AUDITING

Our commitment to audit quality and professional excellence

RSM US LLP recently published Our commitment to audit quality and professional excellence. This audit quality report is intended to provide a window into how RSM US LLP promotes and monitors audit quality. The report provides information on our audit practice, including various aspects of our system of quality control such as those related to leadership responsibilities, relevant ethical requirements, client acceptance, engagement team management, engagement performance and monitoring.

ACCOUNTING

Borrower’s accounting for Paycheck Protection Program loans

The Coronavirus Aid, Relief, and Economic Security Act established the Paycheck Protection Program (PPP), which is administered by the U.S. Small Business Administration (SBA), to provide loans to qualifying entities. Under this program, a qualifying entity may apply to an SBA-approved lender for a federally guaranteed loan to help offset certain payroll and other operating costs (e.g., rent and utility costs). The loan and accrued interest, or a portion thereof, is eligible for forgiveness by the SBA if the qualifying entity meets certain conditions.

Because there is currently no specific guidance in U.S. generally accepted accounting principles that addresses the accounting when a business entity obtains a loan that is forgivable by a government entity, we have prepared a white paper, Borrower’s accounting for Paycheck Protection Program loans. In this white paper, we discuss the following:

- Business entities’ accounting for PPP loans
- Not-for-profit entities’ accounting for PPP loans
- The views on accounting for PPP loans expressed by the staff of the U.S. Securities and Exchange Commission and the American Institute of Certified Public Accountants
- The disclosures that borrowers should provide about any PPP loans received

For information about other financial reporting issues related to the coronavirus pandemic, refer to our white paper, Coronavirus: Financial reporting considerations. For additional resources related to the coronavirus pandemic, visit our Coronavirus Resource Center.
PCC proposal: Determining fair value of share-option awards

Private company equity shares underlying a share option often are not actively traded, and thus, observable market prices for those shares or similar shares do not exist. Therefore, determining the fair value of traditional private company share-option awards at grant date or upon modification to an award often can be costly and complex. In response to this complexity, the Private Company Council (PCC) has set forth a potential solution on which the Financial Accounting Standards Board is seeking comment through a proposed Accounting Standards Update (ASU).

If finalized, the proposed ASU provides a practical expedient whereby a nonpublic entity may determine the current price of a share underlying an equity-classified share-option award issued to employees or nonemployees using a valuation method performed in accordance with specific regulations of the U.S. Department of the Treasury. Such regulations allow the use of any one of the following valuation methodologies to comply with the “presumption of reasonableness” requirements of U.S. Internal Revenue Code Section 409A:

- A valuation determined by an independent appraisal within the 12 months preceding the grant date
- A valuation based on a formula that, if used as part of a nonlapse restriction with respect to the share, would be considered the fair market value of the share
- A valuation made reasonably and in good faith and evidenced by a written report that considers the relevant factors of the illiquid stock of a start-up corporation

Nonpublic entities would be allowed to apply the practical expedient on an award-by-award basis. However, the practical expedient may not be applied to liability-classified awards.


PUBLIC SECTOR

OMB issues 2020 Compliance Supplement

The Office of Management and Budget (OMB) recently released the 2020 Compliance Supplement, which is effective for audits of fiscal years beginning after June 30, 2019. The 2020 Compliance Supplement adds, deletes and modifies prior Supplement sections. Appendix V of the 2020 Compliance Supplement provides a list of changes from the 2019 Compliance Supplement.

Further, the 2020 Compliance Supplement continues the OMB mandate requiring each federal agency to limit the number of compliance requirements subject to the audit to six, with the exception of the Research and Development cluster, which has been permitted to identify seven compliance requirements as subject to the audit. For this purpose, the requirements relating to A., “Activities Allowed and Unallowed,” and B., “Allowable Costs and Cost Principles,” are treated as one requirement. The Part 2 matrix and the related program sections in Parts 4 and 5 reflect this OMB mandate. The six-requirement mandate does not apply to programs not included in the Supplement.

The OMB and federal awarding agencies are working to identify COVID-19 funding programs and the need for these programs to be added in an addendum to the Supplement. The soonest we expect this addendum to be published is in late September.
Regulatory update for broker-dealers
Several regulations affecting broker-dealers (BDs) recently have been issued or updated. The following are highlights of and reminders about these important regulations:

Regulation Best Interest: The Broker-Dealer Standard of Conduct

Regulation Best Interest: The Broker-Dealer Standard of Conduct established a new standard of conduct for BDs and natural persons who are associated persons of a BD (associated persons) when making a recommendation of any securities transaction or investment strategy involving securities (including account recommendations) to a retail customer. When making such a recommendation to a retail customer, the BD and associated persons must act in the best interest of the retail customer at the time the recommendation is made, without placing their financial or other interest ahead of the retail customer’s interests. The compliance date for this general obligation was June 30, 2020, upon which the BD and associated persons must have created or updated the necessary disclosures, policies, procedures and systems, as appropriate, to achieve compliance with Regulation Best Interest.

This general obligation is satisfied only if the BD and associated persons comply with four specified component obligations:

- Disclosure obligation: Provide certain required disclosure, before or at the time of the recommendation, about the recommendation and the relationship between the BD/associated person and the retail customer;
- Care obligation: Exercise reasonable diligence, care and skill in making the recommendation;
- Conflict-of-interest obligation: Establish, maintain and enforce written policies and procedures reasonably designed to address conflicts of interest; and
- Compliance obligation: Establish, maintain and enforce written policies and procedures reasonably designed to achieve compliance with Regulation Best Interest.

The standard also introduces new record-making and recordkeeping requirements.

Regulation Best Interest does not apply to investment advice provided to a retail customer by a dual-registrant when acting in the capacity of an investment adviser, even if the retail customer has a brokerage relationship with the dual-registrant or the dual-registrant executes the transaction in a brokerage capacity. A “retail customer” is a natural person, or the legal representative of such person, who (a) receives a recommendation of any securities transaction or investment strategy involving securities from a broker, dealer or a natural person who is an associated person of a broker or dealer; and (b) uses the recommendation primarily for personal, family or household purposes. The determination of whether a broker-dealer has made a recommendation that triggers application of Regulation Best Interest is based on the facts and circumstances of the particular situation and therefore is not determined by a bright line rule or test.

The following provide additional guidance regarding Regulation Best Interest:

- Regulation Best Interest: A Small Entity Compliance Guide
- Frequently Asked Questions on Regulation Best Interest
- Risk Alert: Examinations that Focus on Compliance with Regulation Best Interest
SEC FAQ: Multiple exemptions and Non-Covered Firms

Non-carrying BDs may have multiple business activities with customers and therefore may be able to claim exemption from Rule 15c3-3 under more than one of the paragraphs of Rule 15c3-3 (for example, paragraphs (k)(2)(i) and (k)(2)(ii)). In July 2020, the SEC clarified (in Question 12 of the related SEC FAQ) that the BD should identify all paragraphs of Rule 15c3-3 under which the BD claims exemption from Rule 15c3-3 in its exemption report. The BD should reflect all such exemption provisions supporting its claim in the exemption report, and should also identify any applicable exceptions under each. In such a situation, the BD should indicate on its FOCUS Report each exemption provision in Rule 15c3-3(k)(2) it is relying on to claim an exemption from the rule, as applicable.

The SEC also clarified (in Question 8 of the FAQ) that a BD is considered a “Non-Covered Firm” if it meets the following:

- Directly or indirectly receives, holds, or otherwise owes funds or securities for or to customers (other than money or other consideration received and promptly transmitted in compliance with paragraph (a) or (b)(2) of Rule 15c2-4);
- Carries accounts of or for customers; or
- Carries PAB accounts (as defined in Rule 15c3-3).

A Non-Covered Firm that limits its business activities to one of more of the following activities may file an exemption report:

- Proprietary trading
- Effecting securities transactions via subscriptions
- Receiving transaction-based compensation for identifying potential merger and acquisition opportunities for clients, referring securities transactions to other broker-dealers, or providing technology or platform services
- Participating in distributions of securities (other than firm commitment underwritings) in accordance with the requirements of paragraphs (a) or (b)(2) of Rule 15c2-4
- Engaging solely in activities permitted for capital acquisition brokers

A Non-Covered Firm should include in its exemption report a description of its business activities and a statement that it (1) did not directly or indirectly receive, hold, or otherwise owe funds or securities for or to customers; (2) did not carry accounts of or for customers; and (3) did not carry PAB accounts. In addition, a Non-Covered Firm should not indicate in the FOCUS Report that it is claiming an exemption, and Items 4550, 4560, 4570 and 4580 of the FOCUS Report should be left blank.

Rules 17h-1T and 17h-2T

Exchange Act Rules 17h-1T and Rule 17h-2T require a BD to maintain and preserve certain records related to its organizational structure and affiliates and to file Form 17-H with the SEC on a quarterly basis. Effective June 29, 2020, the SEC issued an order to update the filing threshold for Form 17-H filings if the BD:

- Does not hold funds or securities for, or owe money or securities to, customers;
- Does not carry the accounts of or for customers (or that is exempt from Rule 15c3-3 pursuant to paragraph (k)(2) of that rule);
- Maintains total assets of less than $1 billion; and
- Maintains capital, including debt subordinated, of less than $50 million (increased from $20 million).
Quarterly securities count of physical certificates under Rule 17a-13

Due to the COVID-19 pandemic, the SEC Division of Trading and Markets has provided that it will not recommend an enforcement action if a BD is unable to conduct a physical securities count from April through December of 2020 if such BD:

- Notifies the SEC’s Office of Compliance Inspections and Examinations by email at OCIE-COVID@sec.gov and notifies the BD’s FINRA Risk Monitoring Analyst of (a) the nature of the problem it will have conducting a physical count and (b) an estimate of the number and value of physical certificates that cannot be counted; and
- Makes and retains a bookkeeping summary of the movements of physical certificates that are received or delivered and were not counted during the impacted period to assist the firm in performing an accurate count once the impacted period passes.

FINRA relief: Net capital treatment of covered loans under the CARES Act

Section 1106(b) of the Coronavirus Aid, Relief, and Economic Security Act (the CARES Act) provides that a recipient of a covered loan (as defined in Section 1106(a)(1)) is eligible for forgiveness of indebtedness on the covered loan in an amount (the Forgivable Expense Amount) equal to the sum of the following costs incurred and payments made during the eight-week period beginning on the date of the origination of the covered loan:

- Payroll costs (as defined in Section 1106(a)(8));
- Any payment of interest on any covered mortgage obligation (as defined in Section 1106(a)(2)), which shall not include any prepayment of or payment of principal on a covered mortgage obligation;
- Any payment on any covered rent obligation (as defined in Section 1106(a)(4)); and
- Any covered utility payment (as defined in Section 1106(a)(5)).

FINRA relief has provided that a member firm that has included a covered loan as a liability on its balance sheet may add the Forgivable Expense Amount back to net capital to the extent the firm has recorded expenses for the costs and payments making up the Forgivable Expense Amount, provided that the add-back to net capital may not exceed the amount of the balance sheet liability for the covered loan that the firm reasonably expects to be forgiven pursuant to Section 1106 (taking into account, among other matters, the limits under Section 1106(d) on the amount of forgiveness). Since the add-back cannot be greater than the balance sheet liability for the covered loan, the add-back cannot increase net capital by more than the balance sheet liability for the covered loan.

A member firm that makes such an add-back must create and retain documentation of the basis of the add-back, including a record of its computation of the Forgivable Expense Amount, a record of the costs and payments making up that amount, and a record of its estimate of any limits under Section 1106(d) with the basis for such estimate. In the firm’s FOCUS Reports, the add-back must be reported in Item 3525, “Other (deductions) or allowable credits.”

SEC

Modernization of Regulation S-K Items 101, 103 and 105

The SEC recently issued a final rule, Modernization of Regulation S-K Items 101, 103, and 105, which includes the following revisions, among others:

- Item 101(a), General development of business – Now largely principles-based, this regulation requires disclosure of information material to an understanding of the general development of a registrant’s business. The revised regulation also:
- Eliminates the previously prescribed timeframes for this disclosure
- Permits a registrant, in filings made after its initial filing, to provide only an update of the general development of the business focused on material developments that have occurred since its most recent filing containing a full discussion of the general development of its business, which must be incorporated by reference

- **Item 101(c), Description of business**
  - Clarifies and expands its principles-based approach with a nonexclusive list of disclosure topic examples drawn in part from the topics previously in Item 101(c)
  - Includes, as a disclosure topic, human capital resources
  - Refocuses the regulatory compliance disclosure requirement by including as a topic all material government regulations – not just environmental laws

- **Item 103, Legal proceedings**, now expressly states that the required information about material legal proceedings may be provided by including hyperlinks or cross-references to legal proceedings disclosure located elsewhere in the document. The revised regulation also increases the quantitative threshold for disclosure of environmental proceedings to which the government is a party from $100,000 to $300,000 with flexibility for the registrant to select a different disclosure materiality threshold, provided that the threshold does not exceed the lesser of $1 million or one percent of the registrant’s consolidated current assets.

- **Item 105, Risk factors**
  - Requires summary risk factor disclosure of no more than two pages if the risk factor section exceeds 15 pages
  - Changes the disclosure standard from the “most significant” risk factors to the “material” risk factors
  - Requires risk factors to be organized under relevant headings in addition to the subcaptions currently required
  - Discourages the presentation of risks that could apply generically to any registrant or any offering, and states that if such risk factors are presented, they must be disclosed at the end of the risk factor section under a separate caption, “General Risk Factors”