Financial reporting briefs

What you need to know about this quarter’s accounting, financial reporting and other developments

March 2019
Top story

**Challenges related to the new leases standard**

Management should focus on making sure the entity has controls in place to appropriately account for leases under the new leases standard. This will require companies to design different policies, processes and controls to account for leases prospectively (i.e., beginning in the quarter that the standard is adopted) because the prospective accounting model for the new leases standard is different from its transition provisions for existing leases (which, for most entities, will involve applying certain concepts of both Accounting Standards Codification (ASC) 840 and ASC 842). It may be challenging for entities to manage separate processes and controls over their entire lease portfolio – one for leases that existed at adoption and another for new leases and those that are modified or reassessed after adoption.

We believe processes and controls in place at the effective date may evolve throughout the year of adoption. For example, if a company implements a new system or modifies an existing one after the effective date, management will need to consider additional processes and controls necessary to address the risks resulting from those IT system changes.

Companies should remember that they will need to make judgments and estimates that will require careful consideration, including the determination of whether a contract is or contains a lease, the allocation of consideration between lease and non-lease components, the determination of the discount rate for the lease and identifying reassessment events.

Other judgments relate to evaluating asset groups for impairment under ASC 360, particularly now that lessees will record right-of-use (ROU) assets and lease liabilities for operating leases under the new leases standard. Consistent with how we evaluate impairment for capital leases under existing guidance, all asset groups that include ROU assets under ASC 842 are subject to impairment testing under ASC 360, which is the guidance used to test long-lived assets, such as property, plant and equipment, for impairment.

As a reminder, when a registrant adopts a new accounting standard in an interim period, the Securities and Exchange Commission (SEC) staff expects registrants to provide both the annual and the interim period financial statement disclosures in quarterly filings in the year of adoption. Preparers will need to provide more disclosures than under legacy guidance, including information about significant judgments and estimates made (for example, determination of discount rates), qualitative and quantitative information (for example, lease liability maturity analysis and terms on which variable lease payments are determined) and practical expedients elected (for example, combining lease and non-lease components). Companies should continually challenge their disclosures based on SEC staff observations and industry practice.

Separately, the Financial Accounting Standards Board (FASB or Board) added guidance to ASC 842 that is similar to the fair value exception in ASC 840-10-55-44 for lessors that are not manufacturers or dealers. The amendments also clarify that lessors in the scope of ASC 942 must classify principal payments received from sales-type and direct financing leases within investing activities in the statement of cash flows. In addition, the amendments clarify the transition guidance in ASC 842-10-65-1(i) related to interim disclosures provided in the year of adoption.
Accounting update

Getting ready for the new credit losses standard
The new credit impairment standard will affect all entities, even those with only short-term assets (e.g., trade accounts receivable). For all entities, one change in practice will be estimating an allowance for losses for receivables that are current with respect to their payment terms. Because entities may not have tracked historical data in the past or may not have had effective controls over the data, they should consider performing a data gap assessment early in their implementation plan. They will need to use the data to develop and support their estimates.

As a reminder, in the periods leading up to adoption of the new credit losses standard, SEC registrants must make disclosures about the standard's anticipated effect on the financial statements and the status of their implementation efforts, as required by SEC Staff Accounting Bulletin (SAB) Topic 11.M (issued as SAB 74). The required disclosures include:

- A brief description of the new standard, the date that adoption is required and the date that the registrant plans to adopt, if earlier
- A discussion of the effect that adoption of the standard is expected to have on the financial statements, unless not known or reasonably estimable, in which case, a statement to that effect may be made
- The potential effect of other significant matters that the registrant believes might result from adoption (e.g., technical violations of debt covenant agreements, planned or intended changes in business practices)

The SEC staff has said it expects these disclosures to evolve as the effective date approaches and more information becomes known. The SEC staff also expects the disclosures to provide users with detailed information about the effects of adoption, rather than boilerplate language. Registrants also should consider disclosing where they are in the implementation process and the significant implementation matters that have yet to be addressed. We anticipate that all registrants that expect a material impact on their financial statements to make these disclosures, although financial services entities and other entities with long-term financing receivables will likely have more detailed qualitative and quantitative disclosures about the effects of adoption and the status of their implementation plans.

As a reminder, the standard is effective for public business entities (PBEs) that are SEC filers beginning in 2020 and for other PBEs in 2021. Separately, the FASB proposed allowing entities to make an irrevocable one-time election upon adoption of the new credit losses standard to measure financial assets measured at amortized cost (except held-to-maturity securities) using the fair value option. The election would be made on an instrument-by-instrument basis.

Revenue considerations for private companies
As private companies begin implementing the new revenue standard, they are encouraged to focus on aspects of the guidance that companies that have already adopted the standard found most challenging. Private companies also should keep in mind that, based on our experience, implementing the standard will likely require more effort than they anticipate.

Even if the results many entities report to their stakeholders aren’t expected to significantly change, all private companies will likely need to expend considerable effort to review their contracts and update their accounting policies and processes. They also need to develop new policies and processes to make the required disclosures. Management can’t wait until the year-end close process to determine how it will collect the necessary information. Management of private companies that expect significant changes in the timing of revenue recognition also should consider discussing these changes with investors and other stakeholders.

In an EY survey of 300 executives from public and private companies, 75% of respondents said the cost of implementing the standard exceeded their initial budgets. Gathering and analyzing the data required to make the new disclosures was especially challenging. About 90% of respondents said they encountered difficulties doing this, and 71% said their disclosures have evolved since they first began reporting under the standard.

As a reminder, private companies are required to adopt the standard for fiscal years beginning after 15 December 2018, and interim periods within fiscal years beginning after 15 December 2019.
What you need to know about the new hedging guidance

The new hedge accounting guidance, which is effective in the first quarter of 2019 for calendar-year PBEs, changes the way entities account for and present their hedging relationships to better portray the economics of their risk management activities in their financial statements. The extent of the changes will vary by entity because some amendments are elective. However, other amendments require entities to change their financial reporting.

Entities must apply the new presentation and disclosure requirements prospectively to all new and existing hedging relationships. These requirements are applied prospectively, which means that comparative information for periods before adoption remains unchanged. This may result in a lack of comparability for entities that historically presented amounts related to hedge ineffectiveness and excluded components in an income statement line other than where the earnings effect of the hedged item is presented (e.g., other income or expense).

In addition, entities with cash flow or net investment hedges as of the date of adoption will be required to record a cumulative-effect transition adjustment to beginning retained earnings with an offsetting adjustment to other comprehensive income (OCI). That’s because for these hedges, the new guidance requires the entire change in the fair value of the hedging instrument included in the assessment of hedge effectiveness to be recorded in OCI until the hedged item affects earnings. Currently, ineffectiveness is immediately recorded in earnings. The cumulative-effect adjustment results in previously recorded ineffectiveness being reclassified to OCI as of the initial application date.

Share-based payments to nonemployee board members

Adopting the new accounting guidance for share-based payments to nonemployees (effective in the first quarter of 2019 for calendar-year PBEs) will not change how companies evaluate the award recipient to determine the appropriate accounting. This is because there are still some differences in the accounting for awards to employees and nonemployees. For instance, since the cost attribution guidance is different, the timing of the recognition of compensation cost for employees and nonemployees may be different.

A common example is share-based payments issued to nonemployee directors. ASC 718 provides an exception under which awards to a nonemployee director for services provided to the company as a director are accounted for as employee awards if he or she was elected by the grantor’s shareholders or appointed to a board seat that will be filled by shareholder election when the current term expires. However, that requirement applies only to awards granted to nonemployee directors for their services as directors. An award granted to a nonemployee director for other services outside his or her role as a director (e.g., legal advice, investment banking advice, loan guarantees) is accounted for as a nonemployee award.

Separately, the FASB issued a proposal that would clarify that entities would follow the guidance in ASC 718 when measuring and classifying equity instruments granted in connection with selling goods or services to a customer. Entities would measure such awards at the grant date in accordance with ASC 718.

Reminders about estimating the effective tax rate

With companies once again setting their annual effective tax rates, we’d like to remind you that the tax provision for the year is the same whether a company prepares only annual financial statements or interim and annual statements. The tax expense for ordinary income in an interim period is measured using an estimated annual effective tax rate. At the end of each interim period, a company must make its best estimate of the annual effective rate for the full year and apply that rate to year-to-date ordinary income.

As a reminder, calculating the effective tax rate may be more complicated than in prior years, now that companies have to consider some of the provisions of the Tax Cuts and Jobs Act such as the global intangible low-taxed income (GILTI) or the base erosion anti-abuse tax (BEAT). The calculation also can be affected by:

- Operations in multiple jurisdictions
- Expectations about whether current-year losses are realizable
- The tax benefit of an operating loss carryforward from a prior year that is realized because of current-year ordinary income
- Tax law changes enacted in the period that affect taxes payable or refundable for the current year
Also, as a reminder, companies should monitor tax law changes in the US and other jurisdictions. The effects of a change in tax laws or rates on deferred tax balances are recognized as a discrete event as of the enactment date and should not be allocated to subsequent interim periods by an adjustment to the estimated annual effective tax rate. Similarly, the effects of a change in tax laws or rates on taxes currently payable or refundable for a prior year should be recognized as of the enactment date. The effects of new tax legislation should not be recognized prior to enactment.

**ITC and proposal on contract liabilities acquired in a business combination**

The FASB issued an Invitation to Comment (ITC) on the measurement of contract liabilities and other topics related to the accounting for revenue contracts acquired in a business combination. The Board also proposed clarifying that the definition of a performance obligation in ASC 606 should be applied when determining whether an assumed contract liability in a contract with a customer should be recognized in a business combination. In the proposal, which is based on a consensus-for-exposure of the Emerging Issues Task Force, the FASB asked stakeholders whether any final guidance should address both the recognition and measurement topics.
Regulatory developments

Consider Brexit disclosures
As the 29 March 2019 deadline for the withdrawal of the United Kingdom (UK) from the European Union (i.e., Brexit) approaches, SEC registrants with operations and/or investments in the UK should take a fresh look at their disclosures about the effects of Brexit in management’s discussion and analysis and other parts of their SEC filings. The SEC staff has said it expects these disclosures to evolve as the effects become clearer.

While companies may have already made some disclosures in their annual reports, they should consider whether there have been material changes in their previously disclosed risk factors or whether they are exposed to any new risk factors that warrant disclosure in their Form 10-Q filings for the first quarter. The implications of Brexit and subsequent actions may be difficult to predict, but registrants should consider whether to disclose reasonably likely effects on matters such as income taxes, financing and operations.

Registrants should also consider whether they need to make quantitative and qualitative disclosures related to critical accounting estimates. For example, if Brexit and the resulting market volatility affect assumptions or the sensitivity of assumptions related to goodwill impairment for at-risk reporting units or result in additional reporting units being considered at risk, a registrant should consider making additional disclosures.

Reminder on stockholders’ equity reconciliation
Calendar-year registrants are required to begin providing a reconciliation of changes in stockholders’ equity in the notes to the financial statements or as a separate statement in their financial statements for the first quarter of 2019. This analysis should reconcile the beginning balance to the ending balance of each caption in stockholders’ equity for each period for which an income statement is required to be filed. As a result, registrants will have to provide the reconciliation for both the year-to-date and quarterly periods and comparable periods in their Form 10-Q filings. Companies should remember that both quarter-to-date and year-to-date periods will need to be presented in Form 10-Q filings for the second and third quarters.

SEC rules on employee and director hedging policies, Reg A exemption
The SEC issued a final rule that requires companies to disclose any practices or policies they have regarding the ability of employees (including officers) or directors to engage in transactions that hedge or offset any decrease in the market value of the company’s equity securities or those of certain related entities. Registrants that do not have such policies or practices must disclose that fact or state that hedging transactions are generally permitted.

The rule, which was mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act, applies to all equity securities held by employees, officers and directors, directly or indirectly, not just equity securities granted as compensation. Registrants must provide the disclosures in proxy or information statements related to the election of directors.

Registrants other than smaller reporting companies (SRCs) and emerging growth companies (EGCs) must provide the disclosures for proxies filed to elect directors during fiscal years beginning on or after 1 July 2019. SRCs and EGCs must provide the disclosures for proxies filed to elect directors during fiscal years beginning on or after 1 July 2020. Listed closed-end funds and foreign private issuers are not subject to the rule.

The SEC also adopted final rules that allow existing Exchange Act reporting companies to use the Regulation A exemption for securities offerings of up to $50 million within a 12-month period. The new rules also permit Exchange Act reporting companies that use the exemption to satisfy their ongoing reporting obligations under Regulation A with their Exchange Act reporting rather than comply with the separate ongoing Regulation A reporting requirements.
SEC proposes expanding ‘test-the-waters’ accommodation
The SEC proposed allowing all issuers to gauge market interest in registered securities offerings by discussing potential offerings with certain institutional investors before filing a registration statement. Currently, only EGCs are allowed to make these test-the-waters communications.

PCAOB adopts standard on estimates, amends standards on specialists
The Public Company Accounting Oversight Board (PCAOB) adopted a new standard on auditing accounting estimates and amended its standards on the auditor’s use of the work of specialists. The changes generally enhance existing audit approaches and are intended to promote consistency in practice in an area that the PCAOB said auditors find challenging. In making the changes, the PCAOB is responding to the increasing use and significance of accounting estimates in the preparation of financial statements and the increase in both the frequency and significance of specialists’ involvement in audits.

The PCAOB noted that accounting estimates are often the areas of greatest risk in an audit and that, in many cases, specialists are used to either develop or help evaluate these estimates. Auditors may need to spend more time evaluating the work of company specialists, and management may need to provide more information about its use of specialists (e.g., when it engages specialists to help it value intangible assets acquired in a business combination).

The new estimates standard and the amendments are subject to SEC approval and interested parties will have a chance to provide comments. If the changes are approved by the SEC, they will be effective for audits of periods ending on or after 15 December 2020.
Other considerations

AMT refunds not subject to sequestration

The Internal Revenue Service (IRS) said that alternative minimum tax (AMT) refunds for taxable years beginning after 31 December 2017 will not be subject to sequestration. The 14 January 2019 statement reverses an earlier IRS announcement that refundable AMT credits under Section 53(e) would be subject to sequestration. Sequestration refers to reductions of government spending required by the Balanced Budget and Emergency Deficit Control Act of 1985, as amended.

Summary of open comment periods

Items are FASB proposals unless otherwise noted.

<table>
<thead>
<tr>
<th>Proposal</th>
<th>Comment period ends</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proposed Accounting Standards Update — Business Combinations (Topic 805): Revenue from Contracts with Customers — Recognizing an Assumed Liability (a consensus of the FASB Emerging Issues Task Force)</td>
<td>30 April 2019</td>
</tr>
<tr>
<td>Invitation to Comment — Measurement and Other Topics Related to Revenue Contracts with Customers under Topic 805</td>
<td>30 April 2019</td>
</tr>
<tr>
<td>Solicitations of Interest Prior to a Registered Public Offering (SEC proposal)</td>
<td>19 April 2019</td>
</tr>
<tr>
<td>Proposed Accounting Standards Update — Compensation — Stock Compensation (Topic 718) and Revenue from Contracts with Customers (Topic 606): Codification Improvements — Share-Based Consideration Payable to a Customer</td>
<td>18 April 2019</td>
</tr>
</tbody>
</table>
To the Point

- FASB amends accounting for costs of films and license agreements for media and entertainment entities (7 March 2019)
- FASB issues more amendments to help lessors apply the new leases standard (5 March 2019)
- FASB seeks input on measurement of contract liabilities assumed in a business combination (15 February 2019)
- IRS says Section 53 AMT refunds are not subject to sequestration (16 January 2019)
- PCAOB adopts new standard on estimates and amends standards on using the work of specialists (10 January 2019)
- FASB proposes allowing NFPs to simplify their accounting for goodwill and intangible assets (20 December 2018)
- SEC seeks input on earnings releases and quarterly reports (19 December 2018)

Technical Line

- Private Company Reporting Update – Focus areas for implementing the new revenue recognition standard (21 February 2019)
- How the new leases standard affects real estate entities (17 January 2019)
- How the new leases standard affects automotive entities (3 January 2019)
- Year-end accounting and disclosure reminders for reporting under ASC 606 (20 December 2018)
- Applying the definition of a business to oil and gas transactions (20 December 2018)
- How the new revenue standard affects the insurance industry (19 December 2018)

Financial reporting developments

- Credit impairment for short-term receivables under ASC 326 (7 March 2019)
- Derivatives and hedging (after the adoption of ASU 2017-12, Targeted Improvements to Accounting for Hedging Activities) (28 February 2019)
- Impairment or disposal of long-lived assets (22 February 2019)
- Lease accounting – Accounting Standards Codification 842, Leases (17 January 2019)
- Derivatives and hedging (before the adoption of ASU 2017-12) (3 January 2019)
- Share-based payment (before the adoption of ASU 2018-07, Improvements to Nonemployee Share-Based Payment Accounting) (20 December 2018)
- Earnings per share (20 December 2018)
- Asset retirement obligations (19 December 2018)

Comment letters

- FASB’s proposed amendment to the new credit losses standard (7 March 2019)
- FASB’s proposal to extend certain PCC alternatives to NFPs (18 February 2019)
- FASB’s proposal on codification improvements to help lessors apply the new leases standard (15 January 2019)
- FASB’s proposal on changes to the three new standards on financial instruments (19 December 2018)

Other

- EY revenue recognition survey (22 January 2019)
- SEC in Focus – January 2019 (10 January 2019)
- Board Matters Quarterly – January 2019 (10 January 2019)
- Accounting pronouncements effective in 2018 (20 December 2018)

On-demand webcasts

- EY Q4 2018 financial reporting update
- Global tax policy and controversy in 2019

Upcoming webcasts

- Divestments in 2019: agility, growth and transformation
- Accounting for income taxes: a quarterly perspective