Financial reporting briefs

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

September 2019
Reminders about leases

Entities that have adopted the new leases standard need to make sure that they have policies, processes and controls in place to account for new or modified leases and those that must be reassessed or remeasured under Accounting Standards Codification (ASC) 842. A critical step in accounting for new, modified or reassessed lease contracts is to determine the appropriate lease term.

The lease term, which begins on the lease commencement date, is the noncancelable term of the lease together with (1) periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option, (2) periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option and (3) periods covered by an option to extend (or not terminate) the lease that only the lessor can exercise.

While the Financial Accounting Standards Board (FASB or Board) did not define “reasonably certain” in ASC 842, it indicated in the Background and Basis for Conclusions that the term is generally interpreted as a high threshold and has the same meaning as “reasonably assured” in ASC 840. Therefore, no change in practice is expected.

Nonconsecutive periods of time must be considered when determining the lease term. Retailers may lease space for nonconsecutive periods of time over several years. In these cases, the retailer controls the right to use the leased space for a lease term that is the sum of the nonconsecutive periods of time. For example, if a retailer enters into a noncancelable lease to use the same retail space for the months of October, November and December each year for a period of five years, the lease term at the commencement date of the lease is 15 months (three months per year for the five annual periods specified in the contract).

After adopting ASC 842, lessees must continue to have appropriate controls and processes in place related to the inputs used to estimate the incremental borrowing rate (IBR). Although lessees began estimating the IBR for existing leases upon adoption of ASC 842, the inputs to this estimate, such as a lessee’s credit rating or market conditions, may change over time, and a lessee needs to make sure it has processes and controls to identify and capture any changes.

Lessors that have adopted the new leases standard will need to monitor the collectibility of lease payments (and any amounts necessary to satisfy a residual value guarantee) both at and after the lease commencement date. ASC 842 provides an impairment model to account for uncollectible operating lease receivables. If collection of operating lease payments, plus any amount necessary to satisfy a residual value guarantee for any individual lease, is not probable (either at lease commencement or after the commencement date), a lessor’s lease income is constrained to the lesser of the amount of cash collected or lease income reflected on a straight-line or another systematic basis, plus variable lease payments when accruable.

However, the FASB staff recently clarified that a second approach would also be acceptable. After applying the guidance in ASC 842, a lessor can also choose to record a reserve under ASC 450-20 (i.e., a loss contingency reserve). This reserve would apply to receivables for operating leases that individually are not impaired under ASC 842. It is important to note that a lessor that chooses this approach will have to apply the guidance in both ASC 842 and ASC 450-20. This may be operationally challenging because the thresholds for impairment under the two sets of guidance differ.

We believe that it also may be appropriate for a lessor that accounts for its leases on a portfolio basis, and has data indicating that collection is not probable under ASC 842 for a portion of its lease population, to use a portfolio approach to calculate impairment under ASC 842.
Credit losses: proposed codification improvements, reminders

The FASB proposed several amendments to the new credit losses standard, including an amendment that would require entities to include expected recoveries of the amortized cost basis in the credit loss estimate for purchased credit-deteriorated assets, as long as the recoveries do not exceed the aggregate amount of previous or expected write-offs of the assets.

In addition, the FASB staff issued a question and answer document on its new credit losses standard that addresses using historical loss information, developing reasonable and supportable forecasts, and reverting to historical loss information when estimating expected credit losses.

As a reminder, entities should consider whether they need to create or enhance their processes and controls over key judgments to comply with the new current expected credit loss model. Such processes and controls include incorporating the risk of loss, even if the likelihood of a loss is remote; pooling of assets; accumulating and selecting historical loss data and adjusting for current economic conditions; determining which economic indicators drive credit losses; and forecasting those economic conditions and determining the related adjustment to the credit loss estimate.

Also, entities are now required to recognize an allowance for expected credit losses for short-term accounts receivable, even those that are current. Therefore, changes to processes and controls over accounting for determining the allowance for short-term accounts receivable may be necessary to meet the objectives of the new standard.

For available-for-sale debt securities, entities will no longer be able to consider the length of time a security has been in an unrealized loss position to determine whether a credit loss exists. As a result, entities may need to refine their processes to consider factors they don’t consider today. As part of management’s certification of an entity’s internal control over financial reporting (ICFR) in its periodic report, Securities and Exchange Commission (SEC) registrants must disclose changes in ICFR during the latest quarter that have materially affected or are reasonably likely to materially affect an entity’s ICFR. SEC registrants also need to consider whether to disclose any changes they made to their controls to implement the new standard.

Trends in SEC staff comments on revenue recognition

In comment letters to registrants that have adopted the new revenue standard, the SEC staff has focused on areas of judgment, such as identifying performance obligations and estimating variable consideration. The SEC staff has asked registrants to further explain and sometimes provide their analysis for certain judgments and estimates made in their application of the standard.

On identifying performance obligations, the SEC staff requested analyses of conclusions that certain goods or services were not distinct and, therefore, not separate performance obligations. The staff requested that registrants provide a similar analysis to support their determination that certain promised goods or services in a contract were distinct from other promises in the contract and, therefore, were separate performance obligations.

On variable consideration, the SEC staff requested that registrants explain how they considered the different forms of variable consideration, how they estimated the variable consideration and whether the estimates were constrained.

Other areas of SEC staff focus included analyzing principal vs. agent considerations, applying the residual method to allocate the transaction price, recognizing revenue over time or at a point in time, disaggregating revenue for disclosure purposes and determining the amortization period for certain capitalized contract costs.
The SEC staff has been encouraging companies to continue refining and supplementing their revenue recognition disclosures in areas that require significant judgments or involve estimates. When making this evaluation, companies should consider disclosures by peer companies, industry practice and other best practices as they evolve.

The volume of comments related to revenue recognition nearly doubled in the year ended 30 June 2019 and represented about one-third of overall comments. Overall, this was not unexpected because revenue is frequently an area of comment, and the implementation of a new standard is typically an SEC staff focus area.

**FASB proposes relief for transition from LIBOR and other reference rates**

The FASB proposed providing temporary optional expedients and exceptions to the US GAAP guidance on contract modifications and hedge accounting in light of the expected market transition from the London Interbank Offered Rate (LIBOR) and other reference interest rates to alternatives, such as the Secured Overnight Financing Rate. LIBOR is used extensively in the US and global markets as a reference interest rate in a broad range of financial instruments and commercial agreements, but the banks that report information used to set this rate will no longer be required to do so after 2021.

Under the proposal, an entity could choose not to apply certain modification accounting requirements in US GAAP to contracts affected by what the proposal calls “reference rate reform” if certain criteria are met. An entity that makes this election would present and account for a modified contract as a continuation of the existing contract. The proposal would also provide optional expedients that would enable entities to continue to apply hedge accounting for hedging relationships in which the critical terms change due to reference rate reform if certain criteria are met. The relief would be effective upon issuance, and entities would be able to apply it prospectively through 31 December 2022.

The SEC staff previously issued a statement encouraging companies that have not already done so to begin managing their transition away from LIBOR. The SEC staff noted that companies should also monitor other reference rates undergoing transition. In the statement, the staff of the SEC’s Division of Corporation Finance said it is important for companies to keep investors informed about their progress in managing the transition from LIBOR. Potential disclosures the staff cited include material risks related to the transition and how they are being mitigated.

The staff of the SEC’s Office of the Chief Accountant said the transition could have a significant effect on an issuer’s accounting and financial reporting. Areas that the staff highlighted include modifications of debt instrument terms, hedging activities, inputs used in valuation models and potential income tax consequences. The FASB’s proposal would provide companies relief in some of these areas.

**Simplifying an issuer’s accounting for debt and equity instruments**

The FASB proposed simplifying an issuer’s accounting for convertible instruments by eliminating the requirements in ASC 470-20 to separately account for embedded conversion features. Only embedded conversion features requiring bifurcation in accordance with ASC 815-15 would be accounted for separately. The proposal also would simplify an entity’s accounting for contracts in its own equity (e.g., warrants) by requiring the entity to disregard remote events in certain circumstances and removing some of the conditions for equity classification in ASC 815-40. An entity would not have to reconsider the determination of remote events after the issuance date of the instrument, unless specified events that require reassessment occur.

In addition, the proposal would require entities to use the if-converted method for all convertible instruments in the diluted earnings-per-share calculation and presume share settlement for instruments that may be settled in cash or shares, except for liability-classified share-based payment awards.

**ITC on certain intangible assets, subsequent accounting for goodwill**

The FASB issued an Invitation to Comment (ITC) seeking input on whether it should simplify the accounting for certain intangible assets and subsequent accounting for goodwill. The FASB is also seeking input on whether it should change the disclosure requirements about intangible assets and goodwill and whether it should revisit any other aspects of the guidance on accounting for these items. While the FASB is primarily seeking feedback on public business entities (PBEs), stakeholders of private companies and not-for-profit entities (NFPs) that are currently allowed to elect alternatives to simplify their accounting for certain intangible assets and goodwill may want to comment because these entities could also be affected by any changes to the guidance.
FASB proposes deferring effective dates for four major standards

The FASB proposed deferring certain effective dates for its new standards on credit losses, hedging and leases and, in a separate proposal, deferring all effective dates for its new insurance standard. The proposals were driven by feedback that the Board received highlighting the significant challenges encountered by smaller entities in transitioning to a major new standard.

The FASB is reconsidering its philosophy on establishing effective dates for major projects for private companies, NFPs, employee benefit plans (EBPs) and smaller public companies (i.e., those that qualify as smaller reporting companies, or SRCs, under SEC rules). The Board has developed a two-bucket approach that would give these entities more time to implement major new standards.

The tables below show how the proposals would affect calendar-year entities:

<table>
<thead>
<tr>
<th>Credit losses</th>
<th>Existing effective dates</th>
<th>Effective dates the FASB proposed</th>
</tr>
</thead>
<tbody>
<tr>
<td>SEC filers</td>
<td>2020*</td>
<td>2020*</td>
</tr>
<tr>
<td>Other PBEs</td>
<td>2021*</td>
<td>2021*</td>
</tr>
<tr>
<td>Other entities</td>
<td>2022*</td>
<td>2022*</td>
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* Including interim periods within the fiscal year.

<table>
<thead>
<tr>
<th>Hedging</th>
<th>Existing effective dates</th>
<th>Effective dates the FASB proposed</th>
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<tbody>
<tr>
<td>PBEs</td>
<td>2019, including interim periods within the year</td>
<td>2020 for annual periods, 2021 for interim periods</td>
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<tr>
<td>All other entities</td>
<td></td>
<td>No change from existing effective dates</td>
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* Early adoption, including adoption in an interim period, is permitted.

<table>
<thead>
<tr>
<th>Leases</th>
<th>Existing effective dates</th>
<th>Effective dates the FASB proposed</th>
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<tbody>
<tr>
<td>All PBEs and certain NFPs and EBPs*</td>
<td>2019, including interim periods within the year</td>
<td>2020 for annual periods, 2021 for interim periods</td>
</tr>
<tr>
<td>All other entities</td>
<td></td>
<td>No change from existing effective dates</td>
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</tbody>
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* Early adoption, including adoption in an interim period, is permitted.

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<thead>
<tr>
<th>Insurance</th>
<th>Existing effective dates</th>
<th>Effective dates the FASB proposed</th>
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<tbody>
<tr>
<td>PBEs</td>
<td>2021, including interim periods within the year</td>
<td>2022 for annual periods, 2023 for interim periods</td>
</tr>
<tr>
<td>All other entities</td>
<td></td>
<td>2022, including interim periods within the year</td>
</tr>
<tr>
<td>SEC filers, excluding SRCs</td>
<td></td>
<td>2024 for annual periods, 2025 for interim periods</td>
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</table>

* This bucket includes NFPs that have issued or are conduit bond obligors for securities that are traded, listed or quoted on an exchange or an over-the-counter market and EBPs that file or furnish financial statements with or to the SEC.

* Early adoption is permitted.
Regulatory developments

Reporting on CAMs
Auditors issued their first reports that include discussions of critical audit matters (CAMs), which are intended to help investors and other users of the financial statements understand matters that involved “especially challenging, subjective or complex auditor judgment” in audits. The Public Company Accounting Oversight Board (PCAOB) requirement to report on CAMs is the most significant change in auditor reporting in decades. So far, we have seen an average of two CAMs identified in auditors’ reports. The most common areas identified are related to business combination, revenue recognition, income tax and goodwill impairment topics.

During 2019, the PCAOB released two publications with insights for audit committees and investors. The PCAOB also issued an overview of the standard; a summary of its observations of audit firm methodologies, based on reviews that the PCAOB staff performed of how audit firms were preparing to implement the requirement; and a series of frequently asked questions. Separately, the Center for Audit Quality issued a publication to help investors understand CAMs.

SEC proposes amending more disclosure rules under Regulation S-K
The SEC proposed amending its disclosure requirements for the description of business, legal proceedings and risk factors under Regulation S-K. The proposal is intended to improve disclosures for investors and simplify compliance efforts for registrants. Among other things, the proposal would allow registrants to take a more principles-based approach to the description of business and risk factors disclosures, and it would require disclosures about human capital resources and related measures or objectives on which management focuses, if material.

AICPA issues standards on the auditor’s report and ERISA plan audits
The American Institute for Certified Public Accountants (AICPA) issued a new standard that significantly changes the form and content of the auditor’s report to increase its informational value, make it more relevant, and more clearly articulate management’s responsibilities for the financial statements and the auditor’s responsibilities for the audit. The standard requires the auditor to make certain new communications to those charged with governance, including communicating significant risks the auditor identifies. The standard also establishes new guidance for auditors engaged to communicate on key audit matters, but it does not require the communication of key audit matters unless the auditor is engaged to do so.

Separately, the AICPA issued a new standard for financial statement audits of EBPs that are subject to the Employee Retirement Income Security Act (ERISA). In doing so, the AICPA is trying to improve the quality of ERISA plan audits and increase the relevance of the auditor’s reports on these financial statements by changing their form and content.

The standard requires auditors to consider plan provisions that affect the risk of material misstatement when designing and performing audit procedures and to communicate “reportable findings” in writing to those charged with governance, among other things. The standard also requires new engagement preconditions and representations from management.

It also requires auditors to perform specific procedures on ERISA 103(a)(3)(c) audits (previously referred to as limited-scope audits), including evaluating management’s assessment of whether the entity certifying the investment information is a qualified institution. Auditors can no longer disclaim an opinion solely because of the certified investment information.
AICPA proposes amendments to standard on auditing accounting estimates

The Auditing Standards Board (ASB) of the AICPA issued a proposal that is intended to enhance the standard on auditing accounting estimates and related disclosures. Among other things, the proposal would require specific risk assessment procedures for estimates, including fair value measurements, that address the increasingly complex business environment and complexity in financial reporting frameworks. The proposal also would emphasize the need for professional skepticism when auditing estimates because they generally involve assumptions and estimation uncertainty that make them susceptible to misstatement due to management bias.

In developing the proposal, the ASB considered revisions to auditing standards on estimates made by the International Auditing and Assurance Standards Board and the PCAOB. Comments are due by 22 November 2019.

Lee sworn in as SEC Commissioner, Teotia named Chief Accountant

Allison Lee was sworn in as an SEC Commissioner for a term expiring on 5 June 2022. She filled 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.

Separately, Sagar Teotia was named Chief Accountant of the SEC. Mr. Teotia had served as Deputy Chief Accountant from 2017 until June 2019, when he became Acting Chief Accountant. Mr. Teotia was previously a partner in Deloitte's national office after having served as a professional accounting fellow at the SEC from 2009 to 2011.
## Other considerations

### Summary of open comment periods

Items are FASB proposals unless otherwise noted.

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<td>Proposed Accounting Standards Update — Financial Instruments — Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates</td>
<td>16 September 2019</td>
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<tr>
<td>Proposed Accounting Standards Update — Financial Services — Insurance (Topic 944): Effective Date</td>
<td>20 September 2019</td>
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<tr>
<td>Invitation to Comment, Identifiable Intangible Assets and Subsequent Accounting for Goodwill</td>
<td>7 October 2019</td>
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<tr>
<td>Proposed Accounting Standards Update — Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting</td>
<td>7 October 2019</td>
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<tr>
<td>Proposed Accounting Standards Update — Debt — Debt with Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging — Contracts in Entity’s Own Equity (Subtopic 815-40): Accounting for Convertible Instruments and Contracts in an Entity’s Own Equity</td>
<td>14 October 2019</td>
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<tr>
<td>Modernization of Regulations S-K Items 101, 103, and 105 (SEC proposal)</td>
<td>22 October 2019</td>
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To the Point

- FASB proposes relief for the transition away from LIBOR and certain other reference rates (6 September 2019)
- FASB proposes deferring effective dates for the new standard on long-duration insurance contracts (21 August 2019)
- FASB proposes deferring certain effective dates for major standards (15 August 2019)
- SEC proposes further modernization of Regulation S-K disclosure requirements (14 August 2019)
- FASB proposes simplifying an issuer’s accounting for debt and equity instruments (1 August 2019)
- FASB considers extending effective dates of certain major standards (18 July 2019)
- FASB staff clarifies lessor accounting for uncollectible operating lease receivables (17 July 2019)
- AICPA issues final standard that changes the requirements for ERISA plan audits and auditor’s reports (11 July 2019)
- FASB seeks input on subsequent accounting for goodwill and accounting for intangible assets (11 July 2019)
- AICPA issues final standard that changes the form and content of the auditor’s report (13 June 2019)

Technical Line

- How the new revenue recognition standard affects automotive entities (5 September 2019)
- How the new revenue standard affects health care entities (22 August 2019)
- How the new revenue standard affects telecommunications entities (22 August 2019)
- How the new leases standard affects airlines (20 August 2019)
- How the new leases standard affects automotive entities (20 August 2019)
- How the new leases standard affects consumer products and retail entities (20 August 2019)
- How the new leases standard affects engineering and construction entities (20 August 2019)
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- How the new leases standard affects health care entities (20 August 2019)
- How the new leases standard affects life sciences entities (20 August 2019)
- How the new leases standard affects oil and gas entities (20 August 2019)
- How the new leases standard affects real estate entities (20 August 2019)
- How the new leases standard affects telecom and media and entertainment entities (20 August 2019)
- How the new revenue recognition standard affects downstream oil and gas entities (20 August 2019)
- How the new revenue recognition standard affects midstream oil and gas entities (20 August 2019)
- How the new revenue recognition standard affects upstream oil and gas entities (20 August 2019)
- How the new revenue standard affects media and entertainment entities (14 August 2019)
- How the new revenue standard affects retail and consumer products entities (25 July 2019)
- IRU contracts: A purchaser’s guide to identifying and classifying leases (after the adoption of ASC 842) (17 July 2019)

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- Foreign currency matters (3 September 2019)
- Lease accounting: Accounting Standards Codification 842, Leases (28 August 2019)
- Earnings per share (14 August 2019)
- Derivatives and hedging (after the adoption of ASU 2017-12, Targeted Improvements to Accounting for Hedging Activities) (31 July 2019)
- Consolidation: determination of a controlling financial interest and accounting for changes in ownership interests (30 July 2019)
- Fair value measurement (25 July 2019)
- Issuer’s accounting for debt and equity financings (23 July 2019)
- Transfers and servicing of financial assets (23 July 2019)
- Equity method investments and joint ventures (11 July 2019)
- Statement of cash flows (25 June 2019)
- Certain investments in debt and equity securities (after the adoption of ASU 2016-01) (24 June 2019)
- Certain investments in debt and equity securities (before the adoption of ASU 2016-01) (24 June 2019)
- Credit impairment under ASC 326 (20 June 2019)
- Share-based payment (after the adoption of ASU 2018-07, Improvements to Nonemployee Share-Based Payment Accounting) (20 June 2019)
- Share-based payment (before the adoption of ASU 2018-07, Improvements to Nonemployee Share-Based Payment Accounting) (20 June 2019)

Comment letters

- SEC’s proposal on disclosures about acquisitions and disposals of businesses (29 July 2019)
- SEC’s proposal to modify the accelerated and large accelerated filer definitions (29 July 2019)
- FASB’s proposed amendments to the new credit losses standard (25 July 2019)
- FASB’s invitation to comment on proposed simplifications to the accounting for income taxes (28 June 2019)
- FASB’s proposal to incorporate certain SEC disclosure requirements into US GAAP (27 June 2019)

Other

- The Private Angle: starting the journey to implement the new leases standard (29 August 2019)
- Accounting pronouncements effective for the second quarter of 2019 (12 July 2019)
- SEC in Focus – July 2019 (11 July 2019)
- Quarterly tax developments – June 2019 (26 June 2019)

On-demand webcasts

- EY Q2 2019 financial reporting update

Upcoming webcasts

- Accounting for income taxes: a quarterly perspective (24 September 2019)