Financial reporting briefs

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

December 2019
Welcome to the December 2019 Financial reporting briefs. This edition highlights the latest developments in financial reporting and alerts you to some important considerations for 2019.

Interested in what happened at the AICPA Conference on Current SEC and PCAOB Developments? We've got it covered in our Top story. Our Accounting update section discusses the new standards on leases, credit losses and effective date deferral for major standards, among other things.

In our Regulatory developments section, we provide updates on other SEC and PCAOB developments.

Need more information? Check out our Reference library, where we list our recent publications on the topics discussed here and provide links to them.

Top story

AIPCA Conference on Current SEC and PCAOB Developments

Regulators and standard setters discussed a broad range of financial reporting topics and emerging issues last week at the annual AICPA Conference on Current SEC and PCAOB Developments (Conference) in Washington, DC. The speakers and panelists included representatives of the Securities and Exchange Commission (SEC or Commission), the Financial Accounting Standards Board (FASB or Board), the International Accounting Standards Board (IASB) and the Public Company Accounting Oversight Board (PCAOB) who shared their views on various accounting, financial reporting, auditing and regulatory issues. The theme of the Conference was how regulators, standard setters, preparers and auditors are increasing stakeholder engagement to achieve consistent, high-quality financial reporting, which is the bedrock of the US capital markets.

Highlights included:

New accounting standards – The FASB staff and SEC staff commended the successful implementation of the major new accounting standards on revenue recognition and leases and anticipate the successful implementation of the credit losses standard. The SEC staff emphasized that it has consistently accepted well-reasoned judgments applied by registrants adopting the new accounting standards. The FASB staff emphasized that it continues to provide implementation support and will evaluate whether reporting under the new standards is meeting the FASB's objectives.

Critical audit matters – PCAOB and SEC officials expressed appreciation for the efforts of auditors to implement the PCAOB requirement to discuss critical audit matters (CAMs) in the auditor’s report. The PCAOB noted that it is proactively monitoring auditors' initial reports with CAMs by performing selected reviews and publishing observations and additional staff guidance. Representatives of company management and audit committees noted that the auditors’ reporting of CAMs has resulted in companies challenging and improving the quality of their own disclosures.

Reference rate reform – The SEC staff highlighted the risks and complexities associated with phasing out the London Interbank Offered Rate (LIBOR), a process often referred to as reference rate reform. Because LIBOR is a reference rate that is widely used in loans and commercial contracts, the SEC staff is actively monitoring transition activities to address financial reporting and disclosure issues that might arise. The FASB expects to issue final guidance in early 2020 to temporarily ease the accounting burden for entities changing the reference rate in contracts if they meet certain criteria.

Non-GAAP financial measures – The SEC staff encouraged registrants to engage in “responsible” non-GAAP reporting by, among other things, making sure these measures are calculated consistently period to period. SEC staff members also discussed non-GAAP financial measures calculated using accounting principles that have been superseded by new standards (e.g., the new credit losses standard). The SEC staff believes that measures that exclude the effects of the new standard will be inappropriate because they are considered to have been prepared using “individually tailored accounting principles” that cause them to be misleading.

Auditor independence – SEC officials stressed the importance of auditor independence and compliance with the Commission’s independence rules. The SEC recently amended its Loan Rule and expects to propose revising other independence rules in 2020. Both the SEC and the PCAOB continue to focus on independence violations in their enforcement activities.
Accounting update

Year-end reporting under the new leases standard

As they prepare for year-end reporting, companies that adopted the new leases standard should carefully review their accounting and disclosures in areas that require significant judgment, estimates and changes in practice. These areas include identifying reassessments events, determining whether a contract is a lease or contains a lease, determining the lease term and determining the discount rate to use for new or modified leases.

Companies may also want to make sure their processes and controls over these areas are designed appropriately, especially if they implemented a new information technology (IT) system for lease accounting or modified their IT system during the year. In addition, they should take a fresh look at their disclosures to make sure they adequately address the objectives of the new requirements. The SEC staff is expected to carefully review these disclosures.

Lessees may want to make sure their processes and controls are designed to identify reassessment and remeasurement events because the accounting for these events may have a material effect on the financial statements. As a reminder for lessees, the reassessment and remeasurement requirements apply to both new leases accounted for under Accounting Standards Codification (ASC) 842 and leases that existed at transition and were historically accounted for under ASC 840.

As a reminder, determining whether a contract is a lease or contains a lease is more important under the new leases standard than it was under ASC 840 because an entity that fails to identify a complete population of leases could materially misstate its financial results. That is, under ASC 842, lessees have to recognize a right-of-use asset and lease liability on their balance sheets for most leases, including most operating leases. Identifying a complete population of leases may require more coordination between finance/accounting personnel and their peers in areas such as real estate, procurement, operations and corporate development.

Determining the lease term is important because it is used to calculate lease payments, classify leases, and measure lease assets and lease liabilities. Lessees are required to monitor leases for significant changes that could trigger a change in the lease term. When the lease term changes, lessees are required to reassess lease classification, remeasure the lease liability and adjust the right-of-use asset, and reassess the discount rate. Lessees may want to review their processes and controls to identify and account for events that may trigger a change in the lease term.

Lessees need to have processes and controls in place to monitor any changes in their credit ratings; market conditions, such as the decline in interest rates over the past year; or other inputs to the incremental borrowing rate used to calculate lease liabilities and right-of-use assets for new, reassessed or modified leases.

Getting ready for the new credit losses standard

The effective date of the new credit losses standard is a few weeks away for SEC filers that aren’t smaller reporting companies (SRCs), but all entities should be considering updates they’ll have to make to their processes and controls to apply the new guidance on the current expected credit losses model and the impairment model for available-for-sale debt securities. It is important to remember that the new standard applies to a number of financial assets, including short-term accounts receivable. While an entity’s financial results may not change materially, many entities, including many outside the financial services industry, will need to update processes and controls over the allowance for short-term accounts receivable to meet the objectives of the new standard.
Entities are also encouraged to update their disclosures on the expected quantitative and qualitative effects of the new standard on their financial statements consistent with the disclosures included in SEC Staff Accounting Bulletin Topic 11.M (SAB 74).

The new standard requires more disclosures about management’s process to estimate credit losses, including key assumptions and judgments. Entities will need to use judgment when determining the level of detail to include, especially about sensitive topics, such as management’s forecast of future economic conditions. We expect that management outside of the entity’s accounting and finance functions may want to review these disclosures. Entities should also have discussions with their auditors now to set expectations on testing procedures or documentation. The FASB issued Accounting Standards Update (ASU) 2019-11 to make several narrow-scope amendments to the new standard, including one requiring entities to include certain expected recoveries of the amortized cost basis in the allowance for credit losses for purchased credit-deteriorated assets.

FASB issues final guidance to simplify the accounting for income taxes
The FASB issued final guidance to simplify the accounting for income taxes. The new guidance eliminates 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 clarifies and simplifies other aspects of the accounting for income taxes. The amendments are effective for calendar-year public business entities (PBEs) in 2021, including interim periods within that year. For all other calendar-year entities, it is effective for annual periods beginning in 2022 and interim periods in 2023. Early adoption is permitted.

FASB proposes amendments to new hedging guidance
The FASB proposed amendments to clarify and improve certain aspects of the hedge accounting model amended by ASU 2017-12. The proposal would clarify the guidance on changing the hedged risk in cash flow hedges, designating contractually specified components in cash flow hedges of nonfinancial forecasted transactions and accounting for “dual” fair value and net investment hedges. It would also replace the term “prepayable” in the guidance on the shortcut method with the words “early settlement features.” The FASB is addressing implementation issues related to the application of the new last-of-layer method for hedging portfolios of prepayable financial assets in a separate project.

FASB defers effective dates for four major standards
The FASB deferred certain effective dates for its new standards on credit losses, hedging and leases, and all of the effective dates for its new long-duration insurance standard. The deferrals were driven by feedback that the Board received highlighting the significant challenges smaller entities have faced in transitioning to a major new standard.

The credit losses standard is still effective for all SEC filers that are not SRCs for fiscal years beginning after 15 December 2019, including interim periods within those fiscal years. However, it is now effective for all other entities for fiscal years beginning after 15 December 2022, including interim periods within those fiscal years. The Board also aligned the effective dates of ASU 2017-04 on goodwill impairment with the new effective dates of the credit losses standard.

The hedging standard is effective for entities that are not PBEs for fiscal years beginning after 15 December 2020 and interim periods in the following fiscal year. The standard is currently effective for PBEs.

The leases standard, which is currently effective for PBEs and certain not-for-profit entities and employee benefit plans, is effective for all other entities for fiscal years beginning after 15 December 2020 and interim periods in the following fiscal year.

The long-duration insurance standard is effective for SEC filers that are not SRCs for fiscal years beginning after 15 December 2021, including interim periods within those fiscal years. All other entities will be required to adopt it for fiscal years beginning after 15 December 2023 and interim periods in the following fiscal year.
Reminders on postretirement disclosures

While the new guidance on disclosures for defined benefit plans (ASU 2018-14) isn’t effective for calendar-year PBEs until 2020, some entities are adopting it early since it eliminated several disclosure requirements, including disclosure of amounts in accumulated other comprehensive income that are expected to be amortized into net periodic benefit cost over the next year.

However, entities will be required to make two new disclosures under the new guidance. Entities with cash balance plans and other plans with promised interest crediting rates must disclose the weighted average interest crediting rate. Entities also must provide an explanation of the reasons for significant gains and losses related to changes in the benefit obligation. There is no bright line for determining what is significant, so management will need to use judgment in evaluating what is contributing to significant changes in the obligation.

Considerations on new guidance on cloud computing arrangements

The new guidance on accounting for the costs of implementing a cloud computing arrangement (i.e., hosting arrangement) that is a service contract, which is effective for calendar-year PBEs in 2020, requires customers in these arrangements to follow the internal-use software guidance in ASC 350-40 when determining which implementation costs to capitalize as assets or expense as incurred. This may be a change in practice for some entities. Entities will be required to capitalize certain implementation costs incurred during the application development stage. Capitalized implementation costs related to a hosting arrangement that is a service contract will be amortized over the term of the hosting arrangement, beginning when the module or component of the hosting arrangement is ready for its intended use.

The guidance requires a customer to present the expense related to the capitalized implementation costs in the same line item in the income statement as the fees associated with the hosting element of the arrangement. The capitalized implementation costs would be presented in the same line item in the balance sheet as a prepayment of the fees for the associated hosting arrangement, which may be different than the classification of implementation costs for internal-use software.

Entities should also consider any necessary changes to their processes and internal controls.
Regulatory developments

Reporting on critical audit matters

Auditors issuing their first auditor’s reports that include a discussion of CAMs are identifying an average of 1.7 CAMs in each report, based on the initial observations by the PCAOB staff as reported in its Critical Audit Matters: Spotlight publication. The PCAOB staff said the most common CAMs identified thus far relate to goodwill impairment, revenue recognition, income taxes and business combinations. These discussions of CAMs 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 PCAOB requirement to report on CAMs is the most significant change in auditor reporting in decades. In the publication, the PCAOB staff said it plans to continue to monitor CAMs reporting as the requirement is phased in to determine whether further action may be necessary. The PCAOB staff said it will focus on the costs and benefits of the reporting and will complete a full post-implementation review after the requirement is implemented for all audits of 2020 financial statements.

PCAOB issues concept release on quality control standards

The PCAOB issued a concept release seeking feedback on a potential approach for revising its quality control standards that require firms to design and implement a quality control system that provides reasonable assurance that the firm’s personnel comply with applicable professional standards and the firm’s standards of quality. The PCAOB hasn't updated these standards since they were adopted in 2003 and is considering whether to make changes to prompt firms to improve their quality control systems and to more proactively identify and address emerging risks and deficiencies. Comments are due by 16 March 2020.

Disclosure reminders and updates

As the end of the year approaches, companies need to consider the accounting and financial reporting implications of economic events and conditions, such as a potential recession, lower consumer spending, lower interest rates, the expected market transition from LIBOR and other interbank offered rates, debt and equity market volatility, new or pending trade agreements, commodity price volatility, the withdrawal of the United Kingdom from the European Union (i.e., Brexit), inflation, and changes in business strategy or organization.

When disclosing risk factors, an SEC registrant should tailor them to its own facts and circumstances. Such disclosures may include a discussion of the effects of Brexit on production and supply chains, changes in regulation, availability of qualified employees and other aspects of a company’s business operations. Disclosures on the transition from LIBOR should address the status of the company’s efforts to evaluate and mitigate risks related to the discontinuation of LIBOR or other interbank offered rates. In order to help facilitate the expected market transition from LIBOR and other interbank offered rates to alternative reference rates, such as the Secured Overnight Financing Rate, the FASB recently agreed to provide temporary optional expedients and exceptions to the US GAAP guidance on contract modifications and hedge accounting. The final guidance is expected in the first quarter of 2020. The FASB’s relief should address concerns about artificial accounting volatility with the transition that would have been reported in an entity’s financial statements if relief had not been provided.

Separately, the SEC staff recently updated the Financial Reporting Manual to remove the requirement for registrants to recast years four and five of selected financial data when they adopt a new accounting standard using the full retrospective approach (e.g., the revenue standard) or they report discontinued operations. Registrants that don’t recast any portion of the five years presented in the selected financial data table should briefly describe the factors that materially affect the comparability of the information reflected in the data or cross-reference to a discussion of those factors.
New Deputy Chief Accountants appointed
The SEC named John Vanosdall and Paul Munter Deputy Chief Accountants in the Office of the Chief Accountant (OCA). Mr. Vanosdall will lead the OCA’s Accounting Group, which consults with stakeholders about the application of accounting standards and financial disclosure requirements. Mr. Munter will lead OCA’s activities on international matters.

New PCAOB board member appointed
The SEC appointed Rebekah Goshorn Jurata as a member of the PCAOB for a five-year term though October 2024. Ms. Jurata, a former SEC staff member and previously Special Assistant to the President for Financial Policy, fills the Board seat vacated by Kathleen M. Hamm at the end of her term in October 2019.

More EGCs are using private company effective dates
In the first nine months of the year, emerging growth companies (EGCs) accounted for 90% of the companies that conducted an initial public offering (IPO), and they increasingly chose to adopt new accounting standards using private company effective dates (i.e., transition date relief), largely because doing so gives them more time to adopt major new standards on topics such as revenue recognition, leases and credit losses. Otherwise, these companies would have had to adopt these standards using the public company effective dates.

From 2018 through 2019, 59% of EGCs elected transition date relief compared with 16% of EGCs from 2014 through 2017. Using private company effective dates is one of the accommodations provided to EGCs by the Jumpstart Our Business Startups Act of 2012, which was designed to encourage companies to go public. Other accommodations include filing confidentially, providing reduced executive compensation disclosures and including only two years of audited financial statements instead of three.
Other considerations

Accounting considerations for asset acquisitions
The new definition of a business established by ASU 2017-01 will likely result in additional acquisitions being accounted for as asset acquisitions rather than business combinations. Determining whether an entity has acquired a business or an asset or a group of assets is critical because the accounting for a business combination differs significantly from that of an asset acquisition.

That is, business combinations are accounted for using a fair value model, with certain exceptions, while asset acquisitions are accounted for using a cost accumulation and allocation model, which requires the cost of an acquisition to be allocated to the individual assets acquired and liabilities assumed on a relative fair value basis. Goodwill is not recognized in an asset acquisition.

There are many implications of this change, which PBEs have already adopted and entities that are not PBEs are in the process of adopting. Furthermore, companies may face unfamiliar financial reporting issues related to the accounting for asset acquisitions because they may have accounted for similar acquisitions as business combinations under the previous definition.

Entities may need to reassess the design of their internal controls over asset acquisitions to make sure they sufficiently address the risks of material misstatements, including controls over the process for determining whether the transaction should be accounted for as a business combination or an asset acquisition.

The FASB is still evaluating whether certain differences between the accounting for asset acquisitions and business combinations can be aligned in the third phase of its project on the definition of a business. These areas include contingent consideration, in-process research and development, and transaction costs.

Considerations for valuation allowances
Companies need to continually assess both negative and positive evidence in determining whether to record, maintain or reverse a valuation allowance under ASC 740, Income Taxes. It may be challenging to apply judgment when making this assessment. As a reminder, the SEC staff frequently asks companies to explain how they considered both positive and negative evidence when evaluating the need for a valuation allowance. By its very nature, future taxable income (exclusive of the reversal of existing temporary differences and carryforwards) requires estimates and judgments about future events that may be predictable but are far less certain than past events that can be objectively measured. Having a cumulative loss does not necessarily mean a company is required to recognize a valuation allowance. Cumulative losses are, however, a significant piece of negative evidence. Conversely, a return to profitability does not automatically mean a valuation allowance should be released.

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 – Codification Improvements</td>
<td>26 December 2019</td>
</tr>
<tr>
<td>Proposed Accounting Standards Update – Derivatives and Hedging (Topic 815): Codification Improvements to Hedge Accounting</td>
<td>13 January 2020</td>
</tr>
</tbody>
</table>
Reference library

To the Point

- AICPA allows agreed-upon procedures engagements to be performed in more situations (5 December 2019)
- FASB issues narrow-scope amendments to credit losses standard (5 December 2019)
- FASB defers certain effective dates for major standards (18 November 2019)
- FASB proposes amendments to clarify and improve its hedge accounting guidance (14 November 2019)
- FASB requires the ASC 718 measurement approach for all share-based payments to customers (14 November 2019)
- FASB revises its proposal to simplify the balance sheet classification of debt (13 September 2019)

Technical Line

- Year-end accounting and disclosure reminders for reporting under the new leases standard (21 November 2019)
- How the new revenue standard affects banks (10 October 2019)
- How the new revenue standard affects brokers and dealers in securities (10 October 2019)
- A closer look at the accounting for asset acquisitions (26 September 2019)
- How the new revenue standard affects life sciences entities (18 September 2019)
- How the new revenue standard affects airlines (12 September 2019)

Financial reporting developments

- Lease accounting: Accounting Standards Codification 842, Leases (4 December 2019)
- Income taxes (22 November 2019)
- Gains and losses from the derecognition of nonfinancial assets (ASC 610-20) (21 November 2019)
- Business combinations (10 October 2019)
- Revenue from contracts with customers (ASC 606) (30 September 2019)
- Revenue recognition: Multiple element arrangements (20 September 2019)
- Software: Revenue recognition (18 September 2019)

Comment letters

- SEC’s proposal to update statistical disclosure requirements for bank and savings and loan registrants (27 November 2019)
- ASB’s proposal to amend AU-C 800 series (28 October 2019)
- FASB’s revised proposal to simplify the balance sheet classification of debt (28 October 2019)
- SEC’s proposal to modernize disclosures of description of business, legal proceedings and risk factors under Regulation S-K (21 October 2019)
- FASB’s proposal to simplify an issuer’s accounting for debt and equity instruments (14 October 2019)
- FASB’s proposal to facilitate the effect of reference rate reform on financial reporting (7 October 2019)
- FASB’s proposal to defer the effective dates for the new standard on targeted improvements to the accounting for long-duration contracts (20 September 2019)
- AICPA’s proposed amendments to the auditing standard on audit evidence (18 September 2019)
- FASB’s proposal to defer certain effective dates for the new standards on credit losses, hedging and leases (16 September 2019)

Other

- 2019 AICPA Conference on Current SEC and PCAOB Developments (15 December 2019)
- 2019 SEC annual reports – Form 10-K (9 December 2019)
- 2020 proxy statements: an overview of the requirements (9 December 2019)
- 2020 SEC quarterly reports – Form 10-Q (9 December 2019)
- EITF Update – November 2019 (11 November 2019)
- The Private Angle: navigating the accounting requirements of the new leases standard (17 October 2019)
- Third Quarter 2019 Standard Setter Update (16 October 2019)
- Accounting pronouncements effective for the third quarter of 2019 (10 October 2019)
- Quarterly tax developments – September 2019 (3 October 2019)
- SEC in Focus – October 2019 (3 October 2019)
- SEC Comments and Trends – September 2019 (18 September 2019)

On-demand webcasts

- EY Q4 2019 financial reporting update
- What to consider for year-end SEC reporting