CNM TAG – Summary of Recent Accounting Developments 1/18/19

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AICPA SEC and PCAOB Conference

- SEC staff comments on application of ASC 842—see Appendix
- SEC staff comments on ICFR—see Appendix

CNM Articles

- PCAOB Developments
- CECL is Coming
- ASC 842—Incremental Borrowing Rate

Big Four Accounting Guides – new or revised

- KPMG—Revenue for software and SaaS (December 2018), Revenue Recognition Handbook (November 2018), Leases Handbook (December 2018), Revenue: Real Estate (January 2019)
- EY—Revenue from contracts with customers (October 2018), Lease accounting (January 2019)
- Deloitte—Roadmap to Applying the New Revenue Recognition Standard (2018), Roadmap to Accounting for Share-Based Payment Awards (2018), Roadmap to Accounting for Business Combinations (2018), Roadmap to Accounting for Equity Method Investments and Joint Ventures
- PwC—Revenue from contracts with customers (September 2018)

New Accounting Standards

- ASU 2018-20 (December 2018), Narrow-Scope Improvements for Lessors[1]
  - Permits lessors, as an accounting policy election, to not evaluate whether certain sales taxes and other similar taxes are lessor costs and instead consider them as lessee costs
  - Require lessors to exclude from variable payments lessor costs paid by lessees directly to third parties
  - Allocate certain variable payments to lease and nonlease components when the changes in facts and circumstances on which the variable payment is based occur
- ASU 2018-19 (November 2018), Codification Improvements to Topic 326, Financial Instruments—Credit Losses[2]
  - Delays the effective date for nonpublic business entities to fiscal years beginning after December 15, 2021 (e.g., January 1, 2022 for calendar fiscal year)
  - Excludes operating lease receivables from the scope of ASC 326
- ASU 2018-18 (November 2018), Collaborative Arrangements (Topic 808): Clarifying the Interaction between Topic 808 and Topic 606[3]
- ASU 2018-17 (October 2018), Consolidation (Topic 810): Targeted Improvements to Related Party Guidance for Variable Interest Entities[4]
- ASU 2018-16 (October 2018), Derivatives and Hedging (Topic 815): Inclusion of the Secured Overnight Financing Rate (SOFR) Overnight Index Swap (OIS) Rate as a Benchmark Interest Rate for Hedge Accounting Purposes

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[1] Effective upon adoption of ASC 842—January 1, 2019 for public companies and January 1, 2020 for other companies with calendar fiscal years with early application permitted.

[2] Effective upon adoption of ASC 326—January 1, 2020 for public companies and January 1, 2022 for other companies with calendar fiscal years with early application permitted.

[3] Effective January 1, 2020 for public companies and January 1, 2021 for other companies with calendar fiscal years with early adoption permitted.

[4] Applicable only to nonpublic entities effective January 1, 2021 for private companies with calendar fiscal years with early adoption permitted.

[5] Effective upon adoption of ASU 2017-12 for public companies and other companies that have not yet adopted ASU 2017-12. (ASU 2017-12 is effective January 1, 2019 for public companies and January 1, 2020 for all other companies with calendar fiscal years.) For all other entities that already have adopted the amendments in Update 2017-12, the amendments are effective January 1, 2020 for companies with calendar fiscal years.

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Other

- FASB Staff Q&A, Topic 326, Issue 1—Whether the Weighted-Average Remaining Maturity Method is an Acceptable Method to Estimate Expected Credit Losses
- Financial Executives International (FEI) guides on internal control over financial reporting considerations related to ASC 842 and CECL (November 2018)
- PCAOB Release No. 2018-005 (December 20, 2018), Auditing Accounting Estimates
- PCAOB Release No. 2018-006 (December 20, 2018), Amendments to Auditing Standards for Auditor's Use of the Work of Specialists

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Appendix

SEC Conference – SEC Staff Comments – ASC 842

Andrew Pidgeon, a professional accounting fellow in OCA, discussed several consultations related to the new leases standard.

Lessee transition — change in the composition of minimum rental payments

Mr. Pidgeon discussed two consultations related to the transition guidance in ASC 842 that requires an entity to use the minimum rental payments calculated under ASC 840 to measure the initial lease liability.

Given that there is diversity in practice about whether executory costs should be included in minimum rental payments under ASC 840, the SEC staff had previously said it would not object to registrants consistently applying their historical accounting policy on whether to include executory costs in minimum rental payments.

In a recent consultation, the SEC staff did not object to a registrant applying ASC 250, Accounting Changes and Error Corrections, to voluntarily change its historical accounting policy for minimum rental payments regarding the exclusion or inclusion of executory costs, Mr. Pidgeon said. ASC 250 permits a registrant to change its generally accepted accounting principle to another generally accepted accounting principle, if the change is preferable.

A second consultation related to a lessee's measurement of minimum rental payments that are based on an index or a rate. ASC 842 requires a lessee to measure variable lease payments that depend on an index or a rate using the prevailing index or rate at the measurement date (e.g., lease commencement date for initial measurement). However, ASC 840 does not specify whether indexed future minimum rental payments disclosed by a lessee (i.e., payments included in the measurement of the initial ASC 842 lease liability) should be measured using the prevailing index or rate at lease inception or the current index or rate, which has resulted in diversity in practice.

Mr. Pidgeon said the staff did not object to a registrant consistently applying its historical ASC 840 accounting policy for measuring future minimum rental payments based on an index or a rate for the purpose of measuring its lease liability in transition to ASC 842. He said that the staff also did not object to a registrant applying ASC 250 to voluntarily change its policy from using the index or rate at lease inception to the current index or rate.

Mr. Pidgeon said that the staff believes it would be reasonable for a registrant to consider whether the lease obligation that results from using the current index or rate represents a better measurement of the registrant's current lease obligations when assessing preferability under ASC 250.

How we see it

Companies that plan to change their historical ASC 840 accounting policy for measuring minimum rental payments should evaluate whether such a change is quantitatively or qualitatively material before applying ASC 250.

Certain lessee and lessor costs

Mr. Pidgeon also discussed two consultations related to certain costs a lessee and lessor may incur to prepare an asset for its intended use after lease inception but before lease commencement (e.g., costs to mobilize the asset).

Mr. Pidgeon said the staff did not object to a lessee making an accounting policy election to capitalize the costs paid to a third party other than the lessor by analogizing to the guidance in ASC 360, Property, Plant, and Equipment, on bringing an asset to the condition and location necessary for its intended use, if the costs are not within the scope of other topics in US GAAP. Similarly, Mr. Pidgeon said the staff did not object to a lessor making an accounting policy election to defer the costs it incurred by analogizing to the guidance on contract fulfillment costs in ASC 340-40, Other Assets and Deferred Costs — Contracts with Customers, if the costs are not within the scope of other topics in US GAAP and would qualify for deferral if the lease were in the scope of ASC 606.

Mr. Pidgeon encouraged registrants that elect either accounting policy to apply the policy consistently and include appropriate disclosure of the policy, if material.

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Appendix

SEC Conference – SEC Staff Comments

ICFR and audit standard setting

Internal control over financial reporting

The SEC staff said management's assessment of ICFR is more important than usual this year due to the higher risk that controls may fail to timely detect or prevent a material misstatement of the financial statements following the adoption of new accounting standards.

Evaluating the operating effectiveness of ICFR

Emily Fitts, a professional accounting fellow in OCA, said that both the design of controls and the evaluation of their operating effectiveness require management's well-reasoned and supported judgment, which is grounded in the assessment of the risk of control failure and the risk of material misstatement, considering changes in risks. As these risks increase, more persuasive evidence is generally needed, she said.

To determine whether controls operated effectively and as designed, Ms. Fitts shared some questions for management to consider:

- Did the assessment include an evaluation of how the operation of the control mitigated the identified risks?
- If a control is designed to address multiple financial reporting risks or if the control is multifaceted, did the assessment include an evaluation of the operating effectiveness of each aspect of the control?
- For controls that operate more than once per annual period, was the consistency of the execution of the control considered?
- When the control was designed with a threshold, was the threshold applied consistently and was further evaluation of items exceeding the threshold conducted when necessary?
- Were the competency and authority of the personnel who performed the control, or monitored its performance, evaluated and considered?
- In considering the competency and authority of the responsible personnel, did the assessment consider whether there had been any changes in the personnel who either perform the control or monitor its performance?

To determine whether management has a reasonable basis for its assessment of the operating effectiveness of controls, Ms. Fitts shared the following questions for management to consider:

- Is the sample size to evaluate the effectiveness of the control sufficient, considering the number of instances in which the control operated during the assessment period?
- Were the risks associated with the control considered in determining the appropriate level of persuasiveness needed for the evidence to be obtained?
- For controls related to financial reporting elements with a higher risk of material misstatement (e.g., susceptibility to fraud, need for significant judgment, complexity), did the nature, timing and extent of the evaluation procedures appropriately reflect the level of risk?
- Was the type of control (i.e., manual or automated) considered in determining the nature, timing and extent of the evaluation procedures?
- Did the control rely on the completeness and accuracy of the information produced by the company? If so, were the controls over that information evaluated and found to be effective?

Evaluating control deficiencies

Tom Collens, a professional accounting fellow in OCA, shared observations related to management's evaluation of the severity of a control deficiency, including whether a deficiency, either alone or in combination with other identified control deficiencies, rises to the level of a material weakness. To assist management in evaluating control deficiencies, Mr. Collens shared the following observations and reminders.

Mr. Collens said the evaluation of deficiencies too often focuses on the actual misstatement that occurred. For example, management may assume that a control deficiency is limited to the area in which a misstatement occurred and may fail to perform a root cause evaluation that would help management determine whether it is reasonably possible that other financial statement areas could be affected.

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Appendix

SEC Conference – SEC Staff Comments

Evaluating control deficiencies (cont.)

Mr. Collens also reminded preparers that it is important to perform a fulsome analysis of the magnitude of a reasonably possible misstatement when there is a control deficiency. For example, if a deficiency resulted in offsetting misstatements in a financial statement line item or disclosure, management may need to consider those misstatements in the aggregate without netting as a starting point for evaluating the potential magnitude of misstatements resulting from the control deficiency.

Finally, Mr. Collens observed that compensating controls should (1) operate at a level of precision that would prevent or detect a misstatement that could be material and (2) be designed to achieve the same objective as the control identified as deficient in order to reduce the severity of that control deficiency to below a material weakness. The existence of a material misstatement would likely indicate that the compensating control was not sufficient.

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Improving disclosures about material weaknesses

Despite improvements the SEC staff generally has noted in disclosures of material weaknesses, Ms. Fitts said companies could do more to make these disclosures more informative for investors. For example, management should help investors understand the cause of the material weakness, its effect on the financial statements (e.g., whether the material weakness is pervasive or isolated to specific accounts or disclosures) and management's remediation plans, she said.

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