Q2 2019 focus: Financial reporting and auditing update

Board perspectives

Current quarter financial reporting matters

Leases: Adoption-year reminders. Calendar year-end public companies were required to adopt the new leases standard (ASC 842) in the first quarter of 2019. All other public companies are required to adopt the standard on the first day of their fiscal year that begins during 2019, and private companies are required to adopt the standard in 2020. Regardless of whether they have adopted ASC 842, many companies are still implementing new IT systems and processes to extract the lease data needed to comply with the new accounting and disclosure requirements. In addition, many companies still have accounting questions in these significant areas—including identifying embedded leases, determining the lease term, and determining the lessee discount rate for the lease. Many companies that have recently adopted the standard also are adjusting their existing IT systems and lease accounting processes to sustainable end-states capable of addressing the ongoing requirements of ASC 842, e.g., identifying and accounting for lease modifications and reassessments. Companies that have not yet adopted the standard are encountering many of the same challenges. Under Regulation S-X, SEC registrants are required to provide the annual and interim disclosures required by a new accounting standard in each quarterly report in the year of adoption, i.e., for ASC 842, the first, second, and third quarter Form 10-Q filings during 2019.

The effective date of CAMs is here. Implementation of Phase 2 of PCAOB AS 3101 regarding communication of critical audit matters (CAMs) by auditors is effective for fiscal years ending on or after June 30, 2019, for audits of large accelerated filers, and for fiscal years ending on or after December 15, 2020, for audits of all other companies for which the requirements apply. The external auditor's communication of CAMs is intended to provide information about audit areas that involved especially challenging, subjective, or complex auditor judgment and to explain how the auditors addressed these issues. The PCAOB expects that in most audits, the auditor will identify at least one CAM. However, in the infrequent circumstance in which no CAMs are identified, the auditor is required to state that in the auditor's report. Ongoing engagement between the auditor, management, and the audit committee will be key to successfully implementing the CAM requirements. Management and the audit committee should talk with their auditor about potential CAMs, including how the specific matters and related descriptions compare with information that the company already discloses. It is not expected that the auditor would provide information in its report about the company that has not been made publicly available by the company, unless that information is necessary to describe the principal considerations in concluding that a matter was a CAM and how it was addressed in the audit. The PCAOB recently published new guidance on the auditor's communication of CAMs. The guidance includes new FAQs related to how auditors should describe their principal considerations in determining CAMs, how they should describe audit procedures and the outcome of audit procedures, as well as the relationship between CAMs and company disclosures and the treatment of recurring CAMs.

Brexit disclosures. The deadline for the United Kingdom to withdraw from the European Union has now been extended to October 31; however, the UK may leave the EU at an earlier date if the parties can ratify a withdrawal agreement. Because the political and economic uncertainty from Brexit is significant and far reaching, the SEC staff is closely monitoring how companies—particularly those with operations in the UK or EU, or with operations that link to the UK—disclose the effect that Brexit may have on their business operations. In addition to risk factor disclosures in Form 10-K or Form 10-Q, companies should consider whether Brexit-related economic uncertainties and market volatility will significantly affect accounting estimates and financial reporting. Companies should monitor the status of Brexit for changes that may require them to revise risk factors, or other disclosures, in their 2019 quarterly reports.

LIBOR disclosures. Banks that currently report information used to set LIBOR are expected to stop doing so after 2021. Efforts to transition away from LIBOR as a benchmark reference for short-term interest rates have been ongoing and the SEC staff has been attentive to the related accounting considerations. Banks may face significant risks and uncertainties in managing the transition from LIBOR to a new rate such as the Secured Overnight Financing Rate (SOFR). The SEC staff has commented that it expects to see disclosures addressing these risks and uncertainties, if material. Separately, the FASB has a project to address the effects on financial reporting of the migration away from LIBOR to alternative reference rates.

New standards and guidance

Amendments to the credit losses standard. The FASB has been devoting attention to its financial instruments projects, particularly on finalizing amendments to the credit losses standard (ASU 2016-13), which becomes effective January 1, 2020, for many public companies. The new credit losses standard will fundamentally change how companies account for credit losses.

Targeted transition relief. ASU 2019-05 allows companies to irrevocably elect the fair value option for existing financial assets on an instrument-by-instrument basis on adoption of ASU 2016-13. Except for existing held-to-maturity debt securities, the alternative is available for all instruments in the scope of ASC 326-20 that are eligible for the fair value option in ASC 825-10. If a company elects the fair value option, it will recognize as a cumulative-effect adjustment the difference between the fair value of the instrument and its carrying amount.

Changes to the guidance on estimating expected credit losses. ASU 2019-04 makes targeted improvements to the Codification as it relates to financial instruments, specifically, credit losses (ASC 326), hedge accounting (ASC 815), and recognition and measurement (ASC 825). The amendments to ASC 326 are the most significant and address how a company considers recoveries and extension options when estimating expected credit losses.

Because of these changes, companies will likely need to develop new processes and internal controls to:

— Monitor financial assets, including those that were fully written off in earlier periods, for potential recoveries;

— Capture historical information about recoveries;

— Identify whether contracts contain contractual extension or renewal options that are not unconditionally cancellable by the company;

— Capture the information necessary to estimate the likelihood that extension or renewal options will be exercised, including the likelihood that contingent events will occur; and

— Measure the effect of the potential extension period on the estimate of expected credit losses.

The amendments affect companies that hold financial assets measured at amortized cost (excluding available-for-sale debt securities), particularly lending portfolios.

SAB 74 disclosure reminders. As public companies gear their efforts toward implementing the credit losses standard, they must ensure that they satisfy the disclosures required under SAB 74, which requires public companies to disclose the potential effects of adopting an accounting standard before it is adopted, unless the effects are not expected to be material. Companies should consider disclosing qualitative and quantitative information and indicate their progress toward implementation. If a company cannot reasonably estimate the effect, it should consider providing additional qualitative disclosures, including a description of the effect of the accounting policies that the company expects to apply, if determined, and a comparison with its current accounting policies. The Center for Audit Quality (CAQ) has released a tool which provides audit committees information to consider as they oversee implementation of the credit losses standard.

For more detail about these and other issues, see KPMG's *Quarterly Outlook*.

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