Speech

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Wesley R. Bricker, Deputy Chief Accountant

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Introduction

Thank you for the kind introduction and invitation to speak at today's conference. Before I continue, let me remind you that the views expressed today are my own and not necessarily those of the Commission, the individual Commissioners, or other colleagues on the Commission staff.

Credible, reliable, and useful financial reporting for investors requires not only high-quality accounting and auditing standards but also robust application of those standards by management and auditors. Today, I would like to provide observations on the ongoing transition period activities for the new standards on revenue recognition and leases as well as the FASB's financial instruments' credit impairment proposal. I would also like to address certain non-GAAP reporting practices. Finally, I will comment on the important role of the PCAOB in promoting auditor attention on current and emerging financial reporting risks through its standard-setting, inspection, and other important programs.

Transition Period Activities

I expect the FASB will soon issue a standard for credit impairment of financial instruments.[1] If issued, the standard will join other recently issued guidance on revenue,[2] leases,[3] and financial instruments classification and measurement,[4] thereby completing the key priorities identified in the FASB and IASB's 2002 Memorandum of Understanding.[5] I commend the FASB and IASB's efforts to enhance the quality, consistency, and comparability of financial reporting across the globe through these standard setting activities.

To provide perspective on the magnitude of the transactions addressed by the new revenue and leasing standards, consider the following:

- In 2014, the S&P 1500 companies, which cover approximately 90% of the U.S. market capitalization, recognized revenue in their financial statements that sums to over $12.8 trillion.[6] The new revenue standard, when adopted by public companies as early as next year, will enhance the reporting and disclosures for the vast majority of those revenue transactions by providing comprehensive guidance that will apply across industries and registrants, whether domestic or foreign.

- For leases, the magnitude is also significant. In 2005, the SEC staff estimated the value of lease obligations of SEC registrants to total $1.25 trillion. Under the new standard, which permits early application and is effective in 2019 for calendar year-end public companies, these lease obligations and assets will be reported on the balance sheet.[7]

Given the pervasiveness of these changes, now is a good time for companies to focus on investor outreach and education so that investors can sufficiently understand the effect of the new standards on companies' financial reporting.[8] In that spirit, I would like to provide a few observations on steps investors might consider taking to gain an understanding of the new standards.

Understanding what is changing, why it is changing, and how

First, disclosure from management regarding what is changing, why it is changing, and how should be useful to investors. Take, for instance, revenue. Revenue is the starting point for performance measures such as operating income, net income, and EPS; for key analytical ratios such as margins, return on equity, and return on assets; and for valuation metrics such as revenue multiples and price-to-earnings. As a result, the new revenue standard has the potential to change not only the top line, but also the bottom line and analysis that depends on the financial statements.

While all industries and business models will likely be impacted to some degree by the new guidance, investors should pay particular attention to those companies with complex business models (such as those with long-term contracts or multiple performance obligations within a contract) since the new guidance could significantly impact the timing and amount of reported revenue.

Under the new five-step model, revenue is recognized when control of the good or service transfers from the seller to a customer. This model represents a shift from the current revenue recognition guidance which emphasizes the transfer of "risks and rewards," rather than control, as a criterion for recognition. For some companies, such as those with construction and production-type contracts, this control based model may impact the timing of revenue recognition as compared to current GAAP.

In attempting to understand how revenue recognition is changing, investors might want to consider some of the important building blocks of the model, such as the role and definition of a contract with a customer; identifying the portions of a contract that are important in the context of the standard (called performance obligations); understanding distinctions between transfers of control at a point in time or over a period of time; and the delineation between contract assets and accounts receivable. Investors will be better positioned to understand the reporting under the new guidance with a familiarity of these core reporting concepts.[9]

I also encourage investors to begin to understand the company-specific impacts of the new guidance. This understanding may include considering the following questions:

- Does the company have an implementation plan for adopting the new standards? If so, how will the audit committee monitor the company's progress of that implementation plan?
- What changes will be made to the company's accounting policies due to adoption of the new standards, and what is the potential impact of those changes on financial results and trends?
- How will the standards affect the company's corporate policies and practices, such as sales commissions, compensation plans, and contracting approaches?
- What are the income tax accounting implications of adopting the new standards?

While this list is clearly not all-inclusive, it underscores for management the importance of full and transparent communication with investors.

Understanding when it is changing

Investors may also want to understand when and how companies will transition into reporting under a given standard. For example, the new standard on financial instruments' classification and measurement permits, but does not require, early adoption of certain provisions of the standard. Further, some provisions should be applied by means of a cumulative-effect adjustment, while other provisions are only applied prospectively. On the other hand, the new revenue recognition standard provides companies with several transition options including full retrospective, retrospective with several available practical expedients, and cumulative catch up. For its part, the new lease standard also provides for a number of practical expedients that a company may apply upon transition. Understanding the transition options selected will inform comparisons of financial results within a company, from company to company, or across an industry.

Transition disclosures

Consistent with these comments, the SEC staff has long advised that a registrant should provide disclosures to investors of the impact that a recently issued accounting standard will have on its financial statements when that standard is adopted in a future period (so-called "transition disclosures").[10] Without adequate transition disclosures, investors may not be prepared to fully understand changes in the company's financial performance from one period to the next and the impact of adopting a new accounting standard. Investors should expect the level of disclosures to increase as companies make further progress in their implementation plans for adopting the new standards and, when necessary, engage with company management to understand these disclosures.

The importance of timely investor education and engagement is highlighted by examples from past adoptions of accounting standards when the transition goes well, and when it does not. For example, during the transition period for the FASB's standards on consolidation and transfers of financial assets, [11] certain financial institutions disclosed the anticipated impact of bringing substantial assets and liabilities back onto the balance sheet in multiple reporting periods leading up to the effective date without adverse market reaction attributed to the reporting in the first period of adoption.[12] By contrast, a change to the revenue recognition rules in 2010 resulted in one registrant reporting financial results that surpassed analyst expectations by billions of dollars. Although the registrant was simply complying with the new accounting rules, after-hours trading of its stock was temporarily halted in order to give investors time to digest the news.[13]

Transition Activities for Revenue Recognition

I'd now like to turn to a few additional transition matters specific to revenue recognition.

As companies apply the new revenue recognition standard to their specific revenue arrangements, interpretive questions may arise. The FASB's Revenue Transition Resource Group (TRG) has addressed a number of questions to date and I continue to encourage management, auditors, and others to refer interpretive issues to the TRG.

Application of the new standard also requires preparers to make judgments in financial reporting that will later be evaluated by auditors, regulators, and investors. An appropriate application of judgment will often identify and define the issue; gather the facts and information, including an understanding of the contractual terms and economic substance; perform the analysis and identify alternatives; reach a decision; and complete documentation and rationale for the conclusion.

The SEC staff will continue to respect well-reasoned, practical judgments when those judgments are grounded in the principles of the standard and considered the utility of the resulting information to investors. Conversely, aggressive interpretations that appear to be taken to achieve a specific outcome, such as preserving existing reporting, will not be well received, particularly when that outcome is inconsistent with the principles of the new standard.

Because of its importance, the SEC staff has been, and will likely continue to be, focused on the reporting of revenue arrangements and the related disclosures. I encourage consultation with OCA, particularly when:

- a registrant has unusual, complex, or innovative transactions for which no clear guidance exists, or
- a preparer finds that it is applying the guidance in a manner differently from the manner in which TRG members believed the guidance should be applied.

To date, OCA has consulted with registrants on various questions.

- One example addressed the application of the definition of a "contract" within Topic 606. While a future contract might appear to be likely or even compelled economically or by regulation, in the staff's view it would be inappropriate to recognize revenue for a contract before the contract exists with enforceable rights and obligations.
- OCA also addressed the contract combination guidance, noting the guidance in Topic 606 explicitly limits what contracts may be combined. The staff objected to a registrant's proposal to extend the contract combination guidance beyond contracts with the same customer or related parties of the same customer.
- Finally, OCA has also observed that the FASB did not intend to change practice with respect to the timing of loss recognition for those contracts in the scope of Topic 605-35 (as amended) and did not object to a registrant's proposal to continue to apply its current accounting policy for loss contracts.

I am also aware that registrants have expressed concern about the requirement to provide restated financial statements when a Form S-3 registration statement is filed after the registrant has filed its first Form 10-Q reflecting adoption of the revenue standard. This requirement to restate the financial statements means that companies that adopt the revenue standard under a full-retrospective transition approach would be required to restate an additional year in its Form S-3 to show the effect of the new revenue standard on that earlier period.[14]

While this issue is not specific to the new revenue standard, the pervasive impact of the new revenue standard amplifies the issue.

To this, I would observe the transition provisions in the new revenue standard reference existing GAAP, which provides for an impracticability exception to retrospective application if, for example, a company is unable to apply the requirement after making every reasonable effort to do so.[15] OCA is available for consultation if a registrant believes that, based on its facts and circumstances, a retrospective application of the new revenue recognition standard to all periods required to be presented in a Form S-3 is impracticable.

Credit Impairment on Financial Instruments

I'd like to move on now to the FASB's proposed standard on credit impairment on financial instruments. I am pleased that in making decisions to date about their proposal, the FASB has solicited and received broad input from investors, including at a recent credit impairment TRG meeting. I support the FASB's decision to establish a transition resource group to solicit, analyze, and discuss implementation issues that could arise when companies implement the upcoming credit impairment standard.[16]

If finalized as proposed, the standard would incorporate concepts that are consistent with the current guidance:

- First, the estimate should reflect management's best estimate. Management should be positioned to make a best estimate and communicate that estimate to users of the financial statements.
- Next, management is required to use all available information, without misusing or overlooking available information, when making their best estimate.
- Third, documentation and procedural discipline, including the identification of relevant data, assumptions, and methodologies, will be required to ensure that the estimate is adequately supported. The documentation and supporting evidence should be able to support review, validation, and audit of the estimate.

Many aspects of the Commission's existing guidance related to loan loss allowance methodology[17] will continue to be relevant under the new credit impairment standard. In evaluating the proposed accounting standard, management should focus in the first instance on the company's own requirements to make and keep books and records in reasonable detail and devise and maintain a sufficient system of internal accounting controls.

I have already heard some suggestions that management will need to look to their auditor to determine what processes are required. I find these suggestions troubling since management should be looking to the accounting standard, books and records, and internal control requirements rather than to auditors in the first instance to make their determinations. This approach should also facilitate the audit process and help avoid the perception that auditors are directing management's processes through the audit, which of course could lead to other questions around internal controls or auditor independence.

However, auditors will have a role in working through new applications of existing standards for auditing management's credit impairment estimates. I understand that the AICPA Depository Institutions Expert Panel is already evaluating the guidance, application questions and approaches, and illustrative examples.

OCA will continue to actively monitor those efforts, much like we have done with revenue recognition.

Non-GAAP Reporting

Now, I would like to spend a few minutes on non-GAAP measures. Recently, you may have heard concerns about non-GAAP measures from Chair White, Commissioners, Jim Schnurr, Keith Higgins, and others. Today, I would like to reiterate and add to those comments.

The Commission's original non-GAAP rules were adopted in 2003. Seven years later in 2010, the staff observed that while those rules had achieved substantial progress towards reducing the inappropriate use of non-GAAP measures, certain staff interpretive guidance had resulted in some unintended consequences. For example, certain measures that some argued would be useful were being effectively prohibited. In light of this, the staff guidance was revised in 2010 to avoid that result.[18]

Since those revisions, the Division of Corporation Finance has continued to issue comments concerning non-GAAP measures and, in some cases, has objected to certain measures. These comments have focused on a company's disclosure as to why their non-GAAP measures are useful;[19] apparent cherry picking adjustments within a non-GAAP measure; and adjustments to remove normal, cash operating expenses.

Recent examples of company practices related to non-GAAP measures have caused concern, including the use of individually-tailored accounting principles to calculate non-GAAP earnings; providing per share data for non-GAAP performance measures that look like liquidity measures; and non-GAAP tax expense. Recent examples of company practices related to operating metrics have also caused concern. I'll discuss the first of the non-GAAP examples now and Mark Kronforst, Chief Accountant in the Division of Corporation Finance, will discuss the other two, operating metrics, and other observations during our panel discussion.

On the use of individually-tailored accounting principles, consider a company that has a subscription-based business. The company bills for the full subscription at the outset, but since it will deliver over time, it earns and recognizes GAAP revenue over that same period. Now assume this company calculates non-GAAP revenue as though it had a different business. That is, it calculates what revenue it would have had, had it not sold a subscription, but rather had sold a product.

The effect of the measure is that the company accelerates revenue recognition to the billing date and proceeds to calculate earnings based on this non-GAAP revenue. At that point, this company's GAAP results are based on revenues recognized as the service is provided and the non-GAAP results are based on revenues that are merely billed to the customer.

In this instance, the measure does not appear to help investors understand and analyze core operating results. Rather, it is a replacement of an important accounting principle with an alternate accounting model that does not match the company's subscriptions business or earnings process, which is over time.

Revenue adjustments do more than just adjust from GAAP: they change the very starting point from which other performance analyses flow. As the staff monitors current practices and implementation of the new revenue standard, we will be looking to see if the reporting concepts within those standards are supplanted by any number of company-specific non-GAAP alternatives. For all of these reasons, if you present adjusted revenue, you will likely get a comment; moreover, you can expect the staff to look closely, and skeptically, at the explanation as to why the revenue adjustment is appropriate.

Before I move on, I think it's important to reiterate four points that have been made about non-GAAP measures in recent months.

- First, preparers should consider how their disclosure controls and procedures apply to the disclosure of non-GAAP measures.
- Second, despite the fact that GAAP measures sometimes gets forgotten once analysts and the press start commenting on a company's results, investors should refer back to a company's financial statements so that the non-GAAP measures are put into the proper context.
- Third, audit committees should be paying close attention to the non-GAAP measures a company presents, including the required related disclosures, and the processes it follows to consider both the appropriateness and reliability of the measures.[20]

- I also would note that Chair White has mentioned the possibility of future rulemaking in this area. [21]

In the meantime, the staff will be sharing its observations on non-GAAP measures in various forums. Obviously, if necessary, the staff will consider potential recommendations to the Commission for rulemaking in this area, but I hope companies will seize this opportunity to review their practices and make any necessary changes.

Importance of PCAOB Standard Setting and Attention to Emerging Risk

Let me conclude with a few observations on two areas on which the PCAOB is focused: improving its standard setting process and identifying and responding to emerging risks.

The PCAOB has been focused over the last year on improving its standard setting process to be more effective and efficient. I believe this process holds promise for more transparency into the work performed by the PCAOB, more opportunities for stakeholder input, and enhanced engagement by the PCAOB Board members throughout the standard setting process.

The PCAOB has acknowledged that it is already working on integrating some new tools from this review into its active standard-setting agenda. And indeed, the staff has already seen encouraging results from some of the initial changes. For example, after years of work and deliberations, last December the Board completed its transparency project under which audit firms will be required to disclose on a separate form filed with the PCAOB the name of the engagement partner and other significant participants in the audit. The final transparency rules adopted by the Board[22] are currently pending Commission action. In April, the Board approved a proposal to strengthen existing requirements and impose a more uniform approach to a lead auditor's supervision of other auditors.[23] In the next few months, you should see more consultation papers and proposals coming out of the PCAOB in other important areas, including a revised proposal for changes to the auditor’s reporting model. I encourage all of you, as stakeholders in the audit process, to pay attention to the PCAOB standard setting activity and respond to requests for comment from the PCAOB.

Another area of importance for the PCAOB’s focus is understanding and addressing, on a timely basis, the implications to audit quality of new and emerging risks. Such risks are inherent in the dynamic environment in which today’s public companies operate and include the impact of changes in technology and the growing use of big data on the manner in which audits are conducted. The continuously evolving accounting frameworks, including the new standards on revenue, leases, and classification and measurement, are one such risk. Other risks may emerge as a result of trends such as new business models, ever more complex transactions, and the continued global nature of business activities.

In order to preserve and, where necessary, strengthen the quality of independent audits in the years to come, it is essential to ensure that auditing standards are appropriately responsive to these developments. Similarly, it will be important to keep the PCAOB’s inspection program focused on those new and emerging risks.

Some of the ways the PCAOB is addressing this challenge is by focusing on the implementation of new standards and continuing to enhance its risk-based approach to inspections. In addition, the PCAOB is working with its inspectors and economists to explore ways to introduce an element of randomization into its inspections. Being less predictable could help facilitate more robust analysis of audit quality over time.

Closing

In closing, I look forward to working with the accounting profession as we collectively embark on this period of change and implementation. Preparers, auditors, audit committees, regulators, and standard setters all play a role in providing investors with high-quality, decision-useful information that allows for informed investment decisions and facilitates capital formation. While the magnitude and pervasiveness of the forthcoming changes are significant, I am confident that the profession can meet the challenge.

Thank you for your kind attention, and I look forward to discussing these matters further during our panel discussion.

[1] Proposed Accounting Standards Update, *Financial Instruments-Credit Losses (Subtopic 825-15).* See http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FNewsPage&cid=1176168101253.
[2] Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606).*
[3] *Accounting Standards Update No. 2016-02, Leases (Topic 842).*
[4] *Accounting Standards Update No. 2016-01, Financial Instruments-Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities.*
[5] *See "The Norwalk Agreement" available at http://www.fasb.org/jsp/FASB/Document_C/DocumentPage&cid=1218220086560.*
[6] *Amount represents total sales reported for fiscal year 2014 by the S&P 1500 index companies. See http://us.spindices.com/indices/equity/sp-composite-1500. This number does not reflect the impact of the new standard including, for instance, the potential recognition of revenue that is deferred under the current guidance.*
[7] *See Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers available at http://www.sec.gov/news/studies/soxoffbalancerpt.pdf as well as FASB Understanding Costs and Benefits, ASU: Leases (Topic 842) available at: http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176167901882.*
[8] *See New Revenue Recognition Accounting Standard: What Investors Need to Know (July 29, 2014) available at: https://blogs.cfainstitute.org/marketintegrity/2014/07/29/new-revenue-recognition-accounting-standard-what-investors-need-to-know/. On a 2014 CFA webcast on the new revenue recognition standard, 64% of participants indicated that they would pay greater attention to the standard in the 12-30 month period prior to the effective date.*
[9] *For additional information, see, for example, the FASB In Focus Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers (Topic 606) available at: http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176164075187.*
[10] *See SEC Staff Accounting Bulletin (SAB) No. 74 (Topic 11:M), Disclosure of the Impact that Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period.*
[11] *FASB Statement No. 167, Amendments to FASB Interpretation No. 46(R) which detailed changes to the consolidation model and Statement No. 166, Accounting for Transfers of Financial Assets, an amendment of FASB Statement No. 140.*
[12] *See, for example, Annual Report on Form 10-K for Citigroup Inc. for the fiscal year ended December 31, 2009.*
[13] *See http://blogs.wsj.com/cfo/2015/01/27/for-new-revenue-recognition-rules-its-ready-vs-not/.*

[14] For example, a calendar year-end company that adopts the revenue standard under a full-retrospective approach on January 1, 2018, would present financial statements for 2018, 2017, and 2016 under the amended guidance. However, if the company files a Form S-3 in June 2018 after filing its Form 10-Q for the first quarter ended March 31, 2018, it would be required to restate 2015 as well, in order for those financial statements to meet the requirement in Item 11(b) of Form S-3.
[15] See ASC 250-10-45-9.
[16] See http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FNewsPage&cid=1176167999438.
[17] See Securities and Exchange Commission Accounting Series Release No. FR-28 (Article 9, Section 401.09), "Accounting for Loan Losses by Registrants Engaged in Lending Activities" (December 1986), and SAB No. 102 (Topic 5:M) — Selected Loan Loss Allowance Methodology and Documentation Issues, available at http://www.sec.gov/interps/account/sab102.htm.
[18] See Compliance & Disclosure Interpretations Non-GAAP Financial Measures available at: http://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm.
[19] See Item 10(e) of Regulation S-K which requires companies to disclosure why their non-GAAP measures are useful.
[20] See Mary Jo White, Chair, U.S. Securities and Exchange Commission, Keynote Address at the 2015 AICPA National Conference: "Maintaining High-Quality, Reliable Financial Reporting: A Shared and Weighty Responsibility" (December 9, 2015), available at: https://www.sec.gov/news/speech/keynote-2015-aicpa-white.html.
[21] See 2016 Capital Markets Summit – Conversation with SEC Chair White (March 16, 2016) available at: http://videos.uschamber.com/detail/videos/capital-markets-summits/video/4805706279001/2016-capital-markets-summit---conversation-with-sec-chair-white?autoStart=true.
[22] PCAOB Release No. 2015-008 Improving the Transparency of Audits: Rules to Require Disclosure of Certain Audit Participants on a New PCAOB Form and Related Amendments to Auditing Standards.
[23] PCAOB Release No. 2016-002 Proposed Amendments Relating to the Supervision of Audits Involving Other Auditors and Proposed Auditing Standard – Dividing Responsibility for the Audit with Another Accounting Firm.

Modified: May 5, 2016