A look at this quarter's financial reporting matters

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- <u>Standard-setting</u> <u>updates</u>
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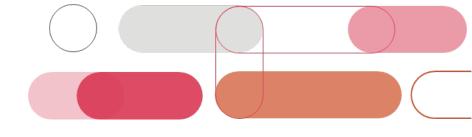
Introduction

We begin this edition of *The quarter close* with a mid-year check-in on SEC comment letter trends. Spoiler alert: non-GAAP financial measures continue to draw the most comments from the SEC staff. We also highlight key considerations for service or supply arrangements that may have embedded leases.

In sustainability reporting news, the SEC stayed its climate disclosure rules in light of pending litigation. However, beyond the SEC's rules, companies may be subject to a range of sustainability reporting obligations. We keep you informed on the latest developments.

This quarter we spotlight recent international standard-setting activities, including a new IFRS standard that redefines financial performance reporting. Although US GAAP reporters are not subject to IFRS standards, you'll want to stay updated on the changes, which could influence the views of stakeholders in the US. In addition, we summarize the FASB's latest decisions on its project on software costs.

In this edition of *The quarter close*, we highlight these and other relevant accounting and reporting topics you should consider as you close out the second quarter of 2024.





Accounting and reporting hot topics

Ask the National Office: Checking in on comment letter trends



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As we approach the mid-point of 2024, have we observed any changes in SEC comment letter themes?

Top comment letter themes have remained consistent over the past few years with non-GAAP measures and management's discussion and analysis (MD&A) leading as the most frequent areas of comment. While the nature of these comments has not changed significantly, recently we have seen the SEC staff issue similar comments to multiple companies within the same industry group. These comments have focused on a specific non-GAAP measure commonly used within a particular industry and disclosures about the impact of current macroeconomic conditions such as rising interest rates within the financial services sector.

Have we observed trends in the types of comments related to non-GAAP measures?

We have seen an increase in comments related to the disclosure of free cash flow. These comments have questioned how registrants describe the non-GAAP measure (for example, as a measure of performance or liquidity) and whether adjustments made to calculate the measure align with how it is described.

Other ongoing areas of focus include the need for enhanced disclosure of why management believes the non-GAAP measure provides useful information to investors, presentation with greater prominence than the most directly comparable GAAP financial measure, how the measure was reconciled to the most comparable GAAP financial measure, and whether adjustments essentially created individually tailored accounting principles.

What are other areas of frequent comment?

MD&A continues to be a close second in volume of comments. One area of focus is the impact of the current macroeconomic environment. For example, in the financial

services sector, the staff have issued comments specifically related to MD&A disclosures about commercial real estate and the discussion of interest rate impacts in S-K Item 305 quantitative and qualitative market risk disclosures. The staff has publicly stated that these disclosures may also be relevant to registrants outside of the financial services sector.

Additionally, the staff has focused on the discussion and analysis of results of operations, including the description and quantification of each material factor, offsetting factors, unusual or infrequent events, and economic developments causing changes in results between periods. For example, if revenue increased and the rationale is due to higher volumes offset by reduced pricing, the staff may ask registrants to quantify each contributing factor.

Any observations related to the new cybersecurity disclosures?

One aspect of the new rules requires reporting of material cybersecurity incidents under Item 1.05 of Form 8-K. We have observed some comments from the staff on Form 8-K incident reporting, generally asking for more detail regarding how the cybersecurity incident has had (or is likely to have) a material impact on the registrant's financial condition or ongoing results of operations. Recently, the Division of Corporation Finance issued a <u>statement</u> clarifying that companies choosing to voluntarily disclose incidents that are not material (or not yet determined to be material) should not report these incidents under Item 1.05 of Form 8-K as that item should be used only for material incidents.

And based on where we are in the year, we expect to start seeing comments on the new Form 10-K cybersecurity disclosures, so stay tuned for further developments.

For more information on SEC comment letter trends, refer to our <u>SEC comment letter trends landing page</u> on Viewpoint.

Accounting and reporting hot topics

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Pillar Two: Your frequently asked questions, answered

Pillar Two tax legislation has been implemented in over 35 countries, with certain provisions becoming effective as of January 1, 2024. The objective of Pillar Two is for large multinational enterprises to pay a minimum level of tax (a threshold effective tax rate of 15%) on the income arising in each jurisdiction where they operate. This global minimum tax brings significant complexity in determining impacts on the income tax provision for interim and annual financial reporting in calendar year 2024 for many multinational reporting entities. Read our publication, *Accounting for Pillar Two: Frequently asked questions*, for our insights on questions related to the implementation of Pillar Two, including interim considerations, valuation allowance impacts, and more.

Are leases hiding in your service or supply arrangements?

Leases that are embedded within a service or supply arrangement might get overlooked because, unlike a regular lease, the purpose of these transactions is to provide services or goods to a customer, not to allow for the use of an asset. In fact, the contract usually does not even include the word "lease." However, failing to identify an embedded lease can have significant accounting implications for both the supplier and the customer in these arrangements.

Assessing whether a contract contains a lease

A contract generally contains a lease when it conveys the right to control the use of a supplier's physical asset to a customer. The table below summarizes the conditions that, if met, result in the contract containing a lease:

Condition	Factors to consider
The supplier must use specific assets while fulfilling the contract. The contract might not identify those assets, but even if it does not, assets might be <i>implicitly</i> identified.	Examples of when a specified asset may exist include (1) the asset is physically on, or near, the customer's premises, (2) the supplier is buying or building new assets to fulfill the contract, or (3) the supplier only has one set of assets that would be feasible to use to fulfill the contract.
The supplier does not have a substantive right to substitute the asset throughout the usage period. Substituting the asset due to maintenance should be ignored.	Even if the terms of the contract allow the supplier to substitute the asset, the right is not substantive if (1) the supplier does not have the practical ability to substitute, for example an alternative asset is not readily available, or (2) the supplier would not economically benefit from using the substitute asset.
The customer has the right to obtain substantially all of the economic benefits. Consider both primary outputs and by-products.	Assess whether the customer is contractually entitled to substantially all of the economic benefits. The assessment should also consider whether the supplier must obtain the customer's permission to use the assets to serve other customers, or to use the output internally.
The customer directs how and for what purpose the asset is used throughout the period of use. Decisions made before or after the period of use (e.g., who designed the asset) should be ignored.	Consider decisions most relevant to changing how and for what purpose the asset will be used. Weight should be given to decisions that significantly impact the economic benefit that could be derived from the asset. Does the customer control most of those decisions?

Accounting and reporting hot topics

It is often the last condition – whether a customer could "direct how and for what purpose an asset is used throughout the period of use" – that requires the most judgment. Key questions and examples of answers that may indicate this condition is met include:

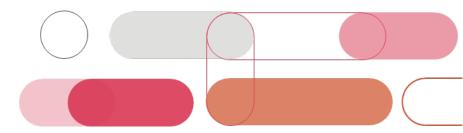
Question	Examples
How?	Customer decides <i>how</i> the asset will be used. For example, customer decides what to produce with the equipment, or decides whether to use a container for transportation or for storage.
When?	Customer controls <i>when</i> the asset will be used. For example, a power generator is only used when the customer facility is open and it needs electricity. Or, the customer may order goods or services "on demand;" that is, with such short lead time that the supplier has little discretion over the production schedule.
Where?	Customer controls <i>where</i> the asset is used. For example, when portable, the customer may move the equipment from one floor to another.
Whether, or how much?	Customer decides <i>whether</i> , or <i>how much</i> , the asset will be used. For example, the asset is idle when not in use, or the customer can determine how much or how long the asset will be used.

Accounting implications of embedded leases

When the contract contains a lease, the arrangement is no longer simply a service or supply contract. For example, if a supply arrangement contains a lease, the customer is no longer purchasing products. The customer is leasing a piece of equipment and also hiring the supplier to operate and maintain the leased equipment on its behalf. The supplier, rather than selling products, is leasing equipment and providing contract labor and maintenance services. Both parties would recharacterize the arrangement from its contractual form and may have to allocate the consideration among the newly characterized lease and nonlease components. This allocation can be complex, particularly when the arrangement includes variable consideration.

For more information

To learn more, listen to our podcast, *<u>Identifying embedded leases in your contracts</u>*, and read chapter 2 of our <u>*Leases*</u> <u>*guide*</u>.





Developments in sustainability reporting

Last quarter, we reported on the SEC's release of its final climate disclosure rules. Since then, as anticipated, legal challenges have been filed against the SEC by multiple parties. As a result, the SEC stayed its climate disclosure rules in April to "facilitate the orderly judicial resolution" of pending legal challenges. However, given ongoing interest from investors, and the overlapping nature of many of the sustainability reporting requirements worldwide, companies are encouraged to think holistically about the range of their sustainability reporting obligations. Systems, processes, and controls should be developed that position a company to produce high-quality data in support of any current or emerging sustainability reporting responsibilities. Doing so will also position registrants for compliance with the SEC rules should the stay be lifted, and the rules become effective. Below we cover other notable updates from the second quarter in sustainability reporting.

California climate disclosure bill

On January 1, the California bill requiring information about certain emissions claims and the sale and use of carbon offsets to be posted to a company's website (AB 1305) became effective. The definition of a "voluntary carbon offset" in the law is broad and includes instruments not typically referred to as such, including renewable energy credits and renewable identification numbers (related to renewable fuels) when used for voluntary purposes. In February, a bill (AB 2331) was introduced that, if signed into law, would make it clear that renewable energy certificates issued through an accounting system of a governmental regulatory body or a low-carbon fuel standard credit are not in the scope of AB 1305. The same bill proposes to amend AB 1305 to require initial reporting on January 1, 2025. In May, the bill was approved in the State Assembly and awaits consideration in the State Senate.

Corporate Sustainability Reporting Directive (CSRD)

In April, the European Council <u>approved</u> a delay of the adoption of certain sector-specific and non-EU European Sustainability Reporting Standards (ESRS) by two years until June 2026. The approval only delays when the additional standards will be issued. It does not impact the timing of when companies are required to file their initial CSRD reporting using the sector agnostic standards that became law in December 2023.

In May, EFRAG published (1) final ESRS <u>implementation guidance</u> related to the value chain and materiality assessments and (2) a <u>compilation</u> of new explanations to technical questions asked on the <u>EFRAG ESRS Q&A Platform</u>.

Announcement regarding international alignment

In May, the IFRS Foundation and EFRAG <u>published</u> guidance to illustrate the alignment between the IFRS Sustainability Disclosure Standards and the EU ESRS. The guidance (1) provides information on the alignment of climate disclosures and how to comply with both sets of standards, and (2) describes the alignment of general requirements of the two frameworks (e.g., materiality, presentation, and disclosure of non-climate sustainability topics).

For more information

Refer to the first chapter of our new global <u>Sustainability Reporting Guidance</u> for help navigating the scope of US and global sustainability reporting frameworks. Stay tuned for additional chapters to be released in phases over the course of 2024.

Federal Trade Commission approves non-compete ban

In April, the Federal Trade Commission (FTC) approved a <u>final rule</u> that non-compete clauses are an unfair method of competition. Under the FTC's new rule, existing non-compete agreements with workers will no longer be enforceable after the rule's effective date of September 4, 2024. Existing non-compete agreements with senior executives (as defined by the rule) will continue to be enforceable. However, new non-competes cannot be created, except as it relates to non-compete agreements between buyers and sellers of a business. Companies with intangible assets related to existing employee non-compete agreements should assess whether such agreements will cease to be enforceable upon the effective date of the rule and consider the impact to the useful life for such assets.

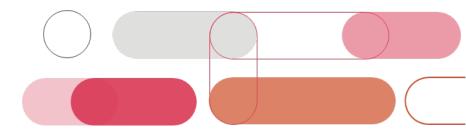
SEC clarifies voluntary reporting of cybersecurity incidents

In May, the Division of Corporation Finance released a <u>statement</u> clarifying the form and content of disclosures of cybersecurity incidents on Form 8-K. While a July 2023 rule requires disclosure of material cyber incidents on Item 1.05 (Material Cybersecurity Incidents) of Form 8-K, a company may elect to voluntarily disclose a cyber incident it has determined was not material or an incident for which it has not yet made a materiality determination. The statement encourages companies to make these voluntary disclosures under Item 8.01 (Other Events) of Form 8-K instead of Item 1.05. Then, if a company later concludes that the incident is material, it must file an Item 1.05 Form 8-K within four business days of that materiality determination. The statement also reminds companies of the factors that should be considered in the materiality assessment. For more on the disclosure rules, read <u>SEC adopts cybersecurity disclosure</u> *rules*. For more on the materiality assessment for cyber incidents, read <u>Making materiality judgments in cybersecurity incident reporting</u>.



Trends in SEC enforcement actions

Enforcement actions are an important tool used by the SEC to advance its mission of protecting investors and promoting market integrity. In its fiscal year ended September 30, 2023, the SEC actively pursued close to 800 enforcement actions against individuals and corporations for violations of securities laws, which is a 12% increase over the past two years. The drivers of the violations spanned a range of topics including improper accounting, misleading disclosures, and earnings manipulation. The SEC also continued its focus on emerging issues such as cybersecurity, crypto assets, and ESG. Companies and boards may find it helpful to consider lessons learned from the past as they evaluate the effectiveness of their control environments and compliance programs. Read our publication, <u>Trends in SEC enforcement</u> <u>actions</u>, to learn more.





Standard-setting updates

International standard-setting developments – what you need to know

In the first half of 2024, the IASB has issued a significant new standard on financial statement presentation and a proposal focused on disclosures about acquired businesses. Although US GAAP reporters will not be subject to these new requirements, US companies may want to get up to speed on the changes as they could impact subsidiaries reporting under IFRS. Additionally, developments in international reporting can influence the perspectives of stakeholders and standard setters in the US.

New financial performance reporting requirements

In April, the IASB issued IFRS 18, *Presentation and Disclosure in Financial Statements*, introducing new requirements to improve the comparability of the financial performance of similar entities, with a focus on updates to the statement of profit or loss. The new standard will be effective beginning in 2027 for calendar year-end IFRS reporters and requires retrospective application. IFRS 18 includes three major areas of change:

Defined structure of the statement of profit or loss

- **Categories** Items in the statement of profit or loss will be classified into categories. The three main categories are:
 - Operating Includes: (1) results from main business activities and (2) income and expenses that are not classified in any of the other categories (i.e., the "residual" category).
 - Investing Includes income and expenses from: (1) investments in associates, joint ventures, and unconsolidated subsidiaries, (2) cash and cash equivalents, and (3) other assets that generate a return individually and largely independent of other resources.
 - Financing Includes: (1) all income and expenses from liabilities that involve only the raising of finance (such as typical bank borrowings), and (2) interest expense and the effects of changes in interest rates from other liabilities (such as unwinding of the discount on a pension liability).
- **Required subtotals** Entities will be required to present specified totals and subtotals, including "operating profit or loss," "profit or loss," and "profit or loss before financing and income taxes," with some exceptions.

Related disclosures

- Management-defined performance measures IFRS 18 defines certain measures used by management that relate to financial performance as management-defined performance measures (MPMs). Information related to these measures shall be disclosed in a single footnote, including a reconciliation between the MPM and the most similar specified subtotal in IFRS Accounting Standards.
- **Disclosure of expenses by nature** Expenses will be presented in the operating category by nature, function, or a mix of both. IFRS 18 includes guidance on determining the most appropriate approach. When items are presented by function, an entity is required to disclose information by nature for specific expenses (e.g., employee benefits, depreciation, amortization).

Aggregation and disaggregation

IFRS 18 provides enhanced guidance on the principles of aggregation and disaggregation, which are used in defining the line items presented in the primary financial statements and information disclosed in the notes.

Standard-setting updates

Proposed amendments to improve reporting about acquisitions

In March, the IASB issued a proposal that would add new disclosures about a business combination in response to stakeholder concerns about the sufficiency of information about the performance of acquisitions and the challenges associated with goodwill impairment tests. The proposed disclosures would include:

- information about the performance of business combinations, including acquisition-date key objectives and related targets for a strategic business combination and the extent to which those key objectives and related targets are met in subsequent periods, and
- quantitative information about the synergies expected to arise from a business combination.

The proposal also includes targeted amendments to the impairment test for cash-generating units containing goodwill. Comments on the proposal are due July 15.

For more information

For more details regarding IFRS 18, refer to our publication, <u>IFRS 18 is here: redefining financial performance reporting</u>. Also, listen to our podcasts on <u>IFRS 18</u> and the <u>proposed disclosures for acquisitions</u>.

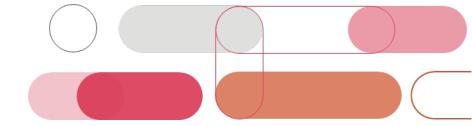


FASB changes course on software costs project

Project spotlight

In March 2024, the FASB reconsidered the direction of its project on software costs after receiving feedback from stakeholders, including financial statement users. The FASB took on the project with a goal to modernize the accounting for software costs and enhance transparency. After initially considering various approaches, including a new single capitalization model, the FASB has decided to pursue targeted improvements to the existing guidance for internal-use software in ASC 350-40. Specifically, the FASB plans to (1) specify that costs of software that has unresolved high-risk development issues would be accounted for as research and development expenses and (2) clarify the starting capitalization threshold when a company utilizes a nonlinear software development process. The FASB has also directed the staff to explore improvements to disclosures to enhance transparency about a company's software costs.

For the latest updates, refer to the FASB's project page.





PwC reference library

PwC's accounting podcasts

<u>PwC's accounting podcast series</u> includes a library of podcasts covering today's most compelling accounting, reporting, and business issues. Subscribe to our podcast feed on your platform of choice.

In June, we kicked off our miniseries on consolidation. Listen in for insights on evaluating the applicability of the variable interest entity model and whether another entity needs to be consolidated.

Some of our more popular podcasts this quarter:

Talking ESG: FAQs on the SEC climate disclosure rules

Talking ESG: The challenge – and promise – of a circular economy

Lease classification – Finance or operating lease?

Asset acquisition accounting

Deciphering the accounting for equity-linked instruments

Accounting and reporting webcasts

<u>PwC's accounting and reporting webcasts</u> keep you informed about emerging accounting, regulatory, and market developments impacting financial reporting. Register <u>here</u> for our upcoming CPE-eligible webcasts.

Accounting and reporting publications

Accounting for Pillar Two: Frequently asked questions

Argentina: Exchange rate and related disclosure considerations

FASB issues guidance on income tax disclosures

FASB issues guidance on accounting for crypto assets

FASB updates segments guidance

Don't roll the DISE on the FASB's expense disaggregation project

Accounting for Inflation Reduction Act energy incentives

SEC reporting

PCAOB adopts foundational and quality control standards

Trends in SEC enforcement actions

SEC adopts cybersecurity disclosure rules

To GAAP or to non-GAAP

Sustainability reporting

<u>Guidelines on Self-Regulation of Listed Companies –</u> <u>Sustainability Report (Trial) of the People's Republic of</u> <u>China</u>

Navigating the SEC climate-related disclosure requirements

Navigating the ESG landscape

Worldwide impact of CSRD - are you ready?

California's not waiting for the SEC's climate disclosure rules

Governance insights

Board effectiveness: A survey of the C-suite

Six board priorities for an early-stage GenAI strategy

The audit committee has specific responsibilities under the EU's CSRD

Enterprise resilience considerations: Questions for board members to consider

Board Central, a PwC product helps empower boards to effectively oversee cyber risk

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