with Regulation G and other SEC rules and guidance. Deficiencies identified in 2010 include not disclosing how non-GAAP financial measures provide useful information to investors and presenting non-GAAP financial measures with greater prominence than the most directly comparable U.S. GAAP financial measure.

The Staff noted that while non-GAAP earnings per share (EPS) measures are permitted as performance measures in some cases, the Staff believes the denominator of non-GAAP EPS calculations should generally be calculated in accordance with the accounting requirements for U.S. GAAP, considering the impact of any non-GAAP adjustments to the numerator. For example, if a registrant incurs a loss under U.S. GAAP, anti-dilutive securities are excluded in calculating EPS. However, if non-GAAP income is positive due to the exclusion of certain expenses, previously excluded securities should be included in the denominator of non-GAAP EPS. Further, notwithstanding recent changes in guidance on non-GAAP performance measures, the Staff emphasized that disclosure of cash flow per share, or a measure that approximates cash flow per share continues to be prohibited.

The Staff highlighted that it would generally be inappropriate to conclude on the materiality of an accounting error based purely on its impact on a non-GAAP financial measure. However, if an error is material to a non-GAAP financial measure, but is not material to the U.S. GAAP financial statements, the non-GAAP information may be materially misleading such that the prior financial information should be amended.

Loss Contingencies

The Staff vigorously enforces contingency footnote and MD&A disclosure requirements.

The Staff is focusing on whether current disclosures about contingent liabilities provide enough transparency under current requirements. The Staff said feedback on the FASB's contingencies project suggests concerns about inadequate contingency disclosures "may be driven more by a lack of full compliance rather than insufficient guidance." The Staff noted that the objectives of current accounting disclosure requirements and Item 103 of Regulation S-K are different and that registrants are reminded to look to the requirements of each. A large volume of information does not necessarily correlate to meaningful information.

The Staff observed that many registrants fail to disclose an "estimate of the possible loss or range of loss" because they assert they are unable to make such an estimate with precision or confidence. The Staff reminded registrants that neither "precision" nor "confidence" is included in the relevant standards. Registrants should ensure that they try to make an estimate by undertaking a thorough process to determine the possible loss or range of loss before concluding that such an estimate cannot be made.

The Staff indicated that they expect loss contingency disclosures to be updated as additional information becomes available, including the addition of quantitative information as a matter gets close to resolution. If a registrant discloses a material settlement, the Staff will look at prior period filings to assess whether appropriate disclosures were made. If prior period filings did not include disclosure, the Staff will seek to understand how a material settlement could be reached in one reporting period without disclosure in previous reporting periods.

The Staff noted that its October 2010 “Dear CFO” letter provides the Staff’s views on disclosures related to potential risks and costs associated with mortgage and foreclosure-related activities and exposures. The letter provided a number of examples of foreclosure-related risks and uncertainties expected to be disclosed by companies involved with mortgage securitization, including entities selling loans, servicing loans, and providing insurance related to such loans. The Staff noted that in order to provide a transparent understanding of these exposures, companies that have established a reserve relating to representations and warranties attributable to loans sold may need to consider providing a roll-forward of the reserve that presents separate amounts for increases and decreases in the reserve due to changes in loan activity and changes in estimate.

Internal Control Over Financial Reporting

Dodd-Frank includes a permanent exemption for non-accelerated filers from the internal control audit requirements of SOX Section 404(b). The Staff reminded non-accelerated filers that they still must comply with SOX Section 404(a), which requires public companies to perform and file their own assessments of internal control over financial reporting (ICFR). The definitions of *non-accelerated filer* and *smaller reporting company* are different, and smaller reporting companies should not assume that they are automatically exempt from the ICFR audit requirement. For example, a 2009 accelerated filer would need to have less than \$50 million in public float at the end of the second quarter of 2010 to exit accelerated filer status, but would be a smaller reporting company if its public float fell below \$75 million at that time.

When evaluating deficiencies in ICFR, concluding that a deficiency in internal control is a material weakness is not conditioned on restatements due to errors; rather, a material weakness exists if that deficiency leads to a *reasonable possibility* that a material error *could* occur. The Staff will likely make inquiries and may question a registrant’s judgment when a restatement corrects errors in previously issued financial statements but the registrant concludes no material weakness exists.

The Staff has not seen as much disclosure about changes in ICFR as they expected, given recent economic conditions. Consistent with comments made by the Staff in previous years, the Staff reminded registrants of the importance of assessing changes to ICFR each quarter, particularly those changes made in response to a previously disclosed material weakness. Disclosure of changes in a period prior to the one in which the material weakness is believed to have been remediated could be necessary.

Disclosures relating to material weaknesses could be improved to provide investors with the relevant information behind the material weakness. Investors may not view all material weaknesses equally—some material weaknesses have a pervasive impact across financial reporting, while others may not. Description of a material weakness should not simply refer to the financial statement error, which is the result of the material weakness, but rather should disclose the underlying weakness in the related control that failed to prevent or detect the error.

The Staff acknowledged that it is possible for a registrant to conclude that disclosure controls and procedures are effective when ICFR is ineffective because the definitions are different, but they will expect companies to support such conclusions. The Staff cautioned that most material weaknesses

Assessing changes to ICFR each quarter is important, and changes made in response to a previously disclosed material weakness may require disclosure.

in ICFR would likely cause disclosure controls and procedures to be ineffective.

Disclosure controls and procedures include ICFR but are broader and encompass those controls and procedures over, for example, the preparation of the MD&A. An example of a material weakness in ICFR that may not result in a conclusion that disclosure controls and procedures are ineffective is a material weakness related to safeguarding of assets.

Similar to concerns expressed by PCAOB officials about audits of registrants with all or a significant portion of its operations outside the United States, the Staff has recently been questioning how registrants in this situation prepare their U.S. GAAP financial statements and maintain and assess ICFR. Specifically, the Staff wants confirmation that the registrant has sufficient knowledge to prepare U.S. GAAP financial statements. The Staff has requested information concerning the education and ongoing U.S. GAAP training of relevant company personnel and third parties that assist management. The Staff expects the competence and experience of personnel in foreign operations or at foreign private issuers who are responsible for preparing financial statements and maintaining and assessing ICFR to be comparable to that expected of domestic accounting personnel.

Disaggregated Information for Foreign Operations

Material risks and uncertainties posed by foreign operations may require disaggregated disclosures.

The Staff commented that companies with foreign operations may need to consider disaggregated disclosures of material risks and uncertainties, particularly in circumstances where these risks may result in a financial statement impact disproportionate to the relative size of the foreign operation. Such risks and uncertainties might include currency fluctuations, political destabilization, adverse business climates, and taxation matters.

As an example, the Staff discussed recent events in Venezuela, where hyperinflation, devaluation of the currency, government price controls, parallel exchange rates, and political issues have created significant risks and uncertainties for the Venezuelan operations of U.S.-based companies. Companies with operations in Venezuela or other countries with similar risks should consider disclosing separate financial information about those operations (income, cash flows, etc.), qualitative information about the business and financial risks, and the impact of price controls, recent or expected changes in business practices, exchange rates, and restrictions on repatriation of funds.

In particular, the Staff recommended disclosure of monetary assets and liabilities by denomination of currency (e.g., U.S. dollar vs. Bolivar), and suggested that a statement such as “despite being measured in U.S. dollars, the entity is not operating in a stable U.S. dollar environment” might be appropriate. The Staff said there have been circumstances in which losses have been reported related to foreign entities in countries such as Venezuela that are disproportionate to the size of the entity, so the disclosures suggested above may be appropriate even if the registrant’s foreign operations are not large based on other measures such as relative sales.

The Staff also commented on situations in which companies derive a significant portion of their earnings from a “tax haven” country (e.g., Ireland). In these circumstances, disaggregated disclosure related to operations in that

Company tax structures may impact liquidity and require disclosure.

country may be appropriate, including disclosure of the portion of earnings attributable to that foreign operation and a discussion of how liquidity is affected by possible tax consequences associated with repatriating earnings.

Similarly, the Staff observed that they have seen issues related to compliance with Rule 4-08(h) of Regulation S-X, which requires disclosure of pretax income and income tax expense from domestic and foreign sources. In some cases, the tax rate reconciliations provided by companies present a significant reconciling item related to differences between U.S. and foreign tax rates without providing disclosure about the nature of the differences or any individually significant components of the reconciling item. For example, if a company is deriving significant profit because of a low tax rate in a particular country, specific discussion about the impact on effective tax rates may be warranted, especially given current economic dislocations and uncertainties around the world.

Foreign Equity Method Investee Summarized Financial Information

Domestic registrants are required to present in the footnotes to the financial statements summarized U.S. GAAP financial information of a foreign business accounted for under the equity method. When financial information of an equity method investee is prepared under accounting principles other than U.S. GAAP, the registrant should recast the equity method investee's financial information to U.S. GAAP and summarize that financial information in the footnotes. Further, the registrant's share of income or loss from the foreign equity method investee to be included in consolidated net income should be computed based on financial information of the equity method investee prepared in accordance with U.S. GAAP.

The Staff also said they now consider IFRS for Small and Medium Size Entities (IFRS for SMEs) to be another comprehensive basis of accounting for foreign business financial statements furnished pursuant to Rules 3-05 and 3-09 of Regulation S-X, but those financial statements should be reconciled to U.S. GAAP. The Staff will not accept financial statements prepared under IFRS for SMEs for issuers, predecessors of issuers, domestic acquired businesses, or domestic equity method investees.

Segment Disclosures

Segment disclosures continue to receive Staff scrutiny.

The Staff continues to ask registrants about their analysis of operating segments. The Staff will look at all available information, including information in MD&A, on registrants' Web sites, and discussed in earnings calls, to assess whether companies are describing their businesses in a manner different from their segment footnotes. The Staff commonly requests registrants to provide them with the information provided to the chief operating decision maker (CODM) in the course of his or her review. The Staff is skeptical of suggested positions that information provided to and regularly reviewed by the CODM is not used in making decisions about allocating resources to the segments or assessing performance.

Guarantor Financial Statements

The Staff shared some recent experiences with applying the rules on guarantor financial statements. Entities that guarantee registrant debt generally have financial statement filing requirements under Rule 3-10 of

Regulation S-X equivalent to a registrant. For subsidiary guarantors, relief from the periodic filing requirements is provided if certain conditions are met. In most cases, these conditions require presentation of condensed consolidating financial information in the footnotes to the financial statements of the registrant issuer of the related debt.

In order to qualify for certain exceptions, a direct or indirect subsidiary guarantor must be a 100 percent owned subsidiary of the registrant parent. A subsidiary is generally considered 100 percent owned if the parent owns 100 percent of outstanding voting shares of the entity. If any shares of the subsidiary guarantor stock are owned outside the consolidated group, use of the exception is not permitted, although the Staff will consider requests for relief in certain circumstances. The Staff cited one scenario in which “non-voting” shares of a guarantor were owned by a third party that had the right to appoint directors. The Staff disallowed the exception because the minority shareholders participated in the governance of the entity.

The Staff also noted that one of the conditions for relief from the filing requirements is that the guarantee must be full and unconditional throughout the term of the registered debt. In one scenario evaluated by the Staff, the debt agreement contained a provision under which the guarantor could “opt out” of the guarantee obligation during the term of the debt, and thus the condition was not met.

Proposed Disclosures on Short-Term Borrowings

The proposed short-term borrowing rules would apply to all registrants, not just financial institutions.

The Staff remarked about proposed new rules related to disclosure of short-term borrowings, including disclosure of fluctuations in borrowings over the period. The proposed rules would require a disaggregated quantitative presentation of short-term borrowings as well as a qualitative discussion of the business reasons for such borrowings. The proposed disclosures would apply to all registrants with short-term borrowings, not just financial institutions, although financial services companies (including banks and nonbanks) would be required to provide more detailed disclosures. The Staff expects the rules to be finalized in the first quarter of 2011. They said they have received few comments on the proposal and welcome additional input.

Although the short-term borrowings proposal will not be finalized for year-end reporting, the Staff believes a thorough discussion of liquidity and capital resources under existing MD&A requirements would provide qualitative information comparable to what the proposed requirements intend to elicit. These views are discussed further in an interpretive release, “Commission Guidance on Presentation of Liquidity and Capital Resources Disclosures in Management’s Discussion and Analysis,” that was released contemporaneously with the new rule proposal. Additional discussion of the proposed rules and interpretive release can be found in [KPMG Defining Issues 10-40](#).

XBRL Update

The Staff has observed deficiencies with data tagging.

The Staff provided an update on XBRL, including a reminder that the SEC currently has three XBRL programs: one for filings of registrant financial statements; one for filings by Nationally Recognized Statistical Rating Organizations (credit rating agencies), which became effective in November 2010; and one for filings of mutual fund risk and return information, effective January 1, 2011. The three most common areas of comment resulting from review of XBRL submissions of registrant financial statements from June to August 2010 related to negative values, extensions, and axis and members. The Staff directed companies to their full report on observations from their filing reviews for further insights into their findings.¹⁶

The Staff also said that an updated edition of the U.S. GAAP Taxonomy, which will be effective for submissions for periods ending on or after July 15, 2011, is expected to be released in early 2011. The Staff indicated that the FASB was responsible for the development of the 2011 taxonomy and that while most elements were unchanged, references to the FASB Accounting Standards Codification were added to the reference section of elements.

¹⁶ [Staff Observations From Review of Interactive Data Financial Statements \(from November 1, 2010\)](#). Also, see [KPMG Defining Issues No. 10-50](#).

Appendix I: Index of Published Speeches

SEC and PCAOB officials publish speeches on the following Web sites:

SEC – <http://www.sec.gov/news/speech.shtml>

PCAOB – <http://pcaobus.org/News/Speech/Pages/default.aspx>

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

Senior SEC Officials

[Paul A. Beswick](#), Deputy Chief Accountant, SEC Office of the Chief Accountant

[Brian T. Croteau](#), Deputy Chief Accountant, SEC Office of the Chief Accountant

[James L. Kroeker](#), Chief Accountant, SEC Office of the Chief Accountant

[Mary L. Schapiro](#), Chairman, SEC

Senior PCAOB Officials

[Martin Baumann](#), Chief Auditor, PCAOB

[Daniel L. Goelzer](#), Acting Chairman, PCAOB

[Claudius B. Modesti](#), Director of Enforcement, PCAOB

SEC Staff

[Wesley R. Bricker](#), Professional Accounting Fellow, SEC Office of the Chief Accountant

[John F. Offenbacher](#), Senior Associate Chief Accountant, SEC Office of the Chief Accountant

[Nilima Shah](#), Associate Chief Accountant, SEC Office of the Chief Accountant

[Sagar S. Teotia](#), Professional Accounting Fellow, SEC Office of the Chief Accountant

[Lisa D. Watson](#), Professional Accounting Fellow, SEC Office of the Chief Accountant

Presentation Materials (Slides)

[Wayne Carnall](#), Chief Accountant, SEC Division of Corporation Finance

[Craig Olinger](#), Deputy Chief Accountant, SEC Division of Corporation Finance

[Division of Corporation Finance Staff Panel](#) (Wayne Carnall, Angela Crane, Jill Davis, Todd Hardiman, Stephanie Hunsaker, Mark Kronforst, and Craig Olinger)

Appendix II: Glossary

The following terms are used throughout the document:

AICPA – American Institute of Certified Public Accountants

CAQ – Center for Audit Quality

DCF – SEC Division of Corporation Finance

Dodd-Frank – Dodd-Frank Wall Street Reform and Consumer Protection Act

FASB – Financial Accounting Standards Board

FRM – Financial Reporting Manual

GAAP – U.S. Generally Accepted Accounting Principles

IASB – International Accounting Standards Board

IFRS – International Financial Reporting Standards

IFRS Work Plan – SEC Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers

IPO – Initial Public Offering

MD&A – Management’s Discussion and Analysis of Financial Condition and Results of Operations

OCA – SEC Office of the Chief Accountant

PCAOB – Public Company Accounting Oversight Board

SEC – U.S. Securities and Exchange Commission

SOX – Sarbanes-Oxley Act of 2002

Staff – Securities and Exchange Commission Staff

XBRL – Extensible Business Reporting Language

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