CNM LLP
Technical Advisory Firm

Some Things to Think About for 2022

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While it is still early in the year, here are some things to keep in mind regarding accounting and financial reporting for 2022.

Regulatory Update:

1. SEC Proposed Amendments to Cybersecurity Disclosures

On March 9, 2022, the SEC issued its proposed rule amendments to enhance registrants' cybersecurity disclosures by requiring mandatory, ongoing disclosures on the company's governance risk management and strategy with respect to cybersecurity risks, as well as required mandatory disclosure of material cybersecurity incidents. Comments are due at the later of 30 days after publication of the proposal in the Federal Register or May 9, 2022.

For more details, see our article at https://cnmllp.com/insights/sec-proposed-amendments-to-cybersecurity-disclosures/

2. SEC Proposes Climate Change Disclosures

On March 21, 2022, the SEC proposed new rules to enhance and standardize climate-related disclosures included in registration statements and periodic reports. The proposal standardizes the disclosures registrants make about climate-related risks, their climate-related targets and goals, their greenhouse gas emissions and how the board of directors and management governs and manages its climate-related risks. The proposal would also require registrants to quantify certain climate-related impacts in the notes to their audited financial statements. If approved, implementation would depend on the filer status, and would be phased in beginning with fiscal year 2023. Comments are due at the later of 30 days after publication of the proposal in the Federal Register or May 20, 2022.

For more details, see our article at https://cnmllp.com/insights/sec-proposed-rules-to-enhance-and-standardize-climate-related-disclosures/

3. Materiality

On March 9, 2022, the SEC's Acting Chief Accountant, Paul Munter, made a statement going into greater detail about the assessment of materiality as it relates to financial reporting errors. The concept of the "Big R" and "little r" restatements continues to be a hot topic for the SEC.

The SEC will continue to challenge registrants' overreliance on qualitative factors to conclude that a quantitatively significant error is immaterial. The statement also highlighted arguments used by registrants in their analysis, such as GAAP financial statements or certain line items are irrelevant to investors or that a similar error has been made by several registrants, that the SEC has taken exception.

The statement continued to stress that the evaluation of the severity of a control deficiency, because of a restatement, should not be limited to the amount of the actual error. Registrants need to consider the magnitude of the potential misstatement that could result from a control deficiency.

Registrants need to have a process in place to evaluate errors using both qualitative and quantitative factors when evaluating the materiality of an error. It is expected that quantitatively material errors would not be overcome by qualitative factors.

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Accounting Update:

1. *ASC 842, Leases, for Non-public companies and Smaller Reporting and Emerging Growth public companies*

Non-public companies, Smaller Reporting Companies (SRCs), and Emerging Growth Companies (EGCs) who have not yet adopted ASC 842, *Leases*, must adopt the new Standard in 2022. For calendar year companies, the effective date is January 1, 2022.

Under the new Standard, lessees must record a right-of-use (ROU) asset and a lease liability for operating leases. For the most part, the rent expense recognized each month will remain the same. ASC 842 also provides a new definition of a lease for accounting purposes, which will require companies to examine service and other contracts for embedded terms that might meet the new definition of a lease and require separate recognition. There are also new disclosure requirements.

Companies should be preparing for its implementation now, especially if they have a lot of leases. Companies should start by taking an inventory of all leases and focus on any leases that have terms greater than one year.

2. *ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity*

In 2020, the FASB issued ASU 2020-06 to address the complexity in accounting for certain financial instruments with characteristics of liabilities and equity. The amendment simplifies the guidance on issuer's accounting for convertible instruments and guidance on the derivative scope exception for contracts in an entity's own equity. Fewer conversion features will require separate recognition and fewer freestanding instruments, like warrants, will require liability treatment.

The two most significant changes of ASU 2020-06 are:

1. Embedded conversion features will no longer be separated from the host contract for convertible instruments, provided that:
    a. They are not required to be accounted for as derivatives under ASC 815, *Derivatives and Hedging*, (i.e., not clearly and closely related to the host instrument), or
    b. They do not result in substantial premiums accounted for as paid-in capital.
2. More instruments will be able to qualify for the scope exception under ASC 815 as an "entity's own equity" by removing three of the seven requisite conditions from the settlement guidance:
    a. Settlement permitted in unregistered shares (however, if the contract explicitly states that cash settlement is required if unregistered shares are unavailable, the contract will not qualify as equity),
    b. No collateral required, and
    c. No counterparty ranks higher than shareholder rights.

As a result, traditional conversion features (e.g., beneficial conversion features and cash conversion features) no longer will be recorded separately from the host instrument. Also, more contingent conversion features (e.g., upon a change in control or new round of financing) will qualify for the ASC 815 scope exception, which means that they will not need to be recorded separately as derivative instruments (at fair value). Finally, more freestanding instruments, such as warrants, will be classified as equity.

Public companies (except SRCs) must adopt ASU 2020-06, if applicable, for fiscal years beginning after December 15, 2021 (i.e., January 2022 for calendar fiscal years). ASU 2020-06 is effective for all other entities for fiscal years beginning after December 15, 2023 (i.e., January 2024 for calendar fiscal years) with early adoption permissible.

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The ASU also expanded disclosure requirements for convertible instruments, amended certain guidance in ASC 260, *Earnings per Share*, and freestanding contracts on an entity's own equity that does not qualify as equity be accounted for under fair value which changes in fair value recognized in earnings.

SRCs and private entities will want to take advantage of the simplified accounting as soon as possible and should look to early adopt. If you are a private company and looking to IPO or merge with a special purpose entity, or are raising capital through debt or equity financing, you should early adopt even if you don't currently have these types of instruments outstanding yet.

3. *ASC 848, Reference Rate Reform*

Regulators have required supervised banks to stop using LIBOR (the London Interbank Offered Rate) as a benchmark interest rate in any product offerings (e.g., loans) after 2021. The published rate will be discontinued entirely in June 2023.

Many companies have loans, debt securities, investments, and derivative instruments (e.g., interest rate swaps) that are indexed to LIBOR. Financial institutions will need to issue new contracts with an alternative rate index or modify existing contracts to replace LIBOR if the loan or agreement does not already contain provisions for using an alternative rate when LIBOR is no longer available.

As contracts are modified to replace LIBOR with another interest rate index, questions may arise regarding the accounting for such modifications. For example, does the modification need to be recorded as an extinguishment of the original contract and the issuance or acquisition of a new replacement contract, or can the modification be recorded prospectively for the original contract?

Fortunately, the FASB has tried to provide some relief in the form of Accounting Standards Update (ASU) Nos. 2020-04 and 2021-01, *Reference Rate Reform (Topic 848)*. The amendments in this Update apply to contract modifications that replace a reference rate affected by reference rate reform (including rates referenced in fallback provisions) and contemporaneous modifications of other contract terms related to the replacement of the reference rate (including contract modifications to add or change fallback provisions). They provide optional expedients for applying the requirements of certain Topics or Industry Subtopics in the Codification for contracts that are modified because of reference rate reform that meet certain scope guidance.

As banks and other financial institutions begin to issue new contracts (e.g., loans and derivatives) with an alternative rate index, companies who are counterparties to these contracts will need to review new or modified contracts and determine whether they fall within the scope of ASU 2020-04 (Topic 848).

If a rate change from LIBOR does not qualify as change that is within the scope of Topic 848, an assessment needs to be made as to whether the change in terms should be accounted for as a modification or the termination of the original contract and the acquisition of a new contract. Generally, the accounting for a contract modification will differ from a termination of the original contract and acquisition of a new contract.

The guidance also provides entities with an optional expedient to not apply lease modification accounting in ASC 842 and ASC 840 to leases impacted by reference rate reform if eligibility is met.

If any of the optional expedients are elected, it must be applied to all eligible contracts that are accounted for under the same Codification topic. The relief provided in Topic 848 is temporary and cannot be applied to contract modifications that occur after December 31, 2022, or hedging relationships entered into after that date.

Companies need to have a processes and controls in place to identify all contracts affected by reference rate reform to ensure that any modifications necessary are made prior to December 31, 2022, and to ensure any optional expedients are being applied consistently.

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4. ASC 326, Current Expected Credit Losses (CECL)

For non-public companies, SRCs, and EGCs who have not yet adopted ASC 326, the new Standard will be effective January 1, 2023.

ASC 326 requires an allowance for credit losses (ACL) to be measured and recognized for all financial assets recorded at amortized cost (e.g., trade or other receivables) with a few scope exceptions. The ACL must capture the total credit losses expected to be realized (and not just incurred) over the life of the financial asset and must consider reasonable and supportable forecasts of future economic conditions. The financial assets must be evaluated under ASC 326 on a pool basis each period based on shared common risk characteristics unless the asset does not share any risk characteristics with any other financial asset. Designated pools of assets may change over time if the risk characteristics of the underlying assets change.

In addition, ASC 326 modifies the recognition of credit losses for debt securities held for investment and classified as available for sale (AFS). If the debt securities are impaired (i.e., their fair value is less than the recorded investment), an ACL must be recorded for the portion related to credit losses and offset in earnings. The ACL can be recovered if subsequent estimates reduce the expected credit losses.

There are also new disclosure requirements under ASC 326 regarding expected credit losses.

While the adoption of ASC 326 may not have a significant impact for companies that are not financial institutions with large portfolios of financial assets, it will require changes to be made to the procedures and documentation supporting how the ACL is assessed and measured each period. Auditors likely will seek documentation regarding how the initial application of ASC 326 was performed and how the results differ from the prior accounting.

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Who is CNM?

Founded in 2003, CNM is recognized as one of the premier technical advisory firms in Southern California with Big 4 experience that provides the responsive customer service of a boutique firm. And we're a dynamic team that enlists all our energy to help transform the way your company does business – carefully evaluating your needs, simplifying your financial processes, and passionately solving problems in the most cost-effective way.

Our extensive knowledge of US GAAP, ICFR and SEC reporting skills has given us the ability to assist our clients with transactions that are not only multifaceted, but the capability to implement new or complex accounting standards. We have over 175 partners and employees in our Los Angeles, Orange County, San Diego, and New York City offices. Many of our clients are developed from direct referrals from the Big 4 accounting firms, speaking to the level of quality services we provide.

To learn more about how we can help, visit our website at www.cnmllp.com.

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