Financial reporting briefs

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

June 2019
Top story

Reporting under the new leases standard

Accounting Standards Codification (ASC or Codification) 842, Leases, requires most leases to be recognized on the balance sheet and requires enhanced disclosures. The Financial Accounting Standards Board (FASB) believes this will result in a more faithful representation of lessees’ assets and liabilities and greater transparency about the lessee’s obligations and leasing activities than the legacy guidance in ASC 840, Leases, which doesn’t require lessees to recognize assets and liabilities arising from operating leases. The requirement to recognize most leases on the balance sheet may change how an entity communicates with investors about its financial position.

The transition provisions in ASC 842 are applied using a modified retrospective approach at the beginning of the earliest comparative period presented in the financial statements or at the beginning of the period of adoption. The modified retrospective transition method generally results in an entity applying concepts from both ASC 840 and ASC 842 to certain leases that existed before the effective date.

Entities continue to apply the transition accounting until lease modifications or certain remeasurement events occur following the effective date. As a result, an entity could be required to continue applying guidance from ASC 840 to certain existing leases after the effective date of ASC 842. This would require an entity to have two sets of processes, systems and controls in place.

Entities need to have policies, processes and controls in place to account for new, modified or reassessed leases after the effective date. Entities also need to make sure they have policies, processes and controls in place to apply the transition accounting in ASC 842 and to identify events that require a reassessment or remeasurement of a lease.

The disclosure requirements in ASC 842 are more robust than in ASC 840. The objective of ASC 842’s disclosure requirements is to enable financial statement users to assess the amount, timing and uncertainty of cash flows arising from leases. ASC 842 requires lessees and lessors to disclose both quantitative and qualitative information about their leases, the significant judgments and assumptions made in applying ASC 842, and the amounts recognized in the financial statements related to those leases. Judgment is required to determine the appropriate level at which to aggregate or disaggregate disclosures so that meaningful information is not obscured by insignificant details or by groupings of items with different characteristics.

Entities that have adopted the new leases standard should continue to refine and supplement their disclosures, especially in areas that require significant judgment or involve estimates. Similarly, the Securities and Exchange Commission (SEC) staff has said it will re-evaluate registrants’ disclosures after adoption, and its comments may evolve over time.
Accounting update

New credit impairment standard applies to all entities, not just banks

All entities need to focus on the new credit impairment standard because it applies to financial assets such as loans, accounts receivable (including long-term receivables), contract assets, net investments in sales-type and direct financing leases, held-to-maturity securities and certain financial guarantees.

The new current expected credit losses (CECL) model requires entities to record full lifetime expected credit losses on day one. That means entities need to consider the risk of loss, even if that risk is remote, and take into consideration reasonable and supportable forecasts of future economic conditions.

Under the new model, entities will recognize an allowance for almost all assets in the scope of the standard, including assets that are current with respect to their payment terms. Also, the CECL model requires the use of more judgment than today's guidance and is expected to increase earnings volatility.

Since most accounts receivable have payment terms of less than one year, the contractual life of these assets is not as significant a driver of credit losses as it may be for long-term finance receivables and certain contract assets. However, entities need to consider contractual terms that might extend the asset’s life and the likelihood that modifications to payment terms could constitute a troubled debt restructuring. They also need to understand that the contractual life of a contract asset includes both the periods when it is accounted for as a contract asset and when it is accounted for as a receivable. That is, the contractual life is the period up until the receivable is collected or written off, which may be longer than one year. If that’s the case, the entity will need to develop a reasonable and supportable forecast for a longer period.

Entities should also consider the credit risk related to receivables when estimating credit losses on contract assets from the same customer. In addition, entities will need to modify their policies and processes, regardless of whether they expect their allowance to change significantly after adoption.

Fair value option and other standard setting on credit impairment

The FASB issued final guidance that allows 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 is to be applied on an instrument-by-instrument basis. For entities that have already adopted the new credit losses standard, the relief is effective for fiscal years beginning after 15 December 2019 and interim periods therein, and early adoption is permitted. For all other entities, the guidance is effective upon adoption of the new credit losses standard.

The FASB separately issued several other amendments in an Accounting Standards Update (ASU) that amends the guidance on credit impairment, hedging, and recognizing and measuring financial instruments. In response to questions raised by stakeholders, the FASB clarified the scope of the credit impairment guidance and addressed issues related to accrued interest receivable balances, recoveries, variable interest rates and prepayments, among other things. This guidance has the same effective date as the new credit losses standard, unless an entity has already adopted the standard, in which case the guidance is effective for fiscal years beginning after 15 December 2019, including interim periods therein.

FASB amends standards on hedging and financial instruments

The FASB also amended its standards on hedging and recognizing and measuring financial instruments in the ASU noted above. The hedging amendments address partial-term fair value hedges, fair value hedge basis adjustments, application by not-for-profit entities and private companies, and certain transition requirements, among other things. The amendments on recognizing and measuring financial instruments address the scope of the guidance, the requirement for remeasurement under ASC 820 when using the measurement alternative, certain disclosure requirements and which foreign currency-denominated equity securities must be remeasured at historical exchange rates.
The amendments to the hedging standard have the same effective dates as that standard, unless an entity has already adopted the standard, in which case the amendments are effective as of the beginning of the first annual reporting period beginning after 25 April 2019 (e.g., 1 January 2020, for a calendar-year public business entity). The amendments to the recognition and measurement standard are effective for fiscal years beginning after 15 December 2019, including interim periods therein. Early adoption is permitted for entities that have adopted the standards discussed above. The FASB plans to address additional implementation issues and stakeholder questions on the hedging standard in a separate round of Codification improvements.

Revenue recognition: what private companies should focus on
As private companies implement the new revenue recognition standard, they should focus on the aspects of the standard that entities that have already implemented the standard have found most challenging. Those areas include determining the contract duration, identifying performance obligations, estimating standalone selling price, analyzing principal versus agent considerations, identifying customer options, estimating variable consideration, applying the residual approach, determining when performance obligations are satisfied and accounting for contract costs.

Private companies should be aware that the new standard requires them to make significantly more disclosures (both qualitative and quantitative) than they have under legacy GAAP, regardless of whether there is a change in the amount or timing of the company’s revenue recognition. Private companies may need to develop new policies and processes to make the required disclosures, and management should not wait until the year-end close process to determine how it will collect the necessary information.

As a reminder, a calendar-year private company that didn’t early adopt the standard is required to present its results under the new standard beginning with its annual financial statements for 2019.

FASB revises proposal on income tax disclosures
The FASB revised its proposal on income tax disclosure requirements after evaluating feedback from stakeholders and the effects of the Tax Cuts and Jobs Act.

The proposal would require separate foreign and domestic disclosures about pretax income (loss) from continuing operations before intra-entity eliminations and other disaggregated disclosures about tax expense (benefit) and income taxes paid. It also would eliminate requirements to disclose the cumulative amount of each temporary difference that is related to unrecognized deferred tax liabilities and uncertain tax positions and change certain disclosure requirements related to uncertain tax positions, valuation allowances, the effective tax rate reconciliation and tax carryforwards.

The proposal is part of the FASB’s broader disclosure framework project aimed at making disclosures in the notes to the financial statements clearly communicate the most important information.

FASB proposes simplifying the accounting for income taxes
The FASB proposed simplifying the accounting for income taxes as part of its initiative to reduce the cost and complexity of applying accounting standards.

The proposal would eliminate certain exceptions related to the approach for intraperiod tax allocation, the methodology for calculating income taxes in an interim period and the recognition of deferred tax liabilities for outside basis differences. It also would simplify aspects of the accounting for franchise taxes (or other similar taxes), transactions that result in a step-up in the tax basis of goodwill and enacted changes in tax laws or rates in an interim period.

The proposal also would clarify that single-member limited liability companies or similar disregarded entities that are not subject to income tax are not required to recognize an allocation of consolidated income tax expense in their separate financial statements, but they could elect to do so with appropriate disclosure.

FASB proposes incorporating certain SEC requirements into US GAAP
The FASB proposed incorporating several SEC disclosure requirements into US GAAP in response to a request from the SEC. The proposal would add interim and annual disclosure requirements to a variety of topics in the Codification, including those focusing on accounting changes, earnings per share, business combinations, foreign currency matters, and derivatives and hedging. While incorporating these disclosure requirements into US GAAP would simplify compliance for most registrants, the proposal would create more work for smaller reporting companies (SRCs) that currently receive relief from these requirements and nonpublic entities that do not have to comply with SEC requirements. If the FASB finalizes the proposal, we hope that the SEC will remove the related SEC disclosure requirements to eliminate redundancies.
NFPs can simplify their accounting for goodwill and intangible assets

The FASB issued final guidance that allows not-for-profit entities (NFPs) to apply accounting alternatives that simplify the subsequent accounting for goodwill and the accounting for certain intangible assets they acquire. NFPs that elect the goodwill accounting alternative will amortize goodwill and perform a one-step impairment test, at either the entity level or the reporting unit level, only when an impairment indicator exists. NFPs that elect the intangible asset accounting alternative may recognize fewer intangible assets in an acquisition, and they would be required to elect the goodwill accounting alternative. However, NFPs that elect the goodwill accounting alternative are not required to elect the intangible asset accounting alternative. The guidance is effective immediately.
Regulatory developments

Get ready for reporting on critical audit matters
Auditors will begin reporting on critical audit matters (CAMs) in their reports on audits of annual periods ending on or after 30 June 2019 for large accelerated filers and on or after 15 December 2020 for all other filers.

In the dry run we performed in 2018, items we frequently identified as CAMs included the annual impairment evaluation of goodwill or other intangible assets, revenue recognition, income taxes and inventory. Nonrecurring items that we commonly identified as CAMs included business combinations, changes in accounting related to the adoption of the new standards on revenue recognition and leases and the new tax law, debt/equity transactions and other significant unusual transactions.

The Public Company Accounting Oversight Board (PCAOB) staff issued four guidance documents on reporting on CAMs this year. Among the other areas, the PCAOB emphasized that some matters in an audit are inherently more challenging, subjective or complex than others and are more likely to be identified as CAMs. Determining whether auditing other matters involves especially challenging, subjective or complex auditor judgment will depend on the facts and circumstances of the audit.

SEC amends Regulation S-K to simplify disclosure requirements
The SEC amended Regulation S-K to modernize and simplify certain disclosure requirements, including those related to management’s discussion and analysis (MD&A). The new rules give registrants more flexibility to prepare MD&A and allow those that provide three years of financial statements in a filing to omit a discussion of the earliest year from MD&A if such a discussion was included in any previous filing. Registrants that opt to do so must identify where the discussion may be found in an earlier filing. Registrants are also allowed to redact confidential information from material contracts filed as exhibits, without submitting a confidential treatment request, if the information is not material and disclosing it would likely cause competitive harm.

The SEC also clarified the requirements for risk factor disclosures and description of property disclosures to streamline reporting for some registrants. In addition, the SEC added requirements for XBRL data tagging of items on the cover pages of certain filings and for using hyperlinks to information that is incorporated by reference and available on EDGAR. The XBRL requirement will be phased in over three years, based on a registrant’s filing status.

SEC proposes changes to requirements for business acquisitions, disposals
The SEC proposed changes to the significance tests registrants perform to determine whether to provide financial statements of businesses they acquire and pro forma information for those transactions. Registrants would consider their market capitalization, rather than total assets, in the investment test and both their revenue and after-tax income in the income test, rather than only pretax income. In addition, the proposal would formalize existing practice on providing abbreviated financial statements of acquired businesses in certain circumstances.

The proposal also would eliminate any requirement to provide three years of financial statements for an acquired business or a probable acquisition. The pro forma financial information requirements would focus not only on the purchase accounting performed under US GAAP or IFRS but also management’s expectations for synergies and other plans that are reasonably estimable and reasonably expected to occur. The significance threshold for reporting a registrant’s disposal of a business and related pro forma information would increase to 20% from 10%. Finally, the proposal would change requirements for investment, real estate, and oil and gas companies.

SEC proposes excluding some SRCs from accelerated filer definition
The SEC proposed revising the definition of an accelerated filer and large accelerated filer to exclude SRCs that have less than $100 million in annual revenue. As a result, these companies would no longer be required to obtain an annual attestation from their independent auditor on their internal control over financial reporting (i.e., Section 404(b) of the Sarbanes-Oxley Act). These SRCs also would no longer be subject to accelerated deadlines for filing quarterly and annual reports with the SEC.
The SEC proposed the changes to provide relief to a subset of issuers that now qualify as SRCs and can, therefore, make scaled disclosures but still have to meet the accelerated filer requirements. The SEC said it focused on SRCs that have not yet begun generating significant revenue because it believes they could benefit from the cost savings associated with not having to obtain Section 404(b) auditor attestation and redirect those savings into expanding their businesses. The SEC created the overlap between smaller reporting companies and accelerated filers when it expanded the definition of a smaller reporting company last year. The proposal also would increase the revenue thresholds for exiting accelerated filer status to $60 million from $50 million and for exiting large accelerated filer status to $560 million from $500 million. Management would still have to issue a report on internal controls under Section 404(a) of Sarbanes-Oxley.

SEC staff increases focus on non-GAAP measures
The SEC staff is increasing its focus on registrants’ use of non-GAAP financial measures, especially those that individually tailor accounting principles. Examples of non-GAAP measures that the staff has objected to include those that alter the recognition or measurement principles of ASC 606 (e.g., from gross to net accounting) as well as those that include adjustments related to anticipated savings or synergies in a merger because this would be a projection rather than a measure of historical performance.

SEC Chief Accountant Wesley Bricker recently reiterated at a conference that non-GAAP measures, together with their required reconciliation to the related GAAP measures and disclosures, can provide investors with useful information on how management monitors performance. However, he said that non-GAAP measures should not replace GAAP reporting.

Mr. Bricker also emphasized that audit committees that display a strong interest in non-GAAP financial measures can have a positive effect on the quality of disclosures.

PCAOB increases interactions with audit committees
The PCAOB has signaled a desire to increase the frequency of its interactions with audit committees, including having its inspections staff interview audit committee members during inspections of audits. The PCAOB plans to publish its observations from these interviews along with its observations of its inspection findings.

We encourage audit committee members who are asked by the PCAOB during the inspection process to consider participating in the interview process, which is voluntary. We fully support the PCAOB’s mission to improve audit quality and believe that it is important for the PCAOB to understand the perspectives of audit committees in how they fulfill their responsibility of auditor oversight.

Reminder on interim reconciliations of shareholders’ equity
Calendar-year registrants will have to provide for the first time separate quarterly and year-to-date reconciliations of shareholders’ equity in their Form 10-Q filings for the second quarter, as required by the SEC’s Disclosure Update and Simplification rule. Calendar-year registrants actually began providing the analysis in the first quarter, but the quarterly and year-to-date reconciliations for that period were the same. The analysis must 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 must provide the reconciliation for both the year-to-date and quarterly periods and comparable periods in Form 10-Qs.

Most companies have this information available, and some have been providing disclosures about the changes in equity accounts, but all registrants will have to reconsider their presentation in their quarterly filings this year.
Other considerations

**Allison Lee nominated as SEC Commissioner**
President Donald Trump nominated Allison Lee to serve as an SEC Commissioner for a term that would expire in June 2022. If confirmed, Ms. Lee would fill the vacant seat previously held by Kara Stein. Ms. Lee served on the SEC staff from 2005 to 2018, including serving in the Division of Enforcement and as counsel to former Commissioner Stein.

**SEC names Teotia Acting Chief Accountant following Bricker’s departure**
The SEC announced the departure of Chief Accountant Wesley R. Bricker and named Sagar Teotia Acting Chief Accountant. Mr. Teotia joined the SEC as Deputy Chief Accountant in 2017. The Chief Accountant serves as the agency’s main advisor on accounting and auditing issues.

**FAF appoints Cosper to the FASB**
The Financial Accounting Foundation (FAF) appointed Susan M. Cosper to the FASB, effective 1 May 2019. Ms. Cosper previously served as the FASB’s technical director. She will continue to chair the FASB’s Emerging Issues Task Force on an interim basis. Shayne Kuhaneck was appointed as Acting Technical Director.

**Summary of open comment periods**
Items are FASB proposals unless otherwise noted.

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<td>Proposed Accounting Standards Update — Disclosure Improvements: Codification Amendments in Response to the SEC’s Disclosure Update and Simplification Initiative</td>
<td>28 June 2019</td>
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<td>Amendments to the Accelerated Filer and Large Accelerated Filer Definitions (SEC proposal)</td>
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<tr>
<td>Amendments to Financial Disclosures about Acquired and Disposed Businesses (SEC proposal)</td>
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To the Point

- FASB allows NFPs to simplify their accounting for goodwill and intangible assets (30 May 2019)
- The EITF will address revenue recognition related to contract modifications for licenses of IP (23 May 2019)
- FASB proposes simplifying the accounting for income taxes (14 May 2019)
- SEC proposes excluding some smaller reporting companies from accelerated filer status (14 May 2019)
- FASB proposes incorporating certain SEC disclosure requirements into US GAAP (7 May 2019)
- SEC proposes changing disclosure requirements for acquisitions and disposals of businesses (7 May 2019)
- Governmental benefit plans and certain governmental employers need to consider new mortality data (1 May 2019)
- FASB issues amendments to the three new standards on financial instruments (26 April 2019)
- FASB revises its proposal to change income tax disclosure requirements (28 March 2019)
- SEC modernizes and simplifies certain Regulation S-K disclosure requirements (27 March 2019)

Technical Line

- Accounting for the effects of natural disasters (29 May 2019)
- Navigating the requirements for merging with a special purpose acquisition company (16 May 2019)

Financial reporting developments

- Lease accounting – Accounting Standards Codification 840, Leases (7 June 2019)
- Discontinued operations (after the adoption of ASU 2014-08) (30 May 2019)
- Discontinued operations (before the adoption of ASU 2014-08) (30 May 2019)
- Bankruptcies, liquidations and quasi-reorganizations (23 May 2019)
- Segment reporting (16 May 2019)
- Asset retirement obligations (15 May 2019)
- Accounting changes and error corrections (1 May 2019)
- Intangibles – Goodwill and other (12 April 2019)
- Exit or disposal cost obligations (10 April 2019)
- Real estate sales (2 April 2019)
- Lease accounting – Accounting Standards Codification 842, Leases (28 March 2019)

Comment letters

- FASB’s proposal to change the disclosure requirements for income taxes (31 May 2019)
- FASB’s invitation to comment on measurement and other topics related to revenue contracts with customers acquired in a business combination (30 April 2019)
- FASB’s proposal on codification improvements to share-based payment to a customer (18 April 2019)
- SEC’s request for comment on earnings releases and quarterly reports (21 March 2019)

Other

- Credit impairment reference card – Key questions for management to consider related to the use of third parties when determining the allowance for credit losses (6 June 2019)
- Accounting for digitally distributed content (after adoption of ASU 2019-02) – Media and entertainment (23 May 2019)
- The Private Angle – Starting the journey to implement the new leases standard (1 May 2019)
- SEC in Focus – April 2019 (11 April 2019)
- Accounting pronouncements effective for the first quarter of 2019 (4 April 2019)
- Quarterly tax developments – March 2019 (27 March 2019)

On-demand webcasts

- EY Q1 2019 financial reporting update
- Reinventing the supply chain for an autonomous future

Upcoming webcasts

- Accounting for income taxes: quarterly perspective
- Global payroll challenges for US employers