

2021 AICPA & CIMA Conference on Current SEC and PCAOB Developments

Compendium of significant accounting and reporting issues

In this issue:

Summary.....	1
Remarks by SEC Acting Chief Accountant and senior staff on SEC priorities.....	2
Climate change disclosures and other ESG matters.....	2
Materiality in error corrections.....	3
Special purpose acquisition company transactions.....	4
Developments related to the Holding Foreign Companies Accountable Act.....	5
Remarks by FASB Chairman Richard R. Jones on FASB focus areas.....	6
Accounting and disclosure matters.....	7
Revenue recognition.....	7
Digital assets.....	8
Temporary versus permanent equity classification of SPAC shares.....	9
Other accounting matters.....	9
SEC regulatory update.....	10
Division of Corporation Finance overview.....	10
SEC comment letter topics and other focus areas.....	10
Division of Corporation Finance practice matters.....	12
Remarks from the SEC Division of Enforcement staff.....	14
International matters.....	15
Audit matters.....	15
Auditor independence.....	15
Evolution of data and technology..	16
PCAOB standard-setting update ...	16
PCAOB inspections and enforcement matters.....	17
Appendix – Conference speeches ..	19

Summary

Regulators and standard setters discussed a broad range of financial reporting topics and emerging issues last week at the annual AICPA & CIMA¹ Conference on Current SEC and PCAOB Developments (Conference), which was held in person in Washington, DC, and virtually.

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

The theme of the Conference was how regulators, standard setters, preparers and auditors can provide investors with high-quality, decision-useful financial information. “Each stakeholder should constantly reassess its areas of focus in light of changing priorities, evolving investor needs and updates to standards, rules and regulations,” said SEC Acting Chief Accountant Paul Munter.

Highlights included:

Environmental, social and governance matters – SEC officials reminded companies of the Commission’s 2010 climate change guidance, indicating that the SEC staff will continue to review issuers’ climate-related disclosures while rulemaking is underway. The SEC staff expects companies to consider the 2010 guidance and its recently published sample comment letter on climate-change-related disclosures in their year-end reporting.

Materiality in error corrections – SEC officials emphasized that the evaluation of materiality requires an objective evaluation of the total mix of information and that the more quantitatively significant an error becomes, the more difficult it is for qualitative factors to overcome that fact. They also reminded preparers and auditors that when a material accounting error is identified, it is a high hurdle to conclude that a material weakness does not exist, and that a registrant could have errors that are quantitatively small but material due to qualitative factors.

Revenue recognition – The SEC staff said that revenue recognition continues to be a frequent topic of consultations, especially in areas such as principal versus agent considerations, identification of performance obligations and consideration payable to a customer. The staff discussed some challenges in applying the guidance in fact patterns involving technology companies, including platform business models.

LIBOR – The SEC staff issued a **statement** during the Conference encouraging companies to provide robust disclosures about how they are affected by the transition away from the London Interbank Offered Rate (LIBOR). The FASB staff said it is evaluating alternatives to extend the relief provided in Accounting Standards Codification (ASC) 848, *Reference Rate Reform*, because the cessation date for several major USD LIBOR tenors has been pushed back to 30 June 2023.

Audit matters – SEC officials stressed the importance of auditor independence and compliance with the Commission's independence rules, particularly the general standard of auditor independence. PCAOB staff members provided an update on the PCAOB's standard-setting projects and discussed the inspection outlook for 2022. The timing and prioritization of PCAOB projects are expected to be reassessed once the remaining PCAOB members who were appointed in November begin their terms.

Remarks by SEC Acting Chief Accountant and senior staff on SEC priorities

SEC Acting Chief Accountant Paul Munter shared his views on the priorities and focus areas of the SEC's Office of the Chief Accountant (OCA).

He emphasized that high-quality accounting standards, the application of those standards and high-quality audits are key elements in delivering decision-useful information to investors. He noted that the SEC's oversight of the FASB and PCAOB accounting and auditing standard-setting processes is a vital element of creating high-quality standards.

Mr. Munter noted that robust stakeholder outreach continues to be a priority for OCA, including understanding stakeholder concerns and engaging specifically with investors to address their changing needs. He said that the SEC staff engages with stakeholders in several ways, including through its consultation process.

Mr. Munter also highlighted the importance of international engagement, stating that one-sixth of US investor portfolios are invested internationally.

In addition, Mr. Munter issued a **public statement** summarizing OCA's priorities, including many of the topics discussed at the Conference.

Ernst & Young LLP resources

- ▶ Technical Line, [Revisiting the SEC's guidance on climate change disclosures in today's environment](#)

Climate change disclosures and other ESG matters

SEC staff members discussed a number of issues related to climate change and other environmental, social and governance (ESG) matters, including the rule proposal the staff is developing that would require climate risk disclosures and key reminders for registrants about year-end reporting.

Mr. Munter said that the SEC staff is considering various resources in developing a proposal to require climate risk disclosures, including:

- ▶ Letters from individuals and entities in response to the SEC's **request** for public comment on how it can best regulate climate change disclosures
- ▶ Results of the SEC staff's review of public companies' compliance with the Commission's **2010 climate change guidance**

Mr. Munter noted that SEC Chair Gary Gensler described the factors he asked the SEC staff to consider in developing a recommendation (e.g., the location of the disclosures, the need for industry-specific metrics) in a [speech](#) in July 2021.

With rulemaking on climate change underway, officials in both OCA and the Division of Corporation Finance (DCF) emphasized the importance of the 2010 guidance, which addresses various types of disclosures the SEC expects companies to make under existing rules. Renee Jones, Director of the SEC's DCF, added that companies should consider the [sample comment letter](#) DCF posted on the SEC website as an illustration of the types of comments the SEC staff may issue to companies regarding climate disclosures as they prepare their year-end disclosures.

Mr. Munter also noted that the SEC is engaging with global standard setters through its participation in the IFRS Foundation Monitoring Board. Now that the International Sustainability Standards Board (ISSB) has been created to develop a comprehensive global baseline for sustainability disclosure standards, Mr. Munter said the SEC will monitor its international activities closely.

In addition, Ms. Jones said that rulemaking activities for disclosures of other ESG matters (e.g., board diversity, human capital, cybersecurity risk governance) are also in progress.

How we see it

In addition to considering the SEC's 2010 guidance on climate disclosures and the sample comment letter, companies should consider the intersection of ESG matters with financial accounting standards, specifically how an entity may apply current accounting standards to material ESG matters. In particular, companies should consider whether their environmental goals and commitments would affect recognition, measurement or disclosure in the financial statements. We recommend that companies revisit the [FASB Staff Educational Paper](#) before preparing their 2021 annual reports.

Materiality in error corrections

Mr. Munter highlighted the importance of maintaining objectivity when evaluating the materiality of errors identified in historical financial statements and how those errors should be corrected (i.e., whether they should be corrected by restating and reissuing the prior-period financial statements and filing a Form 8-K to communicate the previously issued reports can no longer be relied on in what is known as a "Big R" restatement, by revising the comparative financial statements to correct and disclose the error in the current period in what is known as a "little r" restatement, or just correcting the error in the current-period financial statements because it is immaterial).

Mr. Munter emphasized that when applying Staff Accounting Bulletin (SAB) Topic 1.M, *Materiality*, management should judiciously evaluate the total mix of information, and consider all relevant quantitative and qualitative factors, when determining whether an error is material to investors and other users of the financial statements. Mr. Munter noted that the more quantitatively significant an error becomes, the more difficult it is to use qualitative factors to overcome a conclusion that the error is material and that a "Big R" restatement is warranted.

Mr. Munter said the number of "little r" restatements as a percentage of total restatements has increased significantly over the past 10 years or so. He noted that in a number of recent consultations, the SEC staff objected to registrants' conclusions that a quantitatively significant error, corrected as part of a "little r" restatement, was not material to the prior-period financial statements. In those cases, he said, the staff considered the registrant's facts and circumstances and concluded that there was an insufficient basis to assert that the error was not material to the prior-period financial statements.

Mr. Munter reminded registrants of the importance of the framework in SAB Topic 1.M, specifically the fact that a registrant could have errors that are quantitatively small but material due to qualitative factors.

Lindsay McCord, Chief Accountant in DCF, provided additional insight on how the staff approaches reviews of registrants' materiality analysis through examples of current-year comments. In one example, the staff found that the qualitative factors were not enough to overcome the magnitude of the quantitative error in net income. Several of the qualitative factors cited by the registrant in its materiality analysis reflected its contention that an error in previously issued financial statements is no longer material once a more recent set of financial statements is issued (i.e., a "passage of time" argument). Ms. McCord noted that this view assumes investors are solely focused on current financial results instead of on both historical and current financial statements. She also observed that some investors consider a registrant's history of discovering and correcting accounting errors an indicator of the reliability of the current financial results.

Ms. McCord also discussed the evaluation of the materiality of an equity classification error involving shares of a special purpose acquisition company (SPAC) where the staff objected to a registrant's conclusion that the classification error did not represent a "Big R" restatement. She reiterated that the materiality determination is an analysis based on facts and circumstances, and there is no one-size-fits-all conclusion for all fact patterns.

Mr. Munter also highlighted the importance of maintaining objectivity when identifying and communicating material weaknesses in internal control over financial reporting (ICFR). He noted that when evaluating control deficiencies related to errors, it is often difficult to support an assertion that a material weakness in ICFR does not exist when there is a material accounting error. Ms. McCord further reminded preparers that when evaluating the severity of a control deficiency resulting in an immaterial error, they must also consider the likelihood that a material misstatement may not have been prevented or detected on a timely basis.

How we see it

The SEC staff members' comments reinforce the concepts in existing guidance in SAB Topic 1.M, and are consistent with our expectation that it is often difficult to conclude that quantitatively large errors are immaterial based on qualitative factors. In addition, those comments reinforce the staff's belief that qualitative factors should not be overlooked in materiality analyses when the identified error is quantitatively small.

We expect the SEC staff to increase its scrutiny of registrants' evaluations of errors and how they correct those errors in the financial statements. We encourage entities to objectively and carefully consider their facts and circumstances in determining whether a quantitatively significant error is overcome through qualitative factors, as well as whether a quantitatively small error is material based on qualitative factors.

Ernst & Young LLP resources

- ▶ Technical Line, [Navigating the requirements for merging with a special purpose acquisition company](#)

Special purpose acquisition company transactions

Ms. Jones noted the significant increase in both traditional and SPAC initial public offerings (IPOs) this year and said SPAC transactions continue to be a focus area for DCF. She emphasized the importance of disclosures of the financial incentives of the SPAC sponsor to complete the transaction, including potential conflicts of interest, and the risks to shareholders who continue to hold shares after the SPAC merges with an operating company.

John Vanosdall, Deputy Chief Accountant in OCA, said that the SEC staff conducted a significant number of consultations this year because of robust capital-raising activity in the marketplace, including SPAC mergers. He said operating companies that merge with SPACs often encounter complex accounting and financial reporting issues related to both the merger and the complex financial instruments that were originally issued by the SPAC. Kevin Vaughn, Senior Associate Chief Accountant in OCA, noted that a number of these consultations involved debt and equity accounting. He added that debt and equity accounting matters require a careful consideration of the facts and circumstances of the entity and the instrument.

Mr. Vanosdall referred to the SEC staff **statement** earlier this year on the accounting for warrants issued by SPACs and observed that in both of the fact patterns addressed in the statement, the provisions of the contracts and the company's facts and circumstances led the SEC staff to conclude that the warrants should be classified as liabilities rather than equity under US GAAP.

However, Mr. Vaughn noted that since the statement was released, the SEC staff has evaluated other fact patterns and has not objected to the conclusion that certain warrants could be classified in equity. Mr. Vanosdall said the SEC staff has conducted consultations on a wide range of other issues involving SPACs, including issues related to warrant accounting and earnings per share (EPS), temporary versus permanent equity classification, compensation, business combination accounting and derivatives.

Diana Stoltzfus, Deputy Chief Accountant in OCA, said it is imperative for operating companies that merge with SPACs to have a comprehensive plan to address the demands of being a public company. Such demands include matters that relate to financial reporting, ICFR, audits and auditor independence. Ms. Stoltzfus also shared her view that it is essential for the combined public company to have an experienced audit committee and management team capable of overseeing various functions such as audit, tax and governance to meet investor needs.

Developments related to the Holding Foreign Companies Accountable Act

Mr. Munter discussed the SEC's recent **amendments** to finalize rules that implement the submission and disclosure requirements of the Holding Foreign Companies Accountable Act (HFCAA). These rules apply to registrants the SEC identifies as having filed an annual report with an audit report issued by a registered public accounting firm located in a foreign jurisdiction where the PCAOB determines, in accordance with the HFCAA, that it is unable to inspect or investigate completely.

Under the new rules, if the PCAOB is unable to inspect or investigate completely the registered public accounting firm for three consecutive years, the SEC is required to suspend trading of the issuer's securities. Mr. Munter said he expects the PCAOB to make a determination on the jurisdictions in which it is unable to inspect or investigate completely "fairly soon." Further, Mr. Munter reminded auditors and issuers that 2021 will be the first reporting year to be considered under the three-year HFCAA timeline.

Ms. Jones also reiterated the importance of sufficient disclosures of the risks associated with investing in companies that use variable interest entity structures that introduce exposure to Chinese companies and the regulatory environment in China. Earlier this year, the SEC staff issued an **Investor Bulletin** to educate investors about these risks and Mr. Gensler issued a **statement** that discussed the types of disclosures he has asked the SEC staff to focus on related to these risks.

“
Responsibilities
are no different,
regardless of
how [companies]
come into the
public market.”

— Paul Munter,
SEC Acting Chief Accountant

Remarks by FASB Chairman Richard R. Jones on FASB focus areas

FASB Chairman Richard R. Jones said the key to the FASB's longevity is an independent, inclusive and thorough standard-setting process that has been finetuned over decades to use extensive outreach activities to obtain diverse stakeholder perspectives.

Mr. Jones said that the FASB conducted extensive stakeholder outreach before the invitation to comment on its agenda consultation project. The feedback received generally fell within the following areas:

- ▶ Providing more disaggregation of financial information
- ▶ Providing more guidance on emerging areas of accounting and financial reporting
- ▶ Reevaluating specific areas of US GAAP to reduce unnecessary costs and complexity
- ▶ Evaluating certain FASB standard-setting processes to identify enhancements that would increase transparency and communication

He said the FASB received over 500 responses to its **invitation to comment** on its agenda and is reviewing the feedback. He said the FASB will prioritize topics that can realistically be addressed. Mr. Jones shared the following common themes from responses related to the following two areas:

- ▶ **More disaggregation of financial information** – Mr. Jones said that, as expected, most investors communicated a desire for more granular financial information, while preparers did not favor more disaggregation due to the increased costs associated with providing such information. Mr. Jones noted the Board will continue to consider greater disaggregation of financial information while being mindful that more information doesn't necessarily equate to the most relevant information. He also noted that the Board must be careful not to add unnecessary costs and complexity into the system, which includes costs for all stakeholders, not just costs for preparers.
- ▶ **Reduce unnecessary costs and complexity** – Mr. Jones noted that stakeholders broadly supported reducing unnecessary complexity in financial reporting by reevaluating certain areas of existing US GAAP. He emphasized that such complexity affects all stakeholders, including investors, and said the FASB will focus on reducing it in areas that would benefit all stakeholders. Mr. Jones discussed the areas of unnecessary complexity for investors that were or are being addressed through the FASB's post-implementation review (PIR) process for its major standards on leases, credit losses and revenue recognition and said the FASB will remain engaged and responsive to stakeholders throughout the process:
 - ▶ Leases – The FASB issued Accounting Standards Update (ASU) 2021-05² to require lessors to classify certain leases with variable payments as operating leases in certain circumstances, effectively eliminating day-one losses that investors said did not faithfully represent the underlying economics of the lease.
 - ▶ Credit losses – The FASB proposed³ eliminating the troubled debt restructuring recognition and measurement guidance that stakeholders said is no longer relevant under the new credit losses standard and requiring vintage disclosures of current-year write-offs for financing receivables and net investments in leases. The FASB also added a project to its agenda to address the accounting for acquired financial assets.
 - ▶ Revenue recognition – The FASB issued ASU 2021-08⁴ to address the recognition and measurement of contract assets and contract liabilities related to revenue contracts with customers that are acquired in a business combination.

Mr. Jones noted that the FASB is developing new and more effective ways to interact with investors who are uniquely positioned to provide input that helps the FASB achieve its mission of establishing accounting and reporting standards that result in entities providing useful information. Mr. Jones indicated that to make the case for change, the FASB must be able to convey how and when an investor will use the information provided by proposed standards to influence its capital allocation decisions. Mr. Jones further emphasized the importance of continued involvement by all stakeholders in improving financial accounting and reporting standards and stated that “silence is the hardest thing to evaluate.”

Accounting and disclosure matters

Ernst & Young LLP resources

- ▶ Financial reporting developments, [Revenue from contracts with customers \(ASC 606\)](#)

Revenue recognition

The SEC’s Mr. Vanosdall said that revenue recognition under ASC 606, *Revenue from Contracts with Customers*, continues to be a frequent topic of consultations, specifically in areas such as principal versus agent considerations, identification of performance obligations and consideration payable to a customer. Many of the challenging areas, such as principal versus agent, arise in technology businesses, such as platform business models. Mr. Vanosdall noted that “the volume of these issues that still exist is an important indicator that there could be opportunities to enhance the guidance.”

Jonathan Wiggins, Senior Associate Chief Accountant in OCA, provided further observations from some recent consultations on revenue recognition under ASC 606.

Principal versus agent considerations

When more than one party is involved in providing goods or services to a customer, the standard requires an entity to determine whether it is a principal (i.e., it controls the promised good or service before transfer to the end consumer) or an agent in these transactions by evaluating the nature of its promise to the customer. As a reminder, a principal records revenue on a gross basis, and an agent records as revenue the net amount it retains for its agency service.

Mr. Wiggins said the SEC staff has conducted consultations in which a company has concluded that it is a principal primarily because it integrates goods or services from a third party with its own goods or services and sells the combined good or service to the end consumer. He said that when a company assesses whether it controls the combined good or service before transfer to the end consumer, it is helpful to determine the nature and significance of the integration service and to evaluate whether the company first controls the inputs to the combined good or service. That is, it may be unclear how a company could conclude that it is a principal if the integration service is not significant or it does not control the inputs to the combined good or service.

Mr. Wiggins also noted that the indicators of control in the principal versus agent analysis should support rather than replace the assessment of control and should not be assessed as a checklist without considering the nature and extent of the facts that support the control conclusion.

Consideration payable to a customer

Mr. Wiggins said that issues related to consideration payable to a customer usually arise when a company has concluded that it is acting as an agent in providing a good or service to end consumers and provides incentives to one or more parties in the arrangement. As a reminder, ASC 606 requires consideration payable to a customer to be accounted for as a reduction of revenue unless the payment is for a distinct good or service from the customer. Determining whether incentives paid by an agent are within the scope of ASC 606’s guidance for consideration payable to a customer often requires significant judgment because the company needs to determine the nature of its promise and identify its customer(s) through a detailed analysis of the arrangement.

Mr. Wiggins said that it is important to consider whether the company has a single customer or multiple customers. He said that in very specific, limited fact patterns, the staff has not objected to a company that is acting as an agent concluding that it has a single customer (e.g., the seller) and recognizing incentives to the end consumer (i.e., not the company's customer) as a marketing expense, rather than as a reduction of revenue. However, he noted that the staff has objected to this conclusion in other fact patterns. Mr. Wiggins said that when determining whether incentive payments should be recorded as a reduction of revenue, it is important to consider whether the company has a contractual or an implied obligation to provide incentives to the end consumer on the seller's behalf. He said this includes assessing whether a company is, in substance, providing a price concession to the seller. For example, a company would consider whether "the seller would have a valid expectation that the company would provide incentives to the end user," Mr. Wiggins said.

How we see it

In our [response](#) to the FASB's Invitation to Comment on its technical agenda, we asked the Board to prioritize reevaluating the principal versus agent guidance. We noted this guidance at times is not clear, and as a result, companies with the same or similar fact patterns can reach different conclusions.

We also noted that the identification of an entity's customer or customers can be complex, and entities with seemingly similar fact patterns can reach different conclusions. We observed that technology platform companies may encounter challenges in appropriately classifying their incentive payments to end consumers (i.e., as contra revenue or sales and marketing expense), particularly when the end consumers are not their customers.

Ernst & Young LLP resources

- ▶ Technical Line, [A holder's accounting for cryptocurrencies](#)

Digital assets

Mr. Vanosdall said that under US GAAP, digital assets that are not considered securities or otherwise subject to specialized accounting guidance will likely be accounted for as intangible assets.

Building on that theme, Mr. Vaughn said the SEC staff concluded in a handful of consultations that digital assets that are intangible assets under US GAAP must be accounted for in accordance with the intangible asset model. The registrants in those consultations had acknowledged that their digital assets met the definition of an intangible asset but had nevertheless proposed a range of other accounting models. However, he acknowledged that not all digital assets are the same, and registrants will need to consider the characteristics and rights and obligations associated with the digital assets that they transact in to determine the appropriate accounting.

Hillary Salo, FASB Technical Director and Emerging Issues Task Force Chair, said stakeholders expressed a lot of interest in the FASB taking on a project on digital assets, including cryptocurrency, as part of the FASB's 2021 agenda consultation process. She said the FASB is still evaluating the comments and determining whether to add a project to its agenda. If it does, Ms. Salo said that determining the scope of the project would be critical because digital assets are not all alike.

How we see it

In our [response](#) to the FASB's Invitation to Comment on its technical agenda, we observed that some stakeholders would support a narrow-scope project to provide an option to apply a fair value measurement for digital assets that have certain characteristics and are traded in active markets. We believe such a project would be achievable in the near term and would meet the needs of many users.

Temporary versus permanent equity classification of SPAC shares

Mr. Vaughn noted that under SEC staff guidance,⁵ if an equity-classified instrument could be redeemed for cash upon the occurrence of an event outside the company's control, that instrument is required to be classified outside of permanent equity. This classification is commonly referred to as temporary equity or mezzanine equity.

Mr. Vaughn noted that SPACs are formed with the intent and business purpose of effecting a business combination with a target company. As a result, one of two things will happen within a set period of time: (1) the SPAC will find a target and effect a business combination, or (2) the SPAC will not find a target and will dissolve. He noted that in a typical SPAC structure, certain shares issued by the SPAC will become redeemable in either situation. Therefore, registrants have appropriately concluded that these shares are required to be classified as temporary equity.

Mr. Vaughn discussed a recent consultation in which a SPAC had not classified all shares of a particular class of redeemable shares as temporary equity. The registrant had concluded that because of a provision in its charter that stated that redemptions would not occur if they would cause the company's tangible assets to decline below a certain threshold, a portion of the shares could be classified in permanent equity. The registrant also said its conclusion was justified because the unit of account was the pool of shares and not the individual share.

The SEC staff objected to the registrant's conclusion and did not agree that there was a basis under US GAAP or SEC guidance to consider the pool of the class of shares as the unit of account instead of each individual share. Therefore, each share was required to be presented outside of permanent equity.

Other accounting matters

Staff Accounting Bulletin 120

Mr. Wiggins noted that the SEC staff recently issued **SAB 120** on the measurement of share-based payment awards that are granted when a company possesses material nonpublic information.

Mr. Wiggins said these "spring-loaded" awards raise a number of legal, governance and financial reporting concerns. The SAB says companies must consider the impact of an anticipated announcement of material, nonpublic information on the fair value of these share-based payment awards, and adjustments to inputs used to determine that fair value may be necessary. The SAB also highlights the staff's expectations about disclosures.

In response to a question about the scope of the SAB, Mr. Vanosdall said that while spring-loaded awards can be granted as part of a routine or non-routine grant, a grant made on a one-time basis when the company is in possession of material, nonpublic information may merit more scrutiny. Mr. Vanosdall also highlighted the importance of ICFR and governance practices related to spring-loaded awards.

Tax legislation

The SEC staff is actively monitoring developments in tax legislation and does not anticipate that any changes that may be enacted will be as significant as the changes that resulted from the 2017 Tax Cuts and Jobs Act (TCJA). Mr. Vanosdall reminded registrants of the general requirement of ASC 740, *Income Taxes*, to account for changes in income tax laws in the period that includes the enactment date. He noted that the relief provided in **SAB 118** applies only to the TCJA and wouldn't apply to any new tax legislation. He encouraged registrants to continue to monitor developments in this area.

Reference rate reform

Mr. Vanosdall said the transition away from LIBOR remains a top priority for the SEC staff. He further noted that the Division of Examinations included the LIBOR transition on its list of examination priorities in 2021 while DCF continues to closely monitor disclosures in this area.

Ms. McCord noted that the SEC staff issued a **statement** during the Conference encouraging companies to provide robust disclosures about the LIBOR transition. The statement says disclosures should be detailed and specific rather than general statements about the progress of a registrant's transition efforts and should become more robust as registrants approach the transition date. Rates for some USD LIBOR tenors will be discontinued on 31 December 2021, but others will be available until 30 June 2023.

Ms. Salo said the FASB staff continues to monitor developments in the market related to the LIBOR transition and is currently evaluating alternatives to extend the relief provided in ASC 848 since the cessation date for several major USD LIBOR tenors has been pushed back to 30 June 2023. The current sunset date for ASC 848 is 31 December 2022.

SEC regulatory update

Division of Corporation Finance overview

In addition to providing observations from the DCF's disclosure review program, Ms. Jones discussed SEC rulemaking. She noted that the SEC has proposed amendments to the proxy rules, sought more feedback on its proposal that would require companies to claw back incentive compensation if there is a restatement, and adopted new rules for universal proxy cards and the implementation of the HFCAA. She also noted that the DCF staff is working on recommendations for rule proposals on disclosures relating to climate risk and other ESG matters. Ms. Jones also said that the DCF staff is considering possible rulemaking related to SPAC transactions to address concerns that SPAC sponsors' financial incentives aren't adequately disclosed.

Following the conversation with Ms. Jones, other SEC staff members discussed trends in comment letters that DCF has issued to registrants about their filings and other practice matters.

SEC comment letter topics and other focus areas

Non-GAAP measures and metrics

Sarah Lowe, Deputy Chief Accountant in DCF, noted that while the rules and guidance on the use of non-GAAP measures have changed very little in recent years, non-GAAP measures continue to be a frequent topic in SEC staff comment letters. She highlighted examples related to the prominence and labeling of non-GAAP measures on which the staff has commented in the last year, including when it observed:

- ▶ A discussion of non-GAAP results that excluded GAAP results or overshadowed them
- ▶ A presentation of a full non-GAAP income statement
- ▶ A reconciliation that does not start with the most directly comparable GAAP measure

Ms. Lowe discussed the importance of clearly labeling and describing non-GAAP measures and related adjustments in sufficient detail for an investor to understand all material components. She also said that labeling a contribution margin, or non-GAAP gross margin measure, as net revenue would be an example of "mislabeling" because the title of the measure does not match its description.

The LIBOR transition remains a top priority for the SEC staff.

Ernst & Young LLP resources

- ▶ [SEC Reporting Update – Highlights of trends in 2021 SEC Comment Letters](#)
- ▶ To the Point, [SEC issues guidance on disclosures about key performance indicators and other metrics in MD&A](#)
- ▶ Technical Line, [A closer look at the SEC staff's scrutiny of non-GAAP financial measures](#)
- ▶ Financial reporting developments, [Segment reporting](#)

Ms. Lowe also noted the uptick in comments the SEC staff has issued related to registrants' disclosures of key financial and nonfinancial metrics in their descriptions of the performance of their businesses. When a registrant uses a key metric to discuss operating results in management's discussion and analysis (MD&A), the following additional disclosures should accompany the metric:

- ▶ A clear definition of the metric and how it is calculated
- ▶ A statement indicating the reasons why the metric provides useful information to investors
- ▶ A statement indicating how management uses the metric in managing or monitoring the performance of the business

Ms. Lowe reminded registrants to review both the non-GAAP rules and guidance and the **Commission's guidance** on key performance indicators and other metrics when preparing their filings to make sure that they are appropriately classifying the information disclosed (i.e., as a non-GAAP measure or a metric) and following the appropriate guidance on presentation and disclosures. Ms. Lowe also encouraged registrants to think comprehensively about the information they are providing to investors and consider whether it would be appropriate to include in SEC filings the metrics used outside of their filings (e.g., in earnings calls, in investor presentations).

Ms. Lowe also said it is important for registrants to maintain effective controls and procedures over disclosure of non-GAAP measures and other metrics.

Segments

Melissa Rocha, Deputy Chief Accountant in DCF, said the SEC staff continues to focus on segment reporting and how registrants apply the guidance in ASC 280, *Segment Reporting*, and IFRS 8, *Operating Segments*. The areas of focus by the SEC staff include:

- ▶ How registrants identify operating segments
- ▶ How registrants aggregate operating segments into reportable segments
- ▶ Whether registrants have inappropriately included non-GAAP measures in their segment disclosures
- ▶ Whether registrants provide appropriate entity-wide disclosures related to products and services, revenues attributable to individual foreign countries and revenues from major customers

She indicated that when reviewing registrants' segment reporting, the SEC staff considers all publicly available information. This could include information in the registrant's public filings, as well as information available from a registrant's earnings calls, website, and industry or analyst presentations.

Ms. Rocha also said that the staff has observed companies presenting multiple measures of segment profit or loss in the notes to their financial statements and is likely to comment when that is the case.

Mr. Vaughn also provided reminders on segment disclosures. He noted that the management approach is a fundamental concept in ASC 280, and companies should carefully consider all information that the chief operating decision maker (CODM) uses on a regular basis, including any changes to that information based on changes in the business.

Disaggregation of revenue and presentation of gross profit

Ms. Lowe said the SEC staff continues to ask registrants for information supporting their conclusions on the appropriate presentation of revenue and cost of sales in the income statement. Specifically, the staff focuses on the proper disaggregation of revenue in accordance with Rule 5-03(b)(1) of Regulation S-X and the improper presentation of gross profit when depreciation and amortization have been excluded from cost of sales. Under SAB Topic 11.B, *Depreciation and Depletion Excluded from Cost of Sales*, depreciation and amortization may be excluded from cost of sales if the line item clearly discloses its exclusion and the income statement does not include gross profit. She noted that if both cost of product and cost of service line items are presented, the DCF staff expects the disclosure of depreciation and amortization related to each type of cost of revenue.

Ms. Rocha also said that the SEC staff may request additional information about technology costs, particularly whether such costs should be classified as costs of revenue. She noted that these costs may be especially significant for technology platform companies and may include costs to maintain or enhance the company's platform or technology products or services. She emphasized that a company's description of its technology investments should be consistent with its income statement presentation.

Division of Corporation Finance practice matters

Amendments to rules on disclosures about significant business acquisitions and disposals

Craig Olinger, Senior Advisor to Ms. McCord, discussed a variety of practice issues related to recent amendments to SEC rules on financial disclosures about significant acquisitions and disposals of businesses and real estate operations.

Mr. Olinger clarified several points on how to calculate significance, including:

- ▶ The average aggregate worldwide market value of a registrant's voting and non-voting common equity (WWMV) used in the investment test should include only classes of common equity that are publicly traded. For example, non-traded common shares that are exchangeable into traded common shares should be excluded. Further, the SEC staff has denied requests to use an alternative calculation when a company has a multi-class equity structure.
- ▶ A registrant must use its WWMV in the investment test if WWMV is available, even if the entity was not publicly traded as of the most recent pre-acquisition fiscal year-end (i.e., the annual financial statement period used for the asset and income tests).
- ▶ When a registrant files a new annual report on Form 10-K after completing the acquisition of a business but before the Rule 3-05 financial statements would be required to be filed in a Form 8-K, it can continue to choose to use the most recent audited financial statements on file and does not have to obtain more recent financial statements for the acquired business for purposes of performing the significance tests.
- ▶ When performing the income test for the purposes of applying Regulation S-X Rules 3-09 and 4-08(g) for an investment accounted for under the fair value option, a registrant:
 - ▶ Should continue to apply Section 2435 of the DCF Financial Reporting Manual (FRM) to calculate the income component (i.e., the numerator should be computed using the change in the fair value reflected in the registrant's statement of comprehensive income)
 - ▶ Should compute the numerator for the revenue component using the registrant's proportionate share of the investee's revenue as if the equity method of accounting had been applied

Ernst & Young LLP resources

- ▶ Technical Line, [*Applying the SEC's new requirements for significant acquired businesses*](#)
- ▶ SEC Reporting Series, [*2021 Pro forma financial information – A guide for applying Article 11 of Regulation S-X*](#)

Mr. Olinger also said that when a registrant prepares pro forma financial information for a spin-off transaction, it should carefully differentiate between autonomous entity adjustments, which are required, and management adjustments, which are not required and can only appear in the explanatory notes.

Specifically, changes in the spun-off entity's costs that are not evidenced by agreements such as new lease arrangements or transaction service arrangements should be evaluated carefully and would ordinarily not be reflected as autonomous entity adjustments, but they may be synergies or dis-synergies reflected as management's adjustments. Mr. Olinger also emphasized that management must have a reasonable basis for each management adjustment, and all adjustments that meet the requirement of being "necessary to a fair statement of the pro forma information presented" must be included. In addition, a registrant must state in its disclosure that all such adjustments are included.

Lastly, Mr. Olinger said that the DCF staff is currently working on updating the FRM to reflect recent amendments to Regulation S-X. In the meantime, companies should consult with their advisers before applying any potentially outdated guidance in the FRM. He also said the DCF staff is available to address any interpretive questions related to the amended rules.

Ernst & Young LLP resources

- ▶ SEC Reporting Series, [2021 SEC annual reports – Form 10-K](#)
- ▶ To the Point, [SEC eliminates certain MD&A requirements and revises others to make disclosures more useful](#)

Amendments to MD&A requirements in Regulation S-K

Ms. McCord discussed implementation issues related to amendments to Item 303 of Regulation S-K, which modernized and simplified the MD&A requirements. She said the extent of changes a registrant needs to make to its MD&A will depend on how the registrant previously applied SEC interpretive guidance. Ms. McCord emphasized that registrants are still required to provide disclosures that are material to investors. For example, she said the elimination of the requirement to provide a contractual obligations table should not result in a loss of material information to investors because registrants are required to provide much of that information in their liquidity and capital resource disclosures.

How we see it

We believe that many registrants' current MD&A disclosures generally reflect the substance of the SEC's amendments. While registrants should carefully consider the impact of each change, we do not expect that many companies will need to make significant changes.

Ms. McCord also responded to a question about whether selected quarterly financial data under Item 302(a) of Regulation S-K would be required when a registrant loses emerging growth company (EGC) status and adopts accounting standards that were previously deferred under the EGC transition period accommodation. She pointed registrants to an example⁶ in the [adopting release](#) for the amendments to Regulation S-K that states a calendar year-end EGC that elects to apply ASC 842 for the full fiscal year in its 2022 Form 10-K and loses EGC status as of 31 December 2022 would have a retrospective change that requires an evaluation of materiality under Item 302(a), because the registrant would be required to adopt ASC 842 in the 2022 Form 10-K for both the full fiscal year and interim periods within that fiscal year.

Waiver requests associated with significance tests

Mr. Olinger said the SEC staff continues to receive relief requests from registrants to provide less information about acquisitions than is required by Rules 3-05 and 3-14. He emphasized that a measurement of the significance of an acquisition relative to the registrant should consider all relevant facts and circumstances, and an individual test result that is higher than the results from other tests is not automatically anomalous.

He also said companies requesting waivers from DCF associated with these rules should:

- ▶ Provide a complete background of the acquisition and be as transparent as possible when describing all the relevant facts, including the circumstances leading up to an acquisition, the operations of the selling entity and the business acquired, details about the transaction structure, the types of assets acquired, and considerations given in determining the purchase price
- ▶ Provide all significance test calculations, explaining any inputs that are not straightforward and why the results are not reflective of the relative size of the acquisition
- ▶ Explain why the registrant believes the required financial information is not necessary or material to investors, and importantly, include information that the registrant proposes to present in lieu of the required financial information

Ms. McCord added that registrants should be specific in their waiver requests about all the filings and forms that the request is expected to apply because any relief provided is specific to those filings and forms. In addition, Ms. McCord reminded companies that while Rule 3-13 of Regulation S-X provides for the potential omission or substitution of certain financial statements, it does not give the SEC staff the ability to waive the timely filing requirement of a Form 8-K or any other required information.

Remarks from the SEC Division of Enforcement staff

Gurbir Grewal, Director of the SEC's Division of Enforcement, and Matthew Jacques, Chief Accountant in the SEC's Division of Enforcement, discussed the division's activities and highlighted recent enforcement actions involving accounting issues and disclosures.

Mr. Grewal said the division seeks to promote investor confidence through robust enforcement, penalties that deter bad behavior, and holding companies and individuals, including gatekeepers, accountable for their actions. He emphasized that the division staff is focused on emerging threats to financial reporting related to cryptocurrency, cybersecurity, SPACs and ESG disclosures.

Mr. Jacques said registrants should continue to consider the effects that the COVID-19 pandemic is having on financial reporting, ICFR, and disclosure controls and procedures (DCPs), including modifications to internal controls because of the remote working environment and how management is considering this in its annual ICFR and DCP assessments.

Mr. Grewal also said the EPS initiative, which uses risk-based data analytics to uncover potential accounting and disclosure violations caused by, among other things, earnings management practices, remains a focus and has resulted in enforcement actions.

Mr. Jacques and Mr. Grewal also highlighted recent enforcement actions, including those involving allegations of financial fraud and inaccurate issuer disclosure, including inappropriate evaluations of the effectiveness of ICFR and DCPs. They also discussed auditor-related enforcement matters, including one involving allegations related to independence requirements and others related to an alleged failure to complete critical audit procedures.

International matters

Dr. Andreas Barckow, Chair of the International Accounting Standards Board (IASB), discussed sustainability issues in financial reporting, the IASB's work program and convergence with the FASB.

With respect to sustainability, Dr. Barckow stated that issues such as climate change and other emerging risks are already covered by the existing requirements due to the principles-based nature of IFRS. He also spoke about the relationship between the IASB and the ISSB, which was created recently by the IFRS Foundation, highlighting the importance of the two boards working closely together to drive compatible reporting from the outset.

Dr. Barckow also highlighted three key IASB projects: primary financial statements; post-implementation reviews of IFRS 9, 10, 11 and 12; and goodwill and impairment. He said the IASB's future work will be guided by feedback from its latest agenda consultation. Potential new projects could include work on climate-related risks (including pollutant pricing mechanisms), cryptocurrencies and related transactions, going concern, intangible assets, and the statement of cash flows.

He also reflected on the IASB's work with the FASB and the boards' past convergence efforts. Looking forward, he observed that: "It is one thing getting converged standards. It is yet another to keep converged standards converged." He stated that he plans to work with the FASB chair to preserve the gains of the boards' past work on convergence for the benefit of investors around the globe.

In response, Mr. Jones said that he, the FASB staff and board members all regularly interact with the IASB to share ideas and feedback. He acknowledged that comparability is important to companies that compete globally and stated that each FASB member considers convergence as part of the cost-benefit analysis when evaluating whether to make a change in a standard.

Audit matters

Auditor independence

Ms. Stoltzfus said the SEC staff continues to receive questions related to the "look-back" period in the revised definition of the "audit and professional engagement period" in the October 2020 **amendments** to Rule 2-01 of Regulation S-X. Before the rule was amended, US domestic first-time filers had to comply with all aspects of the SEC's independence rules for all years in a filing for an IPO or SPAC transaction. In connection with the amendments, the rules were aligned with those for foreign private issuers, which require only the most recent fiscal year to comply with all aspects of the SEC's independence rules provided there has been full compliance with applicable independence standards in all prior periods in the filing.

Ms. Stoltzfus said the SEC staff believes that the "general standard of auditor independence" set forth in Rule 2-01(b) together with the four guiding principles laid out in the introductory text of Rule 2-01 apply to all periods presented in an initial registration statement. To illustrate the staff's view, she said that if an auditor were to perform certain bookkeeping or financial statement preparation services for a period that is presented in an initial registration statement, an independence violation of the general standard of auditor independence would exist even if those services were performed before the audit and professional engagement period.

The SEC staff also reminded registrants and auditors that the SEC independence rules do not employ a "threats and safeguards" model used by other independence regulatory regimes. Therefore, a conflict that that may be overcome under other regimes using such a model likely will not be possible under the SEC independence rules if the conflict causes a violation of the SEC's guiding principles.

“
If [a cybersecurity] breach impacts the financial reporting system, then most likely there's a deficiency in ICFR that would require evaluation.”

— Anita Doutt,
Senior Associate
Chief Accountant in OCA

Evolution of data and technology

Anita Doutt, Senior Associate Chief Accountant, said registrants will need to consider how changes in the use of technology in the financial reporting process, including the audit, impact their internal controls and evaluate whether any changes in internal control may require disclosure in accordance with Item 308(c) of Regulation S-K. The SEC staff also discussed evolving cybersecurity risks and highlighted the importance of determining whether a cybersecurity breach impacts an entity's financial reporting process or whether it is limited to other operational aspects of its business.

The SEC staff noted that auditors continue to invest in technology, which may lead to more automated auditing tools and techniques that provide auditors with greater transparency into the transactions under audit. Ms. Stoltzfus reminded auditors that the use of automated tools and techniques does not diminish the importance of the auditor's risk assessment. The SEC staff also reiterated that the PCAOB staff is currently assessing how technology-based tools are being used by registrants and auditors and whether there is a need for guidance or changes to the PCAOB auditing standards or other regulatory action.

PCAOB standard-setting update

Barbara Vanich, PCAOB Acting Chief Auditor, provided an update on the PCAOB's standard-setting projects and said the PCAOB staff continues to monitor emerging topics such as auditing cryptocurrency assets, going concern assessments and ESG matters to assess whether PCAOB staff guidance or other communications are needed.

Ms. Vanich also shared her view that the PCAOB staff has not observed deficiencies related to recently implemented auditing standards (e.g., critical audit matters, estimates and specialists) through its inspection process that would merit additional guidance in these areas. Ms. Vanich noted that the PCAOB staff plans to revisit the PCAOB's priorities when the remaining PCAOB members who were appointed in November are seated.

System of quality control and supervision of other auditors

Ms. Vanich said the PCAOB staff is working on a proposed standard on audit firms' systems of quality control that it plans to recommend to the PCAOB board members. She reminded auditors that most commenters on the PCAOB's 2019 [concept release](#) supported the risk-based approach and framework it laid out for audit firms' systems of quality control. Ms. Vanich added that the PCAOB staff is evaluating comments received in response to the PCAOB's second supplemental request for comment on its proposal on supervision of other auditors. The PCAOB staff intends to work with the new board to determine next steps.

Research projects

Ms. Vanich provided an update on the PCAOB's research agenda, which includes projects on audit evidence and firms' use of data and technology in the audit. With respect to the audit evidence project, Ms. Vanich reminded auditors that the PCAOB recently issued [staff guidance](#) that provides considerations that are intended to assist auditors with assessing the relevance and reliability of information from external sources. She said that the factors addressed in the staff guidance are not intended to be used as a checklist and that the PCAOB staff will continue to conduct outreach and assess what additional action, if any, might be needed.

Ms. Vanich said the PCAOB staff continues to monitor the use of technology in audits as part of its data and technology research project. Ms. Vanich pointed to two Spotlight publications issued in [May 2021](#) and [May 2020](#) that summarize the PCAOB staff's observations. Ms. Vanich said the PCAOB staff is currently focusing on the auditing standards on sampling and substantive analytical procedures and hopes to publish its observations in 2022.

PCAOB inspections and enforcement matters

George Botic, Director of the Division of Registration and Inspections (DRI) at the PCAOB, discussed the impact of the COVID-19 pandemic on the inspection process as well as observations from 2021 inspection activities and focus areas for inspections in 2022.

Mr. Botic highlighted the challenges posed by the COVID-19 pandemic and the emergence of new audit risks in 2021 such as supply chain disruptions, the increase in SPAC transactions and the changes in work environments, including high staff turnover at audit firms and the companies they audit. Despite an environment of perpetual change, Mr. Botic said, the fundamentals of auditing remain “the constant guiding principles that protect investors and that ensure the important work completed by auditors is reliable, accurate and of consistent high quality.”

2021 inspection highlights

Mr. Botic said the 2021 inspection cycle was “the first cycle where the effects of the COVID-19 pandemic were visible across the majority of audits selected.” He said the PCAOB inspected audits of companies in industries that experienced significant disruptions or risks related to the COVID-19 pandemic, including those in the transportation, entertainment and hospitality, manufacturing, retail, and commercial real estate industries, and audits of both SPACs and companies created in mergers with SPACs.

In light of the effects of the COVID-19 pandemic, Mr. Botic noted that inspections focused on areas such as impairment, going concern, allowance for loan losses and areas with increased risk of fraud. A target team of inspectors also focused on other audit areas including fraud procedures, going concern assessments, procedures over cash, interim reviews and SPAC mergers with operating companies.

Mr. Botic also said that in the 2021 cycle, DRI increased the percentage of random selections of audits for inspection and focused more often on non-traditional financial statement areas such as cash and cash equivalents. These changes were made to increase the unpredictability of PCAOB inspection activities.

Mr. Botic summarized areas of recurring deficiencies in inspections in 2021, including allowance for loan losses, business combinations, revenue, inventory and ICFR. Mr. Botic emphasized the importance of an audit firm’s system of quality control in client acceptance and management of the audit firm’s personnel, particularly given high staff turnover at many audit firms. He also noted the continued importance of audit firms’ compliance with the relevant PCAOB and SEC independence standards.

Inspection outlook for 2022

Mr. Botic said 2022 inspections will continue to focus on audit risks related to the current economic environment. This includes the increased number of IPOs, merger and acquisition activity, disruption in supply chains, SPAC activity, and the continued effect of the pandemic on certain industries. He noted that the PCAOB staff plans to engage with the new PCAOB Board members to incorporate their perspectives into 2022 inspection focus areas.

Mr. Botic also said inspections will likely focus on firm-wide risks, including the increase in staff turnover at audit firms and potential risks to a firm’s independence from the sale and delivery of non-audit services. He said the broker-dealer inspection program will likely emphasize audits of those responsible for the custody and control of customer funds and securities.

Mr. Botic also noted that a number of inspections outside the US are overdue because PCAOB inspectors haven’t been able to travel during the pandemic. “We are actively engaging with non-US regulators and audit firms to evaluate how these inspections can be scheduled and completed as quickly as possible while observing the parameters established by non-US regulators,” he said.

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As we approach the
20-year anniversary
of the Sarbanes
Oxley act becoming
law, the language
of that law begins
with the words,
and I quote, ‘to
protect investors.’

— George Botic,
Director of Division
of Registration and
Inspections at the PCAOB

How we see it

Global supply chain disruptions, the acceleration of technological transformation, employee turnover and other effects of the COVID-19 pandemic continue to impact the overall economic environment. Companies and their auditors need to consider whether such matters give rise to new or different financial reporting risks and whether changes to a company's system of internal control over financial reporting have occurred or whether changes are needed to mitigate such risks.

Enforcement matters

Patrick Bryan, Director of the Division of Enforcement and Investigations (DEI) at the PCAOB, discussed recent enforcement trends, notable enforcement matters and DEI priorities. He said DEI continues to prioritize audit violations that present risks to investors or threaten the PCAOB's regulatory process, as well as matters related to significant independence violations. Mr. Bryan noted that DEI expects to focus on impacts of the COVID-19 pandemic, including firms' potential failure to adapt to risks in the current environment and failure to implement appropriate systems of quality control. Mr. Bryan also highlighted recent enforcement matters brought against audit firms with operations in foreign countries, including Canada and Australia, relating primarily to alleged deficiencies in firms' quality control systems.

Endnotes:

- ¹ CIMA was added to the name of the conference this year to reflect the fact that the American Institute of Certified Public Accountants (AICPA) and the London-based Chartered Institute of Management Accountants (CIMA) have joined forces.
- ² ASU 2021-05, *Leases (Topic 842): Lessors – Certain Leases with Variable Lease Payments*.
- ³ Proposed Accounting Standards Update, *Financial Instruments – Credit Losses (Topic 326): Troubled Debt Restructurings and Vintage Disclosures*.
- ⁴ ASU 2021-08, *Business Combinations (Topic 805): Accounting for Contract Assets and Contract Liabilities from Contracts with Customers*.
- ⁵ ASC 480-10-S99-3A, *Distinguishing Liabilities from Equity – Overall – SEC Materials – SEC Staff Announcement: Classification and Measurement of Redeemable Securities*.
- ⁶ Release 33-10890, *Management's Discussion and Analysis, Selected Financial Data, and Supplementary Financial Information*, footnote 70.

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Appendix – Conference speeches

	Speech and link to source
SEC Acting Chief Accountant Paul Munter	▸ <u>Statement on OCA's Continued Focus on High Quality Financial Reporting in a Complex Environment</u>
FASB Chairman Richard Jones	▸ <u>Remarks of FASB Chair Richard R. Jones, AICPA & CIMA Conference on Current SEC and PCAOB Developments</u>
IASB Chair Andreas Barckow	▸ <u>Connectivity, core work and convergence – what next for IFRS Accounting Standards?</u>