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BDO KNOWS: SEC

THE 2012 AICPA SEC AND PCAOB CONFERENCE

The annual AICPA National Conference on Current SEC and PCAOB Developments held December 3-5, 2012, in Washington, DC, provided insights into the Securities and Exchange Commission (SEC) staff's views on various accounting and reporting issues. The remarks made by members of the Office of the Chief Accountant and Commissioner Luis Aguilar are available on the SEC's website, *www.sec.gov*, under Speeches and Public Statements.

OVERVIEW

Unlike years past, the question as to whether US issuers will ultimately transition to International Financial Reporting Standards (IFRS) was not a focal point of the 2012 conference. Discussions of possible transition were replaced with a renewed focus on the quality of financial reporting and the importance of clear and transparent disclosures. The SEC staff provided insights on current accounting issues and suggested improvements for disclosures based on their filing reviews.

The SEC staff also addressed the Jumpstart Our Business Startups Act (JOBS Act). Enacted in 2012, the law was designed to make it easier, and less costly, for smaller companies to raise capital. The SEC staff clarified which companies were affected, what accommodations were available, and how to interpret and apply specific provisions of the law.

The following comments provide additional insight into the SEC staff positions on these and other accounting and reporting issues.

Read more

CONTENTS

click a topic for details

INTERNATIONAL FINANCIAL REPORTING STANDARDS FOR US ISSUERS

One of the most important messages at the conference may have been the message that went unsaid. There was no discussion of the SEC's commitment to a single set of high-quality global accounting standards. There was no guidance regarding an updated "decision date" or any indication as to when the SEC will decide whether US issuers will ultimately transition to IFRS. And there was minimal discussion regarding possible avenues for incorporating IFRS into the US financial reporting system.

Rather, there seemed to be an acknowledgement that having one set of global standards may be a laudable, but unachievable, goal in the near term. Having standards that are comparable as a result of the convergence project may be sufficient for investors and users of financial statements. There was also recognition, on the part of the regulators and standard setters alike, that the delays and the US's unwillingness to commit may likely have consequences. The level of influence currently afforded the US standard setters, as well as its "seat at the international table," may be diminished as the IASB moves forward.

SEC STAFF WORK PLAN

In 2010, the SEC staff was directed to develop and execute a work plan whose purpose was to assist the Commission in determining whether, when, and how to transition to IFRS. The work plan was to address specific areas including: (a) the development and applicability of IFRS, (b) the independence of the standard setters, (c) investor understanding and education, (d) the impact on the US regulatory environment, (e) the impact on issuers, and (f) human capital readiness.

In July of 2012, the Final Staff Report on the Work Plan was published and the SEC staff highlighted some of the key issues contained in the report. However, the staff cautioned that the work plan was designed to gather information – not to provide conclusions – and that inferences that, by its issuance, the Commission has made policy decisions regarding IFRS' incorporation into the financial reporting system for US issuers would be inappropriate.

The report addressed the manner in which IFRS might be incorporated into the US financial reporting system. The SEC staff noted that direct adoption of IFRS (i.e., looking to the IASB as the standard setter and designating the standards of the IASB as authoritative) would be challenging and was not supported by the vast majority of participants in the US capital markets. However, there was significant support for other methods such as an endorsement approach which would allow the US to retain influence on the accounting standard setting process; lessen the burden of conversion for US issuers; and retain references to US GAAP currently embedded throughout US laws, regulations and private contracts.

As for the development and application of IFRS, the SEC staff observed the following:

- Although the IASB has made significant progress in developing a comprehensive set of accounting standards, standards for certain areas such as accounting for extractive activities, insurance contracts, and rate-regulated activities, remain underdeveloped.
- The IFRS Interpretations Committee, tasked with addressing widespread accounting matters identified in practice, should do more to address these issues on a timely basis.
- While financial statements generally appear to comply with IFRS, there continues to be inconsistent application and enforcement of IFRS and, consequently, diversity in the global application of the standards.

For more details regarding these observations and other key issues in the report please refer to the *BDO Knows: SEC Year in Review* newsletter and the Final Staff Report which is available on the SEC's website at *www.sec.gov/spotlight/globalaccountingstandards.shtml*.

REASONS FOR TRANSITIONING TO IFRS

The SEC staff noted that a country's decision to incorporate IFRS into its national accounting standards is a difficult decision and is not based solely on the standards themselves. Countries that have made such decisions have also focused on the role accounting standards play in the public capital markets, the function capital markets serve in society, and which approach would better serve their society.

Based on insights gained through discussions with counterparts in countries around the world, the SEC staff presented three reasons or "policy decisions" as to why a country may ultimately decide to adopt IFRS. The discussions were in general terms (not country specific) and no insight was provided as to how these factors might apply to, or be evaluated in the context of, the US.

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First, a country that anticipates a better standard setting outcome under IFRS would be motivated to pursue the upgrade by incorporating IFRS into its national accounting standards (referred to as "domestic upgrade"). In making such a determination, a country would compare its existing national accounting standards and processes with those of IFRS in terms of the quality of the financial statement information; the cost to produce and maintain the accounting standards; and the control over producing or modifying the standards. Intangible factors would also be considered including whether IFRS would provide a preferable standard setting environment in terms of structure, resources, and objectivity; help overcome any negative perceptions about the national accounting standards; provide the country a "seat at the international table"; and provide a more suitable common platform, because of its impartiality, for a group of countries that are seeking linkage.

Second, the accounting standards used by issuers may impact the cost of foreign capital (referred to as "foreign investment"). If foreign investors are more familiar with IFRS, issuers that prepare their financial statements on this basis may be able to reduce the cost of foreign capital. Consequently, if a country's public companies are, in the aggregate, big attractors of foreign capital – due to lack of available domestic capital or diversification strategies of foreign investors – the country may be motivated to incorporate IFRS.

Third, similarities in the public capital market profiles between two countries may reduce the natural friction that can exist within the processes for cross-border importing and exporting of capital (referred to as "foreign access"). National accounting standards are a part of a country's public capital market profile. As such, a country engaged in such movements of capital could be motivated to incorporate IFRS to provide a feature of similarity between its public capital market profile and that of its cross-border partner.

The SEC staff cautioned that the three factors described above could not be looked at in isolation and that mixed signals when evaluating each may create a difficult policy decision. If the domestic upgrade analysis suggests transitioning to IFRS but there are no discernible benefits under the foreign investment and foreign access analyses, transitioning to IFRS would probably not cause any harm. The more difficult scenario, in the staff's view, would be if the domestic upgrade analysis suggests not transitioning to IFRS and either or both of the other analyses suggests benefits in doing so.

THE JOBS ACT

On April 5, 2012, the JOBS Act was enacted and under Title 1 of the Act a class of issuers called emerging growth companies (EGCs) was created. The EGC designation is not optional or elective and applies to any company – domestic or foreign – that meets all of the following conditions:

- The first sale of common equity securities pursuant to an effective registration statement under the Securities Act of 1933 (the 33 Act) has either not yet occurred or occurred after December 8, 2011.
- Gross revenues during the most recently completed fiscal year were less than $1 billion.
- No disqualifying events, as specified in the JOBS Act and discussed later, have occurred.

Focusing on the first criterion, the SEC staff noted that a company that has only sold common equity securities under a Regulation D offering would meet this criterion since such an offering is not registered under the 33 Act. Similarly, a company that has filed an initial registration statement under the Exchange Act of 34 (i.e., Form 10 or 20-F) to register – not offer – its securities or a company that has only issued debt securities pursuant to an effective registration statement under the 33 Act would meet the criterion. Provided the other conditions are met, the staff confirmed that a company with no plans to offer common equity securities under the 33 Act would remain an EGC indefinitely.

As for the second criterion, the SEC staff clarified that gross revenues correspond to the amount reflected on the net revenue line on the financial statements (i.e., consistent with financial reporting). The phrase "most recently completed fiscal year" should be read literally and not in terms of financial statement filing requirements. For example, a calendar year company that files a registration statement in connection with an initial public offering (IPO) on January, 1, 2013, should look to the revenue during 2012 when assessing eligibility, regardless of the fact that statements for that year are not required, and would not be provided, in the filed registration statement.

The JOBS Act provides relief for EGCs both in connection with IPOs and ongoing SEC reporting requirements. The accommodations provided are optional and discrete so an EGC may elect to take advantage of some and not others. For example, in connection with an IPO for the sale of common equity securities, an EGC may confidentially submit its registration statement or elect to provide only two years of audited financial statements and selected financial data (rather than the customary three and five). An EGC may defer the adoption of new accounting standards by using the effective date applicable to nonpublic companies or streamline its executive compensation disclosures by complying with the smaller reporting company requirements under Item 402 of Regulation S-K. Also, an EGC is not required to have an

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auditor attestation of its internal control over financial reporting performed under 404(b) of the Sarbanes-Oxley Act. On this latter point, the SEC staff clarified that a company that is both an accelerated filer and an EGC may elect to continue to provide an auditor attestation report but would not be required to do so.

Under the JOBS Act, a company retains its EGC status until the earliest of the following disqualifying events and dates:

- The last day of the fiscal year in which revenue is $1 billion or more
- The last day of the fiscal year following the fifth anniversary of the first registered sale of common equity securities under the 33 Act
- The date on which more than $1 billion in non-convertible debt securities has been issued over a rolling three year period
- The date on which the company becomes a large accelerated filer

The SEC staff advised EGCs to continuously monitor their eligibility since disqualification is permanent (i.e., once an EGC is disqualified it may never again qualify as an EGC). Also, since the JOBS Act did not provide any transition guidance that would allow for deferral until the subsequent year, the accommodations afforded EGCs are forfeited immediately upon disqualification (i.e., a company becomes a non-EGC on the dates cited above). This immediate change in status is particularly important for a company that is an accelerated filer and loses its EGC status as a result of exceeding the revenue threshold. Such a company would be required to provide an auditor attestation report on its internal control over financial reporting for the year in which the disqualification occurred. For example, if an accelerated filer's revenues for 2012 equal or exceed $1 billion for the first time (a disqualifying event) an audit report on the company's internal control over financial reporting as of the end of 2012 would be required in its 2012 Annual Report (Form 10-K or 20-F). The SEC staff assumes that registrants will be able to plan for, or foresee, these disqualifying events and consequently will have adequate time to plan and obtain an audit. However, if this is not the case and obtaining an audit would be difficult, if not impossible, the registrant may contact the staff to discuss the possibility of relief.

Since its passage, the SEC Division of Corporation Finance has issued a series of Frequently Asked Questions (FAQs) to provide guidance on the implementation and application of the JOBS Act. The intent is to continue to update the FAQs as questions arise in practice. Described below are some of the more common questions the SEC staff has addressed:

- Confidential submissions – must be substantially complete (i.e., include all required financial statements and audit reports) but consents and officer certifications are not required since this is a submission and not a filing.
- New or revised accounting standards – the election relates to when, and not how, a standard will be adopted (i.e., an EGC can elect to use the nonpublic company extended transition period but cannot apply the nonpublic company financial accounting standards or disclosures, if different). The election must be consistently applied to all standards and the decision to use public company adoption dates, once made, is irrevocable.
- Internal control over financial reporting – the exemption only applies to the auditor attestation (i.e., a management assessment is still required).
- Loss of status – if a company no longer qualifies as an EGC as of year-end, its Form 10-K or 20-F for that year of disqualification would be as a non-EGC (without the accommodations).

For more details regarding the FAQs please refer to our ***BDO Knows: SEC Year in Review*** newsletter and the FAQs which are available on the SEC's website at *www.sec.gov/spotlight/jobs-act.shtml*.

ACCOUNTING

INCOME TAXES

When assessing whether deferred tax assets are realizable, all available information – both positive and negative – must be considered and appropriately weighted. The more objectively verifiable the evidence is, the more it should be weighted in the analysis. The SEC staff acknowledged that a decision to establish or reverse a valuation allowance requires significant judgment. However, consistent with the prior year, the staff emphasized that it would be difficult to conclude that losses in an economic downturn are an aberration. Similarly, if there have been cumulative losses in recent years, it would be difficult to demonstrate that such losses will not re-occur and to overcome this negative evidence.

For a company that has begun to return to profitability, management should consider: (a) the magnitude and duration of past losses and current profits, (b) the factors that generated the losses and profits, (c) the sustainability of the profits, and (d) the reliability and accuracy of forecasts of future financial results. The assumptions used in the forecasts should also be consistent with assumptions used in other areas (e.g., goodwill impairment) and disclosures related to liquidity. If the decision is made to reverse a valuation allowance, the disclosures

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should address the timing of the reversal (i.e., why in this period) and discuss the evidence considered – both positive and negative – and how each factor was weighted.

REVENUE RECOGNITION

Under SAB Topic 13, revenue may be recognized if the following four criteria are met: (a) persuasive evidence of an arrangement exists, (b) delivery has occurred or services have been rendered, (c) the seller's price to the buyer is fixed and determinable, and (d) collectability is reasonably assured. The SEC staff indicated that it has recently begun questioning whether the fourth criterion has been met, particularly in situations where a registrant sells products to resellers, has significant days sales outstanding, and reports high gross margins.

The SEC staff suggested that the following factors be considered when assessing whether collectability is reasonably assured: (a) customer creditworthiness, (b) payment terms, (c) historical collection practices (e.g., past due collection policies and payment term modifications), (d) unfavorable resolutions in collection disputes, (e) trends in the receivable aging, and (f) collection and write-off history. If collection is not reasonably assured, revenue should be deferred until such time as it is; which may not be until cash is actually received.

DISCLOSURES

Investors require complete and transparent disclosures if they are to make informed investment decisions. As such, the quality of disclosures has been, and continues to be, a focal point of the SEC staff. Based on filing reviews and comment letters issued, the SEC staff provided the following observations and suggestions for registrants to consider when drafting their disclosures. Registrants were also encouraged to revisit the guidance provided last year since the themes remain quite similar.

SEGMENTS

Registrants should be alert to possible changes in the identification or aggregation of operating segments. Such changes could occur as a result of changes in the business or the manner in which the business is conducted. For example, an acquisition may cause a change in segments or an aggregation may have been based on an expected convergence of economic factors over time that has not occurred. When changes in reporting segments occur, the comparable prior periods must also be recast unless it is impracticable to do so.

MD&A

The majority of MD&A comments relate to results of operations, which is often a recitation of the income statement rather than an analysis of operations. The discussion should focus on "why" the changes occurred and identify and quantify the underlying factors which could include, among other things, acquisitions, inflation, foreign exchange rates, and new contracts with significant customers or suppliers. The staff also provided the following specific guidance:

- If the net fluctuation between periods is immaterial because of offsetting material factors, the individually material factors should be discussed.
- A segment analysis is often meaningful and, when provided, may be integrated into the consolidated analysis.
- Key metrics should be considered (e.g., comparable store sales) and, if included, the calculation should be described and the metrics should be linked back to the financial statements so investors can understand how changes would impact the financial statements.

Registrants should consider the "spirit" of the contractual obligations table – which is to address liquidity – when assessing materiality and what should, or should not, be reflected. Footnotes should be provided to address timing and other uncertainties that cannot be appropriately captured in the table.

LOSS CONTINGENCIES

Consistent with prior years, the SEC staff continues to focus on losses that are reasonably possible (including losses in excess of any amounts accrued). As required by ASC 450, registrants should provide either: (a) an estimate of the loss (an amount or range) or (b) a statement that an amount cannot be estimated (after a concerted effort has been made). The staff also believes that if the impact is expected to be immaterial, an affirmative statement to that effect is necessary to make the disclosure that is made transparent and complete, although such disclosure is not required by ASC 450.

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Since litigation typically evolves over time, the staff expects the accruals and disclosures to evolve in a similar fashion. Disclosures should be updated as matters progress and material losses should be preceded by foreshadowing disclosures (i.e., surprises should be rare). The staff also observed that its views were unaffected by the FASB's decision to drop this issue from its agenda since the focus has been, and continues to be, on enforcing compliance with existing US GAAP.

GOODWILL IMPAIRMENT

The SEC staff recognized the significant progress that has been made in alerting the public to potential impairments. Consistent with the guidance provided in Section 9510 of the Division of Corporation Finance's Financial Reporting Manual (FRM), registrants are routinely providing early, and quantified, warnings if a reporting unit with material goodwill is at risk of failing the first quantitative step in the goodwill impairment assessment in the foreseeable future (i.e., its fair value is not substantially in excess of its carrying value). However, in the period of actual impairment many disclosures do not adequately address the timing of the charge. Similar to the issue noted above for deferred tax valuation allowances, registrants do not consistently address why a charge is recognized now as opposed to an earlier or later period. Explanations, if provided, typically cite soft market conditions or economic turnarounds and do not provide insight into management's thought process.

Detailed and specific disclosures should be provided in the period in which an impairment charge is recognized that describe: (a) what gave rise to the impairment, (b) what key assumptions in the valuation model were affected, (c) why these changes occurred, and (d) any known trends reasonably expected to affect income. If an interim impairment assessment has been performed – even if it resulted in no impairment – registrants should disclose the test results and triggering event, since this type of disclosure would alert investors to the risk.

The SEC staff also reminded registrants that under US GAAP, assets and liabilities are to be allocated to the reporting units on a reasonable and supportable basis. The staff is aware of instances, generally involving regulated industries, where shareholders' equity has been allocated to reporting units in lieu of specific identification (i.e., as a "proxy" for the carrying amount). The staff has questioned the basis for the allocation and continues to evaluate whether such an approach is appropriate.

VARIABLE INTEREST ENTITIES (VIEs)

In certain foreign countries, foreigners (individuals or corporations) are not allowed to hold direct ownership in businesses involved in certain industries. As a result, control is often based on contractual arrangements and the rights they convey to the various parties. The SEC staff continues to be concerned about these consolidated VIEs and the adequacy of disclosures regarding the associated risks. Detailed information regarding the contractual arrangements, as well as management's assessment, is critical if investors are to understand the basis of accounting and the risks involved.

Under ASC 810-10-50, registrants are required to disclose the methodology used in determining the primary beneficiary and the critical judgments made. To put such an assessment in context, registrants should describe the relevant terms of the arrangement and how they convey the elements of control. Specifically, the disclosures should address the contract terms; the registrant's ability to exercise the contractual rights (e.g., conflicts of interest, limitations); and the nature, purpose, and size of the VIE. Lastly, MD&A should include information that would allow an investor to assess the operations of the registrant without the VIE (i.e., as if deconsolidated).

INDUSTRY SPECIFIC

The SEC staff highlighted certain disclosure comments that arise frequently within specific industries. However, all registrants were encouraged to consider the issues since many are not industry specific and have broad applicability.

Biotech/pharmaceutical – to provide a better understanding of multiple element arrangements, the rights and obligations should be described separately from the accounting. The discussion should address all material terms and, if intellectual property is being licensed, precisely describe the rights conveyed (e.g., right to commercialize a product or to also develop it).

In connection with multiple element arrangements under ASC 605-25, registrants should describe how the units of accounting were determined (i.e., the basis for the "could resell" conclusions) and, for each unit, the pattern/period over which revenue will be recognized. Registrants should also disclose how the relative estimated selling price guidance was applied including: (a) what was included in the arrangement consideration, (b) the amount allocated to each unit of accounting, and (c) the estimated selling price for each unit of account including how it was determined and the underlying assumptions.

Banking – when reserves are released from the allowance for loan losses, MD&A should quantitatively disclose the effect on net income and the reasons for the release on the basis of changes in asset quality. Registrants should disclose how they define indirect exposure to European sovereign debt and manage the risks (consistent with the guidance in Corporation Finance Disclosure Guidance Topic No. 4). All registrants should consider the observations in Corporation Finance Disclosure Guidance Topic No. 5 since they generally apply to all financial institutions, regardless of size.

If a registrant uses a wide range of significant inputs in determining fair value, additional disclosure may be useful such as weighted average or a qualitative discussion of distribution (e.g., clustered at the low or high end of range). If multiple valuation methods are used to determine fair values for a class of assets and liabilities, disaggregating disclosures may be necessary (i.e., identifying the fair value and portion of class valued under each valuation method).

Insurance – the statutory information required under ASC 944-505 and Article 7 of Regulation S-X should not be labeled unaudited, preliminary, or subject to revision. The amount of statutory capital and surplus necessary to meet the regulatory requirement should be disclosed; a statement that the requirement was met is insufficient.

DUPLICATION OF DISCLOSURES

Disclosure overload has been a hot topic for many years, but this year the focus shifted to the duplication of disclosures within the financial statements and elsewhere in the financial reporting package (e.g., MD&A). The issue arose when the FASB sought feedback on three long-standing disclosure projects (liquidity and interest rates, going concern, and a disclosure framework). Registrants uniformly questioned the need for many of the proposed disclosures, noting that they were already provided in connection with SEC financial reporting requirements under Regulations S-X or S-K. The staff believes the underlying issue is what type of information should be reflected within, as opposed to outside, the financial statements. A corollary issue may be what consideration should be given to financial reporting requirements outside the financial statements when the FASB considers financial statement disclosures.

The SEC staff noted that it has provided interpretive guidance over the years as to the purpose and intent of MD&A. In 2003, the staff indicated that the purpose of MD&A is to provide: (a) a narrative explanation of a company's financial statements through the eyes of management, (b) the context within which financial information should be analyzed, and (c) information about the quality and variability of financial information to enable an investor to assess the likelihood that past performance is indicative of future performance. Similarly, in 2010 the staff stated that MD&A is to provide investors "an appreciation of the known trends and uncertainties that have impacted historical results or are reasonably likely to shape future periods."

Based on the above, the staff noted that one could draw some conclusions as to the type of information that should be included in other parts of a financial reporting package (i.e., outside the financial statements) but that a healthy and robust dialogue could greatly contribute to the debate. As a result, the SEC staff, with participation by both the FASB and the PCAOB, will hold a roundtable in the upcoming months to address whether there are disclosure gaps and, if there are, to identify the critical decision points (i.e., dividing line) when determining whether information should appear in the financial statements or in the broader financial reporting package.

▶SEC RULES

NON-GAAP MEASURES

In 2010, the SEC staff revised its interpretative guidance regarding non-GAAP measures to eliminate certain restrictions and prohibitions in hopes that the measures would provide useful information for investors. However, the overriding principle remains unchanged: non-GAAP measures that are misleading are prohibited. The staff reminded registrants that non-GAAP income statements may not be presented in any communications, including earnings releases, since such a presentation gives the non-GAAP measure undue prominence.

The staff also noted that pension-related adjustments are often nondescript and confusing. The staff stressed that the nature of the adjustments should be clearly indicated (e.g., labeled as removal of amortization of losses rather than non-cash pension expense). Further, if the non-GAAP measure adjusts for actuarial gains and losses, registrants should include quantitative disclosures regarding actual and expected returns on assets to provide context.

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GUARANTOR FINANCIAL STATEMENTS

Under Rule 3-10 of Regulation S-X, a subsidiary issuer or guarantor of registered securities is considered a registrant for SEC reporting purposes (i.e., it would file financial statements required by a registrant under Regulation S-X). However, condensed consolidating financial information may be presented by the parent, in lieu of separate subsidiary reporting, if two conditions are met: (a) the subsidiary is 100 percent owned and (b) the guarantee is full and unconditional.

For purposes of analyzing the two conditions, the staff clarified that "100 percent owned" is not the same as "wholly owned," which under Regulation S-K is defined as substantially owned and used in the context of consolidation. To qualify for relief the subsidiary must be 100 percent owned and disclosed as such. The SEC staff also noted that "customary releases" pertaining to subsidiary guarantors would still qualify for relief (consistent with the guidance in Section 2510.5 of the FRM). However, such guarantees may only be described as full and unconditional if the circumstances under which a release would occur are disclosed. The staff observed that parent guarantor releases would not generally qualify for relief since the filing of parent financial statements is the basis for the relief granted to the subsidiaries.

For presentation purposes, the condensed consolidating financial information must follow Article 10 of Regulation S-X in terms of captions and detail; comply with US GAAP (e.g., displaying an intercompany receivable as a contra-liability would be inappropriate); and include a total for comprehensive income presented in either a single continuous statement or two separate but consecutive statements.

PRO FORMA FINANCIAL INFORMATION

Article 11 of Regulation S-X requires registrants, in certain circumstances, to present pro forma financial information to show investors how a specific transaction or event (e.g., significant business combination) may have affected the historical financial statements. The presentation is accomplished through discrete adjustments to historical financial information which are: (a) directly attributable to the specific transaction, (b) factually supportable, and (c) for purposes of the income statement only, expected to have a continuing impact.

At last year's conference the SEC staff clarified that continuing impact should be interpreted as an impact that extends beyond 12 months. In 2012, the staff modified its view to suggest that adjustments that are not "one-time" (i.e., affect more than one day) would have a continuing impact. The staff indicated that it is rethinking its most recent position. Until a decision is reached, registrants were advised to contact the staff when dealing with material pro forma adjustments of this nature (i.e., adjustments that affect a period that is longer than one day but not longer than 12 months). Such adjustments might include interest expense on short-term bridge loan financing, amortization of intangible assets with lives of 12 months or less, and the additional cost of goods sold that results from the turnover of inventory that has been stepped up to fair value in connection with a business combination.

▶CURRENT ACCOUNTING ISSUES

A panel of technical partners from the national offices of the large accounting firms, along with the SEC staff, discussed a number of current practice issues.

REVENUE RECOGNITION – GROSS VERSUS NET

ASC 605-45-45 provides a list of indicators to consider when determining whether revenue should be reported gross (as a principal) or net (as an agent). The "strong" indicators (as identified in US GAAP) consider whether the entity: (a) is the primary obligor and (b) has general inventory risk (before the customer order is placed or upon customer return). Identifying the primary obligor can be very subjective and difficult, especially in service arrangements.

The SEC staff believes that to qualify as a principal (and recognize revenue on a gross basis) a company must be the primary obligor and, in most cases, must also be subject to general inventory risk. The assessment regarding primary obligor (i.e., who is responsible for providing the services or fulfilling the contract) should be from the perspective of the customer and all external communications, including a company's website, marketing materials, and sales contracts, should be considered. The staff also noted that the current practice is based on the strong indicator designation in US GAAP. As a result, the introduction of new standards (i.e., the exposure draft on revenue recognition) may ultimately change practice since, as proposed, all indicators are weighted equally.

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CONTINGENT CONSIDERATION

Accounting for contingent consideration in the context of a business combination, from the perspective of the buyer, is quite clear. Under ASC 805-30-25 and 35, contingent consideration is initially recognized by the buyer at fair value and, to the extent it qualifies as a liability, re-measured to fair value through earnings in succeeding periods. But this guidance is limited and does not apply to the seller of the business or to the buyer of an asset (as opposed to a business). These latter situations had been considered and deliberated by the EITF in Issues 09-4 and 09-2, respectively, but the task force had been unable to reach consensus. Nevertheless, the SEC staff believed the minutes and exposure drafts of the issues were informative and provided the following observations.

In terms of seller accounting, the EITF had originally considered two models for arrangements that did not qualify as derivatives under ASC 815:

- Fair value model – the amount would be recognized initially at fair value based on ASC 810. In subsequent periods, a company would elect to either: (a) re-measure at fair value through analogy to ASC 805 or (b) apply the contingency guidance in ASC 450 (i.e., recognize gains when realized and losses when probable and estimable).
- Realizable model – no amount would be recognized until realized based on the contingent gain guidance in ASC 450.

The SEC staff observed that, at the time of the deliberations, the FASB staff believed there was conceptual merit to both views; although users may have preferred the fair value model. The staff also noted that if a seller is required to allocate goodwill to a business being sold (i.e., the business sold constitutes a portion of a reporting unit) it would appear that the fair value model would be required. The SEC staff considered, but has not addressed in a formal context, a third hypothetical model in which contingent consideration would initially be recognized, to the extent necessary, to offset any initial loss (i.e., if fixed consideration alone was less than the carrying value of net assets). The staff questioned the theoretical basis for such an approach (e.g., the bifurcation of the contingent consideration). Registrants holding such a view should consider consulting with the staff before applying it to a particular fact pattern.

In connection with an asset acquisition, the EITF had issued a consensus for comment that suggested companies apply existing US GAAP and included, as examples, the fair value model under ASC 815, the guidance related to the acquisition of an equity method investment in ASC 323, and the probability model under ASC 450, which was favored by comment letter respondents. The SEC staff noted that the fair value model would be appropriate and, in fact, required if the instrument were a derivative but questioned the basis for applying such a model to an instrument that is not a derivative. Although the staff has long believed that written options should be accounted for as liabilities at fair value, the staff indicated that it has never insisted on applying this view, by analogy, to a buyer's ability to default (i.e., its "option") on its obligation to settle a contingent consideration contract.

CONSOLIDATION OF AN LLC

US GAAP contains a number of models under which an entity may be consolidated. They include the VIE model (based on power and benefits), the voting control model (based on voting shares), and the limited partnership model (based on presumed control of general partner). While US GAAP requires issuers to first determine whether the VIE guidance applies, if it does not, the FASB codification is silent as to which of the two remaining models applies to an LLC.

A decision tree was presented by a panelist as a possible road map for navigating through the literature to determine which consolidation model applies. The thought was that a registrant would consider the various models in the sequence indicated below, starting with a VIE analysis. If the answer to a question is "yes," a registrant would assess consolidation under that model – and that model alone – and if the answer is "no," would continue to the next question.

- Is the LLC a VIE – if yes, identify the primary beneficiary based on power and benefits.
- Is the LLC the functional equivalent of a limited partnership – if yes, determine whether the presumption of general partner (managing member) control may be overcome by the rights of the limited partners (members).
- Does the reporting entity hold a controlling financial interest through a majority voting position.

When considering the limited partnership model, the panelist suggested the focus be on the business purpose and design of the LLC including: (a) the roles and responsibilities of the parties (e.g., same or different, active or passive), (b) which decisions require a vote, if any, and (c) the contribution of each member (e.g., capital, industry expertise, geographic presence, customer relationships).

Since the SEC staff has not addressed this specific issue, there was no formal staff position. However, the staff believed the factors to consider in the limited partnership analysis were reasonable and registrants were reminded to consider all facts and to prepare contemporaneous documentation.

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▶INTERNATIONAL ISSUES

FIRST-TIME ADOPTERS OF IFRS

In 2012, the SEC staff performed a review of annual reports of foreign private issuers (FPIs) (Forms 20-F and 40-F) that, for the first time, reflected financial statements prepared under IFRS. As a result of Canada's adoption of IFRS in 2011, the population of filings was large (around 250) and the majority related to Canadian registrants.

The purpose of the review was twofold: (a) to better understand the impact of first-time adoption and (b) to monitor compliance with specific reporting requirements related to first-time adoption as required under IFRS. The SEC staff shared the following observations and common themes:

- Statement of compliance – reference to IFRS "as issued by the IASB" is required in both the audit report and the notes to the financial statements. If the assertion is omitted a reconciliation to US GAAP is required.
- Going concern – the wording in PCAOB audit reports must comply with PCAOB standards (i.e., the phrase "substantial doubt" must be included and conditional language such as "may cast" must be excluded).
- Selected financial data in Form 20-F filings – a side-by-side comparison of historical home-country GAAP and IFRS is not permitted; if provided, two separate tables must be included.
- MD&A – comparisons between home-country GAAP and IFRS are not appropriate and should be omitted from filings.

XBRL FILINGS FOR IFRS FILERS

The filing date for XBRL data for FPIs using IFRS was originally scheduled for June of 2011. The compliance date was deferred in 2011 and continues to be deferred until such time as the IFRS XBRL taxonomy is completed and approved by the SEC. In the meantime, the SEC staff noted that some foreign private issuers that prepare their financial statements under IFRS have provided XBRL data using the US GAAP taxonomy. The staff stressed that such submissions were inappropriate and the practice should be discontinued since it could potentially distort the data, analyses, and conclusions reached by users of XBRL data.

CONFIDENTIAL SUBMISSIONS

The SEC staff has had a long-standing non-public submission policy that allows certain FPIs to submit an initial registration statement and amendments for staff review on a confidential basis. Beginning in 2012, the staff also implemented confidential registration statement review procedures for companies that qualify as EGCs under the JOBS Act. The following changes were made to the FPI non-public submission process to reflect provisions of the JOBS Act:

- An FPI that is eligible to use the foreign issuer non-public submission policy must now submit its registration statement in the same manner and to the same SEC email address as a domestic EGC under the JOBS Act.
- An FPI may qualify as an EGC under the JOBS Act if it meets specified thresholds involving revenues and cumulative issuances of non-convertible debt securities. In such cases, the FPI must follow the procedures that apply to an EGC relating to confidential submissions and the timing of the public filing of its registration statements.
- An FPI, whether submitting a draft registration statement under the foreign issuer non-public submission policy or as an EGC under the JOBS Act, is now required to publicly file its nonpublic information at the same time that it publicly files its registration statement. All nonpublic draft registration statements must be filed under Exhibit 99 and all previously submitted responses to staff comments must be resubmitted as correspondence on EDGAR.

REPEATED APPLICATION OF IFRS

In May of 2012, IFRS 1 was amended to allow for the re-adoption of IFRS by an entity that had applied IFRS in a previous reporting period but whose most recent financial statements reflect another basis of accounting (e.g., home-country GAAP). Such an entity may choose to: (a) "resume" reporting under IFRS through retrospective adjustment to the original IFRS adoption date or (b) "re-apply" IFRS 1 as if for the first time.

As a result of this change, the definition of "first-time adopter" in Form 20-F is no longer consistent with IFRS 1 and an entity that meets the revised definition under IFRS may not meet the definition under Form 20-F. The "one-time adoption" accommodations that Form 20-F provides upon initial adoption of IFRS (i.e., the reduction in the number of periods required for audited financial statements, MD&A, and selected financial data) may not be available in these circumstances. Foreign private issuers that are considering "re-applying" IFRS 1 were encouraged to contact the staff to determine if accommodations may be applied.

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ADOPTION OF IFRS 10 THROUGH 12

IFRS 10 on *Consolidated Financial Statements,* IFRS 11 on *Joint Arrangements*, and IFRS 12 on *Disclosures of Interests in Other Entities* are effective for annual periods beginning on or after January 1, 2013. Under the original transition provisions any adjustments were to be retrospectively applied to all comparative periods presented. In response to concern that this application would be overly burdensome, the IASB amended the standards in June of 2012 to limit retrospective application to the annual period immediately preceding the period of adoption. Registrants will be allowed – not required – to continue to provide unadjusted comparative information for earlier periods presented. The only caveat is that the lack of comparability must be clearly disclosed by identifying the periods as unadjusted, stating that they are prepared on a different basis, and explaining the basis.

This inconsistency in basis and lack of comparability between periods could create an issue for foreign private issuers that are required to provide three years of audited financial statements (not two) and selected financial data for five years. The staff indicated that it will not insist on retrospective adjustment of earlier periods. However, similar to the IASB conditions, the staff would expect the unadjusted period to be clearly identified on the face of the statements (e.g., through a note reference or otherwise). Similarly, the selected financial data and MD&A should clearly indicate which periods have been retrospectively adjusted and which have not.

PCAOB INSPECTIONS

The regulators – both PCAOB and SEC – have become increasingly frustrated with the PCAOB's inability to perform inspections outside the US. Although progress has been made and agreements allowing for joint inspections were signed in 2012 with several countries, the stalemate continues in other countries such as China. Countries that have denied the PCAOB access are listed on its website to alert investors that registered audit firms operating in these countries have not been inspected. The SEC staff now believes, as communicated in comment letters, that additional disclosure is warranted. If a registrant is audited by a firm operating in one of the countries that has denied PCAOB access it should include a risk factor in its filings stating that the PCAOB has been unable to perform an inspection. The risk factor should also stress that investors are deprived of the benefits provided by such inspections.

▶COMMENT LETTERS

As mandated by the Sarbanes-Oxley Act, a registrant's filings must be reviewed at least once every three years. During 2012, refinements were made to the review process with the objective of issuing fewer, but more targeted and meaningful, comments. The general areas of comment, however, remained fairly consistent with prior years and between domestic and foreign issuers. They included segments, MD&A, income taxes, contingencies, revenue recognition, goodwill, and non-GAAP measures; all of which have been addressed elsewhere in this letter.

The SEC staff noted that responses to comment letters have become part of a registrant's disclosure record (along with a company's website and press releases). The information provided is relied on both by investors when making investment decisions and by the staff when deliberating and concluding on issues. The staff urged registrants to consider this, and exercise due care, when drafting responses.

▶INTERNAL CONTROL OVER FINANCIAL REPORTING

One of the hallmarks of the Sarbanes-Oxley Act was a renewed focus on internal controls and recognition that effective systems of internal control are fundamental to reliable financial reporting. With 2012 marking the 10-year anniversary of the law, the SEC staff reflected on the impact of the law and provided observations for the future.

The SEC staff observed that the increased attention to internal control over financial reporting has increased the reliability of financial information and, in so doing, provided benefits to investors. Management assessments required under Section 404(a) have played an important role. However, studies have indicated that financial reporting becomes even more reliable when an auditor attestation is performed under Section 404(b). Despite this, Commissioner Aguilar noted that there have been repeated efforts to limit the attestation requirements. In 2010 the Dodd-Frank Act permanently exempted all smaller reporting companies and in 2012 the JOBS Act exempted emerging growth companies. He expressed concern that such rollbacks will be harmful for both investors and the capital markets and that uncertainty regarding the reliability of financial reporting of these exempted companies may actually reduce demand for their securities, raise their cost of capital, and harm – not help – the market for IPOs.

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The staff noted that the identification and evaluation of financial reporting risks must be a dynamic process. When evaluating financial reporting risks, management and auditors need to consider how the risks change over time, their impact on internal control over financial reporting, and whether controls are designed to address the evolving risks. For example, in the current economic environment registrants should consider whether adequate controls are in place and operating effectively to identify when securities become thinly traded. Such controls are necessary to ensure that changes to the valuation approach, and the related measurements and disclosures, can be made on a timely basis.

The SEC staff reminded registrants applying the COSO framework that it has five components. While evaluating the control activity component is very important, the remaining components – the control environment, risk assessment, monitoring, and information and communication – are also important to an effective system of internal control and cannot be overlooked. The staff also noted that COSO is in the process of updating its 1992 internal control framework and in September issued its most recent exposure draft. Although the definition and components of internal control remain the same, one of the more significant changes is the incorporation of 17 principles to explicitly articulate and describe the components. And in response to user feedback, guidance and tools to assist in applying the framework have been provided. The staff noted that the updated framework, once available, may provide an opportunity for registrants to revisit and improve the internal controls related to current and evolving risks.

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