

# SEC in Focus

Quarterly summary of current SEC activities

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## SEC staff provides guidance on accounting for US tax reform

The Securities and Exchange Commission (SEC or Commission) staff issued [Staff Accounting Bulletin \(SAB\) 118](#) to provide guidance for companies that are unable to complete their accounting for the income tax effects of the Tax Cuts and Jobs Act (the Act) in the period of enactment.

The SEC staff acknowledged the challenges companies may face in accounting for the effects of the Act by their financial reporting deadlines. The SEC staff noted that Accounting Standards Codification (ASC) 740, *Income Taxes*, doesn't address these challenges and said clarification was needed to address uncertainty or diversity in views about the application of ASC 740 in the period of enactment, which is the period that includes 22 December 2017.

"Allowing entities to take a reasonable period to measure and recognize the effects of the Act, while requiring robust disclosures to investors during that period, is a responsible step that promotes the provision of relevant, timely, and decision-useful information to investors," SEC Chief Accountant Wesley Bricker said.

ASC 740 requires companies to account for the effects of changes in tax rates and laws on deferred tax balances (including the effects of the Act's one-time transition tax on certain foreign earnings) in the period in which the legislation is enacted. The financial statement effects of a change in tax law are recorded as a component of tax expense related to continuing operations.

In issuing the guidance, the SEC staff said it was clarifying the application of ASC 740 for companies that do not have the necessary information available, prepared or analyzed (including computations) in reasonable detail to complete the accounting under ASC 740 for the reporting period in which the Act was enacted.



**EY resources**

- ▶ Technical Line, [SEC staff provides guidance on accounting for the effects of US tax reform](#) (SCORE No. 00015-181US)
- ▶ Technical Line, [A closer look at accounting for the effects of the Tax Cuts and Jobs Act](#) (SCORE No. 07262-171US)

**Reporting provisional amounts**

The SEC staff said that companies must first reflect in their financial statements the income tax effects of the Act for which the accounting under ASC 740 is complete. These completed amounts will not be provisional amounts.

The SEC staff said a company that hasn't completed its accounting by its financial reporting deadline may report provisional amounts based on reasonable estimates. Those amounts will be subject to adjustment during a measurement period of up to one year. The staff's guidance requires companies to make disclosures about any provisional amounts, including the additional information needed to complete the measurements.

A company that cannot make a reasonable estimate should not account for the Act's effects until it can make such an estimate, the SEC staff said. The staff's guidance requires companies to make disclosures about any aspects of the Act for which no accounting recognition has been given, including the reasons for the incomplete accounting.

The SEC staff in the Division of Investment Management issued guidance in which the staff confirmed that investment companies can also rely on SAB 118 for purposes of calculating their net asset value (NAV) and reporting measurement period adjustments. The SEC staff also reminded investment companies to make disclosures, where applicable, about any material effects of the Act on their NAV calculations and information about material aspects of the Act for which the accounting is incomplete. Such disclosures could be made in a press release, on a website or in another reasonable manner.

SAB 118 applies only to the application of ASC 740 in connection with the Act. The SEC staff said it cannot be applied to other changes in tax laws.

**Other SEC disclosure considerations**

The SEC staff also issued [Compliance and Disclosure Interpretation \(C&DI\) 110.02](#) to answer questions companies have raised about reporting the effects of the Act. In the C&DI, the SEC staff said the remeasurement of a deferred tax asset (DTA) to reflect the effect of a change in tax rates or tax laws is not an impairment under ASC 740 and wouldn't trigger an obligation to file a Form 8-K under Item 2.06, Material Impairments. However, the enactment of new tax rates or tax laws could have financial reporting implications, including whether it is more likely than not that the DTA will be realized.

In the C&DI, the SEC staff also noted that registrants employing the measurement period approach described in SAB 118 and concluding that an impairment has occurred (e.g., recognizing or adding to a valuation allowance for DTAs) for the period that includes the enactment date due to changes resulting from the enactment of the Act may rely on the Instruction to Item 2.06. That instruction exempts registrants from filing a Form 8-K if the conclusion is made in connection with the preparation, review or audit of financial statements to be included in the next periodic report to be filed. In those situations, registrants must disclose the impairment, or a provisional amount with respect to that possible impairment, in the next timely filed periodic report.

The SEC staff previously acknowledged the operational and accounting challenges companies could face related to the anticipated tax reform and reminded companies to disclose any material effects of tax reform in management's discussion and analysis (MD&A).

## How we see it

While SAB 118 does not address interim reporting during the measurement period, we believe the effects of initially recording provisional amounts related to the enactment date effects of the Act and making adjustments to those amounts, if significant, should be recognized as discrete events in respective interim periods, similar to the interim accounting for tax law changes in the period of enactment. Accordingly, companies should not allocate the effect of changes in enactment date provisional amounts to subsequent interim periods by adjusting the estimated annual effective tax rate.

## Chairman Clayton and SEC staff discuss areas of audit committee focus

SEC Chairman Jay Clayton and members of the SEC staff said at the annual AICPA Conference on Current SEC and PCAOB Developments in Washington, DC, last month that audit committees should focus over the next year on the implementation of the new accounting standards, the new auditor's reporting model and cybersecurity.

### *New accounting standards*

Mr. Bricker said audit committees can contribute to an effective implementation of the new accounting standards on revenue recognition, leases and credit losses by setting an appropriate tone at the top and leveraging their understanding of the business in overseeing management's application of these standards.

He emphasized the importance of transition disclosures registrants are required to make about the anticipated effects of adopting new accounting standards. Mr. Bricker said these disclosures, which are required by SAB Topic 11.M (issued as SAB 74) in periods prior to adoption, help investors understand the implications of the standards and prepare for the changes.

The SEC staff described consultations related to the new accounting standards and said it will respect reasonable judgments issuers make in applying the new standards, including when it reviews their filings after they adopt the new revenue standard. The SEC staff also stressed that registrants need to perform a robust risk assessment in connection with implementing the new standards and make appropriate changes to internal control over financial reporting to address the new risks.

### *Auditor's reporting model*

Staff members of both the SEC and the Public Company Accounting Oversight Board (PCAOB) encouraged auditors to discuss potential critical audit matters (CAMs) with the audit committee and management before the requirement to include CAMs in auditor's reports is effective, beginning in 2019. Chairman Clayton said audit committees should consider asking their auditors to do a "dry run" of the expanded auditor's report that will include CAMs before the reports are filed publicly.

The new PCAOB standard is aimed at making the auditor's report more relevant and informative for investors and other financial statement users. It defines CAMs as matters the auditor communicated or was required to communicate to the audit committee that relate to material accounts or disclosures and involved especially challenging, subjective or complex auditor judgment.

## How we see it

Audit committees and management should begin considering whether and how the auditor's disclosure of CAMs will affect the company's own disclosures.

SEC officials said audit committees should focus over the next year on implementation of new accounting standards, critical audit matters and cybersecurity.

### EY resources

- ▶ Compendium of significant accounting and reporting issues, [2017 AICPA Conference on Current SEC and PCAOB Developments](#) (SCORE No. 06875-171US)
- ▶ SEC Reporting Update, [Spotlight on cybersecurity disclosures](#) (SCORE No. 06544-171US)

## Cybersecurity

Bill Hinman, Director in the SEC's Division of Corporation Finance (DCF), said the staff guidance, [CF Disclosure Guidance: Topic No. 2 – Cybersecurity](#), issued in 2011, which clarified how Regulation S-K disclosure requirements apply to cybersecurity risks and incidents that could have a material effect on a registrant, works “fairly well” and is “still very sound.” However, he said the SEC staff is thinking about how to refresh the guidance “to underscore its importance,” including elevating it to Commission-level guidance. Mr. Hinman did not say when any refreshed guidance would be issued.

Mr. Hinman said the updated guidance would clarify that cybersecurity risks are in the scope of registrants' disclosure controls and procedures, so registrants need to make sure that the appropriate people are informed about breaches on a timely basis to address any disclosure implications. He said the updated guidance would remind registrants to administer their insider trading policies when material information about cyber incidents has not yet been disclosed.

Mr. Hinman also said that, while registrants need to cooperate with law enforcement investigations of breaches, they should not delay disclosing appropriate information about a material cyber incident because of the existence of an investigation.

### How we see it

The SEC staff said it will increase its scrutiny of cybersecurity disclosures in its comment letter process. We recommend that registrants and their audit committees take a fresh look at their cybersecurity disclosures under the current SEC staff guidance.

## Chairman Clayton expresses continued concerns about ICOs

The SEC's Division of Enforcement recently determined that a company's initial coin offering (ICO) was an offering of securities because purchasers of the tokens had a reasonable expectation that they could receive a return on their investment in the tokens resulting from the actions of the company's management and others. The company subsequently halted the ICO and refunded the proceeds to investors.

In a [statement](#) in connection with that enforcement action, Mr. Clayton emphasized that “a number of concerns have been raised regarding the cryptocurrency and ICO markets, including that ... there is substantially less investor protection than in [the] traditional securities markets, with correspondingly greater opportunities for fraud and manipulation.” He provided a list of questions investors may ask before considering an ICO investment opportunity. Finally, he reminded market professionals that they need to focus on their responsibilities to make sure that their actions in regard to cryptocurrencies do not violate federal securities laws and that they should treat payments made in cryptocurrency as if cash were being conveyed from one party to the other.

At the AICPA conference, Mr. Clayton said virtual currencies such as digital coins (e.g., Bitcoin) and digital tokens representing claims against entities arising from the use of distributed ledger technology are the opposite ends of the “digital currency spectrum.” In his view, a digital token represents a security because “asking people for their money [and using it] in a commercial endeavor with the prospect of increasing the value” of that digital token meets the definition of a security. He said the “long-standing body of law” on securities should apply to such transactions. Mr. Bricker said that, absent an exemption from registration, distributed ledger entries that meet the definition of securities need to be registered with the SEC and their issuers need to include the required disclosures, including financial disclosures.

## EY resources

- ▶ To the Point, [SEC proposes modernizing and simplifying certain Regulation S-K disclosure requirements](#) (SCORE No. 05841-171US)
- ▶ EY Comment Letter, [SEC's proposal to modernize and simplify Regulation S-K](#)

## How we see it

With the increase in ICOs, we expect the SEC and its Division of Enforcement to continue to observe the market and take actions when ICOs appear to violate federal securities laws.

## SEC rulemaking and implementation

### SEC adopts a temporary final rule on registered investment company reporting

The SEC adopted a [rule](#) that requires funds in fund groups with \$1 billion or more in net assets to maintain the information required in Form N-PORT in their records until April 2019 rather than file it with the SEC. The information that funds maintain in their records will be subject to examination by the SEC, which is reviewing how it handles sensitive, nonpublic information that is filed electronically. As a result, larger fund groups will be required to begin submitting reports on Form N-PORT on EDGAR by 30 April 2019, and smaller fund groups will be required to begin submitting reports on Form N-PORT by 30 April 2020.

### Post-implementation review planned for new auditor's reporting model

The SEC chairman said the staff intends to assist the PCAOB in a post-implementation review of the new PCAOB standard that will significantly expand the information in auditor's reports. The review, which the PCAOB has indicated will take place after auditors of large accelerated filers have implemented the requirement to report on CAMs, will consider whether there are any unintended consequences of the standard such as increases in frivolous litigation or counterproductive tension between audit committees and auditors.

The standard, which the SEC approved in October, requires auditors to disclose their tenure as the company's auditor, add language clarifying their responsibilities and reorganize the content of the report by placing the auditor's opinion first, beginning with reports on annual periods ending on or after 15 December 2017. The requirement that auditors include a discussion of CAMs in their reports is effective for audits of large accelerated filers beginning with fiscal years ending on or after 30 June 2019 and for audits of all other affected filers beginning with fiscal years ending on or after 15 December 2020. Certain issuers such as brokers and dealers, emerging growth companies, employee stock plans and investment companies (other than business development companies) are exempt.

### SEC proposes modernizing certain Regulation S-K disclosure requirements

The SEC [proposed amending](#) Regulation S-K to modernize and simplify certain disclosure requirements as part of a broader review aimed at reducing the compliance burden on registrants while still providing all material information to investors.

Among other things, the proposal, which was mandated by the Fixing America's Surface Transportation Act, would allow a registrant to omit a discussion of the earliest annual period from MD&A if the discussion is not considered to be material and the discussion of that period was included in the prior-year Form 10-K. The proposal also would allow a registrant to omit commercially sensitive and confidential information from material contract exhibits in certain cases without obtaining advance permission from the SEC staff. In addition, the proposal would prohibit companies from cross-referencing in the notes to the financial statements to disclosures elsewhere in the filing unless permitted by SEC rule.

## How we see it

In addition to reducing the volume of disclosures in a filing, we believe the proposal would encourage registrants to take a fresh look at their MD&A each year.

## Updates to SEC staff guidance

### SEC staff updates Financial Reporting Manual

The SEC staff in the DCF updated its [Financial Reporting Manual](#) to clarify that:

- ▶ If an emerging growth company (EGC) that follows private company effective dates for new accounting standards loses its EGC status after the public company effective date of a new standard, it should generally adopt the new standard in its next filing after losing its EGC status. However, the staff said that it may not object to other alternatives, depending on the facts and circumstances.
- ▶ In preparing pro forma financial information, registrants must conform the date and method of adoption of new accounting standards by acquired businesses to their own, though the staff said it will consider requests for relief from this requirement.
- ▶ In preparing pro forma financial information for prior periods, registrants do not need to give effect to new accounting standards adopted retrospectively until they reissue historical financial statements for periods that reflect the accounting change.

### SEC staff issues Staff Legal Bulletin 14I on shareholder proposals

The SEC staff issued [Staff Legal Bulletin 14I](#) on shareholder proposals to clarify that:

- ▶ Graphics and images may be included in a shareholder proposal and supporting statement when they comply with other provisions of Rule 14a-8 and if the total number of words, including words in the graphics, does not exceed 500.
- ▶ A company's no-action request proposing to exclude a shareholder proposal as a matter relating to the company's ordinary business operation should discuss the board of directors' analysis of the particular policy issue raised by the shareholder proposal and its significance.

The SEC staff also addressed the challenges and concerns regarding beneficial ownership that proposals by proxy may present (e.g., when shareholders submit proposals through a representative). The SEC staff has said it will examine whether the shareholders who submit proposals by proxy provide documentation describing their delegation of authority to the selected proxies. The documentation is expected to:

- ▶ Identify the shareholder-proponent and the person or entity selected as proxy
- ▶ Identify the company to which the proposal is directed
- ▶ Identify the annual or special meeting for which the proposal is submitted
- ▶ Identify the specific proposal to be submitted
- ▶ Be signed and dated by the shareholder

### SEC staff updates guidance on non-GAAP financial measures

The SEC staff issued [C&DIs](#) on the presentation of non-GAAP financial measures in communications related to mergers and acquisitions. The C&DIs clarify that financial measures included in forecasts provided to a financial adviser and used in connection with a business combination transaction are not non-GAAP financial measures if they are provided to the financial adviser for the purpose of rendering an opinion that is materially related to the business combination transaction, and the forecasts are being disclosed in order to comply with Item 1015 of Regulation M-A or requirements under state or foreign law, including case law, regarding disclosure of the financial adviser's analyses or substantive work.

EGCs that lose their status after the public company effective date of a new accounting standard should adopt the new standard in their next filing.

However, the exemption from Regulation G and Item 10(e) of Regulation S-K for non-GAAP financial measures disclosed in communications relating to a business combination transaction does not apply to disclosures of the same non-GAAP financial measures in registration statements, proxy statements and tender offers other than those in connection with that business combination transaction.

### **SEC staff issues SAB 117 to conform its guidance to ASC 321**

The SEC staff issued [SAB 117](#) to state that once entities adopt ASC 321, *Investments – Equity Securities*, they should no longer apply SAB Topic 5.M, *Other Than Temporary Impairment of Certain Investments in Equity Securities*. ASC 321 provides new guidance that eliminates the ability to present changes in the fair value of investments in equity securities in other comprehensive income.

## **Other SEC activities**

### **CAQ SEC Regulations Committee meeting**

The Center for Audit Quality (CAQ) SEC Regulations Committee issued highlights from its [26 September 2017 meeting](#) in which the SEC staff expressed the following views:

- ▶ There are no US GAAP or other regulatory requirements to retrospectively adjust predecessor-period financial statements when a successor entity makes a voluntary accounting change or adopts new accounting standards.
- ▶ For reorganizations of entities under common control or discontinued operations, the pro forma presentation for the earliest two years should be limited to the effects of recasting the financial statements as required by US GAAP, and other pro forma adjustments should be limited to the most recent annual and interim periods.
- ▶ Financial statements filed pursuant to Rule 3-10(g) of Regulation S-X, *Recently Acquired Subsidiary Issuers or Subsidiary Guarantors*, are in the scope of the SEC Observer's announcement at the 20 July 2017 Emerging Issues Task Force meeting and thus don't have to reflect the new revenue and leases guidance in ASC 606 and ASC 842, *Leases*, respectively, as of the public business entity effective dates.
- ▶ Non-merger proxy statements, Form 8-A and mandatory registration statements under Section 12(g) of the Securities Exchange Act of 1934 are not eligible for the staff's nonpublic review program, while the eligibility of Form S-4 for a merger transaction will depend on the specific facts and circumstances. The staff also addressed interpretive questions about the process for omitting interim financial information from draft registration statements.
- ▶ Including only the information pertinent to the fact pattern in a waiver request under Rule 3-13 of Regulation S-X will facilitate a more efficient staff review process. The staff also discussed fact patterns in which it may grant requests to provide abbreviated financial statements of a predecessor entity such as when full financial statements for some successor periods are also included in the filing.

The CAQ SEC Regulations Committee also issued highlights from its [11 July 2017 meeting](#) in which the SEC staff expressed the following views:

- ▶ SAB 74 requires registrants to provide an estimate of the effect of the adoption of new standards or, if quantitative information isn't available, provide additional qualitative information to assist readers in assessing the effect of the new accounting standards on the financial statements.

**EY resources**

- ▶ [SEC top 10: what public companies, boards and investors should watch for in 2018](#) (SCORE No. 07301-171US)

- ▶ There is no bright line to use as the significance threshold for determining when to include the financial statements of a business proposed for disposal in a proxy statement soliciting authorization for the disposal.
- ▶ Pro forma financial information presented in a Form 8-K for a significant acquisition is encouraged to also give effect to previously reported significant acquisitions during the most recent fiscal year or subsequent interim period.

## Current practice matters

### 2018 US GAAP financial reporting and SEC reporting taxonomies now available

The 2018 US GAAP financial reporting taxonomy and SEC reporting taxonomy are now available on the [FASB website](#). The US GAAP financial reporting taxonomy includes updates for new accounting standards and other improvements. The SEC reporting taxonomy provides elements necessary to meet data-tagging requirements for financial schedules, condensed consolidating financial information for guarantors and disclosures about oil and gas production that are required by the SEC. The SEC is expected to approve the taxonomies in early 2018, after which registrants will be able to use them.

## Personnel changes

### Hester Peirce and Robert Jackson, Jr. sworn in as SEC Commissioners

Hester Peirce and Robert Jackson, Jr. were sworn in as SEC Commissioners, giving the Commission a full slate of five commissioners for the first time since 2015.

Ms. Peirce, a Republican who previously served as a senior research fellow at the Mercatus Center at George Mason University, said after the vote that she will focus on “protecting investors, upholding market integrity, and facilitating capital formation.” Mr. Jackson, a Democrat, who was a law professor at Columbia University and director of the school’s Program on Corporate Law and Policy, said he is committed to “making sure that investors are protected, that our markets provide the level playing field Americans deserve, and that entrepreneurs have access to the capital they need to grow our economy.”

### DCF Chief Accountant Mark Kronforst leaves SEC

Mark Kronforst, Chief Accountant in DCF, has left the SEC after 13 years with the agency, including the past four years in his last role. Kyle Moffatt, Associate Director of Disclosure Operations in DCF, was named acting Chief Accountant in DCF.

### SEC announces appointments

The Commission named:

- ▶ Peter B. Driscoll as Director of the Office of Compliance Inspections and Examinations
- ▶ Brett Redfearn as Director of the Division of Trading and Markets
- ▶ Robert Evans III as Chief of the Office of International Corporate Finance in DCF

### New PCAOB Chairman and member sworn in, additional members appointed

William D. Duhnke III was sworn in as PCAOB Chairman, and Kathleen M. Hamm was sworn in as a new PCAOB member. The SEC has appointed three other new PCAOB members, J. Robert Brown, James Kaiser and Duane DesParte, who will join the PCAOB shortly.

Mr. Duhnke, who previously served as the Staff Director and General Counsel to the US Senate Committee on Rules and Administration, succeeds James Doty as PCAOB Chair.

The swearing in of Ms. Peirce and Mr. Jackson as Commissioners gives the Commission a full slate of five commissioners for the first time since 2015.

Ms. Hamm and Messrs. Brown, Kaiser and DesParte will replace Jeanette M. Franzel, who will continue to serve until the new PCAOB members arrive, and former PCAOB members Steven B. Harris and Lewis H. Ferguson.

## Enforcement activities

### SEC's Division of Enforcement issues its 2017 annual report

The Division of Enforcement said in its annual [report](#) for fiscal 2017 that it brought 754 enforcement actions, including 446 standalone actions, and returned a record \$1.07 billion to harmed investors.

A significant number of the Commission's standalone cases involved investment advisory issues, securities offerings, and issuer financial reporting and auditing. The Commission also brought actions involving market manipulation, insider trading and broker-dealers.

The Division of Enforcement also reported various recent initiatives, including the creation of its Cyber Unit, which will focus on cyber-related threats and violations involving distributed ledger technologies and ICOs.

### Biotech company and executives charged with overstating revenue

A biotech company agreed to [settle](#) charges that it materially overstated revenue for a period of nearly two years, which it ultimately restated.

According to the SEC complaint, the company and its former executives entered into undisclosed side agreements with distributors, violated its disclosed accounting policies for recognizing revenue, lied to its independent auditors and backdated and falsified sales documents. For example, the company recognized revenue in periods before sales had been made and critical agreement terms were finalized, and on consignment inventory before the products had been used in a surgical procedure. The company agreed to pay a \$1.5 million penalty, without admitting or denying the charges. The case involving the former executives remains pending.

### Mining company and executives charged with overstating assets

A mining company and two former executives were [charged](#) by the SEC with overstating the value of assets acquired for \$3.7 billion and later sold for \$50 million.

According to the SEC complaint, the foreign private issuer and its former executives allegedly failed to properly disclose the nature of the setbacks suffered shortly after the acquisition of the assets and failed to initiate a timely impairment analysis to determine the correct carrying value of the assets. The defendants allegedly concealed the adverse developments from the board of directors, audit committee, independent auditors and investors, according to the complaint. The matter is pending in federal court.

## What's next at the SEC?

Now that the two vacant seats on the Commission have been filled, we expect the SEC to pursue additional rulemaking related to disclosures required by Regulations S-X and S-K and to change the definition of a smaller reporting company to increase the number of issuers that qualify.

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