Quarterly accounting roundup: An update on Q3 2017 important developments
The Dbriefs Financial Reporting series

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Agenda

• Hedging
• Leases
• Revenue
• PCAOB Update
• FASB Standard Setting
• EITF
• Implications of Catastrophic Events
• Q&A
Items to note

Keep in mind:
This webcast does not provide official Deloitte & Touche LLP interpretive accounting guidance.
Check with a qualified advisor before taking any action.

Learning Objective:
To enhance participants’ understanding of important accounting issues and developments pertaining to recent actions of standard setters, regulators, and others.
Polling question #1

Are you a financial statement preparer, user, auditor, or other interested party?

• Preparer
• User
• Auditor
• Other
ASU 2017-12—Targeted Improvements to Hedge Accounting
Targeted improvements to accounting for hedging activities

Background

ASU 2017-12: Reasons for project

- Better align an entity’s financial reporting with its risk management activities
- Improve relevance and depict a more faithful representation of hedging activities for investors
- Reduce complexity and costs
Targeted improvements to accounting for hedging activities

Overview
Targeted improvements to accounting for hedging activities
Hedge effectiveness assessment

Initial Prospective Quantitative Hedge Effectiveness Assessment

The ASU requires an initial prospective quantitative assessment of hedge effectiveness in most circumstances:

• Entities required to complete the initial quantitative prospective assessment of hedge effectiveness by the end of the hedge inception reporting period:
  – Up to 3 months for public companies and all financial institutions
  – Nonpublic, nonfinancial institutions—may be up to a year

• Quantitative assessments would use data as of hedge inception

• An initial quantitative assessment is not required if the hedge qualifies for the shortcut or critical terms match methods (or other methods that assume perfect effectiveness)
Targeted improvements to accounting for hedging activities
Hedge effectiveness assessment (cont.)

Subsequent Qualitative Hedge Effectiveness Assessments

• Entities may elect to perform subsequent retrospective and prospective qualitative assessments of hedge effectiveness if:
  
  – Initial prospective quantitative assessment demonstrates that the hedging relationship is “highly effective”
  
  – The entity can, at hedge inception, “reasonably support an expectation of high effectiveness on a qualitative basis in subsequent periods”
  
  – Documentation must specify:
    ◦ How qualitative assessments will be performed, and
    ◦ The alternative quantitative assessment that will be performed if the entity can no longer support a “highly effective” offset qualitatively
  
  – Subsequent qualitative assessment election done on a hedge-by-hedge basis
Targeted improvements to accounting for hedging activities
Loosening the reins on critical terms and shortcut

- Critical terms match for a CF hedge of a group of forecasted transactions if the transactions occur and the hedging derivative matures within the same 31-day period or fiscal month
- “Back-up” long-haul method for certain hedges designated as shortcut if:
  - The hedge was highly effective
  - The entity documented at hedge inception which long-haul methodology it would use to measure hedge ineffectiveness as a back-up
- Shortcut criteria would be amended to allow partial-term fair value hedges of interest risk to qualify for the shortcut method
- Codifies certain practices related to the change in variable cash flows method and hypothetical derivative methods for cash flow hedges
Targeted improvements to accounting for hedging activities
Changes to hedges of financial assets/liabilities

Acceptable designated risks for fair value hedges of interest rate risk have increased.

• New FV hedging strategies include:
  – Benchmark interest rate component of coupons
    ◦ New benchmark component for FV hedges: SIFMA
  – Partial-term hedging
  – Prepayable debt—may consider only how changes in benchmark interest rate impact decision to prepay
  – Last of layer approach—hedging closed portfolio of prepayable assets (or beneficial interest in portfolio of prepayable assets)

Cash flow hedging:
• Benchmark interest rate replaced with contractually specified rate
Targeted improvements to accounting for hedging activities
Component hedging not just for financial transactions anymore

• Nonfinancial purchases and sales
• Purchases/sales of nonfinancial assets containing a contractually specified component, may eligible for component hedging if:
  − The exposure related to variability in cash flows attributable to the component exists throughout the life of the hedge
• Hedges for longer than the contractual term or for a not-yet-existing contract are permissible if certain criteria are met
Targeted improvements to accounting for hedging activities
Effective date and transition

Effective dates:
- PBEs: Fiscal years beginning after 12/15/18 and interim periods therein
- All others: Fiscal years beginning after 12/15/19, interims within fiscal years after 12/15/20
- Early adoption is allowed during any interim or annual period:
  - If adopted during an interim period—transition adjustments as of beginning of fiscal year
  - Also must complete all transition elections by end of quarter of adoption

Transition:
- Modified retrospective approach to existing hedging relationships
  - Cash flow and net investment hedges: adjust OCI for prior ineffectiveness
  - Effects of any modified hedge relationships also in cumulative-effect adjustment
Polling question #2

The hedging standard is effective for public business entities beginning after December 15, 2018 and interim periods therein, for all others the standard is effective for fiscal years beginning after December 15, 2019 and interim periods within fiscal years after December 15, 2020. Early adoption is permitted during any interim or annual period.

When do you expect your company will adopt the standard?

- 2017
- 2018
- 2019
- 2020
- Don’t know/Not applicable
Leases
Leases
Land easements

• Background
  − Land easements typically provide an entity the right to use, access, or cross another entity’s property for a specified purpose (e.g., telephone and electricity poles, access roads, oil and natural gas pipelines)
  − Land easements have varying forms and terms, and there is diversity in practice in the application of existing US GAAP to these arrangements (e.g., accounted for as land, intangible assets, executory costs, or leases).
Leases
Land easements (cont.)

• August Board meeting
  – The Board directed the FASB staff to draft a proposed ASU
  – The Board tentatively affirmed the proposed ASU will include amendments to:
    ◦ Clarify that an entity should first apply ASC 842
    ◦ Provide a practical expedient for existing land easements
    ◦ A technical correction to Example 10 within ASC 350-30-55 to clarify that ASC 842 should be applied first, before applying the guidance in ASC 350
Leases

Transition “hot topics”

• Minimum rental payments used to determine lease liability
  – Would it be appropriate to include executory costs when determining the minimum rental payments used to calculate the lease liability when transitioning to ASC 842?

• Incremental borrowing rate applied during transition
  – Would the incremental borrowing rate at transition be based on the inception date lease term or remaining lease term?

• Foreign exchange rate to be applied to ROU asset
  – Should a preparer use the lease commencement date or initial application date foreign exchange rate when translating ROU assets recognized for a former ASC 840 operating lease?
Leases
Variable payments based on index or rate

Describing the issue...
• Payments based on a change in an index or a rate are considered contingent rental payments under ASC 840
• Lessees often include the escalators based on the change in an index or a rate in their minimum rental payment disclosures under ASC 840

Question and interpretive view...
**QUESTION**: When determining the minimum rental payments for calculating the lease liability during transition, would a lessee need to exclude any minimum rental payments based on the change in an index or rate?

**RESPONSE**: Current view – Yes
• ASC 840 explicitly excludes contingent rentals including those based on the *change* in an index or a rate from the definition of minimum rental payments
• Current FASB view is escalators based on the change in the index or a rate would be excluded from minimum rental payments in the transition lease liability calculation

Question is currently being evaluated by SEC staff
Polling question #3

How prepared is your organization to comply with the new lease accounting standard?

• Extremely prepared
• Very prepared
• Somewhat prepared
• Not too prepared
• Not at all prepared
• Don’t know/Not applicable
Revenue recognition
Revenue recognition
Transition disclosures—Quantification of impact

The following chart illustrates the percentage of SEC registrants that have provided any quantification of the standards impact in their most recent SEC filings:

Quantification of Impact

![Chart showing percentage of SEC registrants providing quantification of impact]

- Ye (Year End): 30%
- Q1: 40%
- Q2: 50%

**Note:** Based on Q2 public filings of a sample of 100 calendar year-end SEC registrants.
Revenue recognition
Transition disclosures—Transition method

The following chart illustrates the percentage of SEC registrants that have disclosed their anticipated transition method in their most recent SEC filings:

Method of Transition

Note: Based on Q2 public filings of a sample of 100 calendar year-end SEC registrants.
Revenue recognition
Grants and contracts for not-for-profit entities

• Board directed the staff to draft a Proposed ASU at the June 7th meeting
• Proposed ASU issued on August 3rd
• Main provisions of the Proposed ASU
  – Determining whether a transaction should be accounted for as a contribution or an exchange
  – Distinguishing between conditional and unconditional contributions

Comments due on the proposed ASU by November 1, 2017
PCAOB Changes to the Auditor's Report and PCAOB Proposed Standards
Quarterly accounting roundup: An update on Q3 2017 important developments

PCAOB standard setting
Changes to the auditor’s report—Overview

- On June 1, 2017, the PCAOB adopted a new auditing standard on the auditor’s report and related amendments to other standards (subject to final approval by the SEC).
- The purpose of the new standard is to enhance the value of the auditor’s report.
- While the new standard retains the current “pass/fail” opinion, it also significantly increases the information included in the auditor’s report.

**Key changes to the auditor’s report**

- **Critical Audit Matters**—The most significant change is a new required section to communicate critical audit matters (CAMs)*
- **Standardized ordering and form**—The “Opinion on the Financial Statements” section is required to be in the first section of the auditor’s report (immediately followed by the “Basis for Opinion” section), and section headers were added to guide the reader.
- **Enhanced descriptions of the auditor’s role and responsibilities**—including a statement regarding independence requirements and a statement related to obtaining a reasonable assurance whether the financial statements are free from material misstatement “whether due to error or fraud”
- **Disclosure of auditor tenure**—The year the auditor began serving consecutively as the company’s auditor.

*Communication of CAMs is not required for audits of (1) brokers and dealers reporting under the Exchange Act Rule 17a-5, (2) investment companies registered under the Investment Company Act of 1940, other than business development companies, (3) employee stock purchase, savings, and similar plans, and (4) emerging growth companies as defined in Section 3(a)(80) of the Exchange Act companies (voluntary inclusion of CAMs in the auditor’s report for such entities is permitted).
PCAOB standard setting
Changes to the auditor’s report—CAMs

Critical audit matters

• CAMs are defined as any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that:

  - Relates to accounts or disclosures that are material to the financial statements
  - Involved especially challenging, subjective, or complex auditor judgment.

• The standard includes a nonexclusive list of factors for the auditor to take into account in determining CAMs.

• The determination and communication of CAMs should be addressed in the context of a particular audit, with the aim of providing audit-specific information rather than a discussion of generic risks.

• Expectation is in most audits to which the CAM requirements apply, the auditor would identify at least one CAM. When no CAMs are identified, the auditor would be required to make a statement to this effect in the auditor's report.
PCAOB standard setting
Changes to the auditor’s report—CAMs (cont.)

Steps the auditor takes to identify CAMs

1. Start with the matters communicated or required to be communicated to the audit committee.
2. Identify those matters that:
   a. Relate to accounts or disclosures that are material to the financial statements.
   b. Involved especially challenging, subjective, or complex auditor judgment.

For each CAM communicated in the auditor’s report, the auditor must:

• Identify the CAM.
• Describe the principal considerations that led to the auditor’s determination that the matter is a CAM.
• Describe how the CAM was addressed in the audit.
• Refer to the relevant financial statement accounts or disclosures that relate to the CAM.

Factors to be taken into account when determining whether a matter involved especially challenging, subjective, or complex auditor judgment:

a. The auditor’s assessment of the risks of material misstatement, including significant risks
b. The degree of auditor judgment related to areas in the financial statements that involved the application of significant judgment or estimation by management, including estimates with significant measurement uncertainty
c. The nature and timing of significant unusual transactions and the extent of audit effort and judgment related to these transactions
d. The degree of auditor subjectivity in applying audit procedures to address the matter or in evaluating the results of those procedures
e. The nature and extent of audit effort required to address the matter, including the extent of specialized skill or knowledge needed or the nature of consultations outside the engagement team regarding the matter
f. The nature of audit evidence obtained regarding the matter
PCAOB standard setting
Changes to the auditor’s report—Effective date

**Effective date**

Phased approach to the effective date for the new requirements (subject to approval by the SEC):

<table>
<thead>
<tr>
<th>All changes except for communication of CAMs:</th>
<th>Communication of CAMs:</th>
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<tbody>
<tr>
<td>• Audits of fiscal years ending on or after <strong>December 15, 2017</strong></td>
<td>• Audits of large accelerated filers: fiscal years ending on or after <strong>June 30, 2019</strong></td>
</tr>
<tr>
<td></td>
<td>• Audits of all other companies: fiscal years ending on or after <strong>December 15, 2020</strong></td>
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Auditors may elect to comply with the new requirements before the effective date at any point after SEC approval.
PCAOB standard setting
Proposed amendments to auditing accounting estimates and the Use of the work of specialists standards

Two PCAOB proposed standards issued June 1, 2017

- Auditing Accounting Estimates, Including Fair Value Measurements ("Estimates Proposal")
- The Auditor’s Use of the Work of Specialists ("Specialists Proposal")

Estimates proposal

- Strengthens and enhances the requirements by establishing a single standard
- Sets forth a uniform, risk-based approach; emphasizes professional skepticism; focus on potential management bias

Specialists proposal

- Strengthens requirements to evaluate the work of a company’s specialist; establish a uniform, risk-based approach when using the work of a company’s specialist as audit evidence.
- Applies a risk-based approach to supervising and evaluating the work of auditor’s specialists.

Comment period closed on August 30, 2017
Auditing accounting estimates
Summary of proposed changes

Estimates proposal key changes

• Add or revise requirements for auditors to devote greater attention to addressing potential management bias in accounting estimates, while reinforcing the need for professional skepticism.

• Extend certain key requirements in existing AS 2502, *Auditing Fair Value Measurements and Disclosures*, to all accounting estimates, to reflect a more uniform approach.

• Improve integration with the risk assessment standards with additional considerations related to accounting estimates to focus auditors’ attention on estimates with greater risk of material misstatement.

• Make other updates to provide additional clarity and specificity.
Auditing accounting estimates
Summary of proposed changes (cont.)

Proposed Appendix A to PCAOB AS 2501, *Auditing Accounting Estimates*

- Provides specific requirements to auditing fair values of financial instruments, including the use of information from pricing sources (e.g., pricing services and brokers or dealers).
  - Establishes requirements for how to determine whether pricing information obtained from third-party pricing sources provides sufficient appropriate audit evidence
  - Requires the auditor to understand, if applicable, how unobservable inputs were determined and evaluate the reasonableness of unobservable inputs.

Proposed Appendix A to AS 1105, *Audit Evidence*

- Adds requirements for the auditor to obtain sufficient appropriate audit evidence when the valuation of an investment selected for testing is based on the investee’s financial condition or operating results
  - Includes certain equity method investments.
Use of the work of specialists
Summary of proposed changes

Specialists proposal

• Separately addresses the auditor’s use of the work of a company’s specialist and use of the work of an auditor’s specialist to more closely align with the roles of these specialists

  – Company’s specialist—a specialist employed or engaged by the company

  – Auditor’s specialist—a specialist employed or engaged by the audit firm
Use of the work of specialists
Summary of proposed changes (cont.)

A company’s specialist

• New Appendix B to PCAOB AS 1105—provides additional requirements with respect to the work of a company’s specialist that is used as audit evidence
• Added requirements:
  − Understand the nature and purpose of the specialist’s work, the source of data used by the specialist, and the company’s process for selecting and using the work of the specialist
  − Obtain an understanding of and assess the knowledge, skill, and ability of the specialist, as well as the specialist’s relationship to the company
  − Perform procedures to test and evaluate the work of a company’s specialist
    ◦ Required to evaluate whether the data was used appropriately by the company’s specialist

In the accompanying release, the PCAOB acknowledged the proposed changes in requirements for the auditor to evaluate appropriateness of methods and reasonableness of assumptions used by a company’s specialist when that company’s specialist work is supporting a non-fair value accounting estimate could be a significant change in practice for some auditors
Use of the work of specialists
Summary of proposed changes (cont.)

An auditor’s specialist

• Adds requirements for applying a risk-based approach to supervision of auditor-employed specialists and extends those requirements to auditor-engaged specialists

• Adds requirements for communication with the auditor’s specialist regarding the scope of the work to be performed and the process for reviewing and evaluating the work

• Amends certain requirements for assessing the knowledge, skill, and ability of an auditor-engaged specialist

• Amends requirements for assessing the objectivity of an auditor-engaged specialist to provide a description of objectivity
Polling question #4

The communication of critical audit matters in the auditor’s report is effective for audits of large accelerated filers with fiscal years ending on or after:

• June 30, 2019
• December 15, 2019
• June 30, 2018
• December 15, 2018
• Don’t know/Not applicable
ASU 2017-11—Down Round Features
ASU 2017-11
Targeted improvements to liabilities and equity

Instruments with down-round features

• Down-round protection would no longer preclude equity classification under ASC 815-40
  – Instrument or embedded feature would still need to meet all other requirements for equity classification
• Rather, account for the down-round if and when it is “triggered”
  – Freestanding equity classified instruments—recognize dividend for “value” transferred
  – Hybrid financial instruments—follow contingent BCF guidance in ASC 470-20

Indefinite deferral under ASC 480

• Replace the indefinite deferral with scope exceptions
• No change to existing GAAP
• Improves navigation within the codification only
ASU 2017-11
Effective date and transition

Effective date:
• PBE’s—Fiscal years beginning after 12/15/18 (including interims)
• All others—Fiscal years beginning after 12/15/19 and interim periods within fiscal years beginning after 12/15/20
• Early adoption permitted as of beginning of any interim period

Transition:
• Two choices:
  − Retrospectively to instruments outstanding as of adoption—cumulative effect as of beginning of fiscal year of adoption
  − Retrospectively to instruments outstanding during all periods presented—cumulative effect as of beginning of first period presented
FASB agenda consultation
FASB agenda consultation

- Intangible assets (including research and development)
- Pensions and other postretirement benefits plans
- Distinguishing liabilities from equity
- Reporting performance and cash flows
Polling question #5

From their Invitation to Comment, which financial accounting and reporting topic should the FASB add to its agenda:

• Intangible assets
• Pensions and other postretirement benefit plans
• Distinguishing liabilities from equity
• Reporting performance and cash flows
• None of the above
• Don’t know/Not applicable
EITF
EITF update
Cloud computing costs

• Cloud computing implementation costs
  – ASU 2015-05 was issued to address scoping of cloud computing costs
    ◦ The project identified whether or not the costs were in the scope of ASC 350-40 (internally developed software)
  – Stakeholders have stated that GAAP is unclear about implementation costs for a cloud computing arrangement for which there is not a software license
  – The lack of clarity led to the FASB adding to the EITF’s agenda a narrow-scope project on the accounting for implementation costs in a cloud computing arrangement
EITF update
Cloud computing costs (cont.)

Alternative A
- Cloud computing implementation costs would be expensed when incurred

Alternative B
- Cloud computing implementation costs would be recognized as an asset (including prepaid assets) or an expense based on existing guidance

Alternative C
- Cloud computing implementation costs would be accounted for the same as implementation costs associated with a software license

Alternative C¹
- Cloud computing implementation costs would be accounted for based on Topic 360
EITF update
Cloud computing costs (cont.)

• July meeting results
  − The Task Force did not support Alternative A or Alternative C1
  − The Task Force asked the staff to perform additional research on Alternative B and Alternative C
  − No decisions were made at the July meeting

• October meeting preview
  − Cloud computing is the only item on the EITF agenda and is expected to be discussed at the October 12, 2017 EITF meeting
Polling question #6

The FASB staff’s Issue Summary on a customer’s accounting for cloud computing implementation costs included four alternatives for the Task Force to consider at its July meeting. Which alternative do you prefer:

• Alternative A
• Alternative B
• Alternative C
• Alternative C¹
• None of the above
• Don’t know/Not applicable
Implications of catastrophic events
Implications of catastrophic events

- Asset impairment
- Reporting and disclosure
- Environmental loss
- Insurance analysis
- Internal controls
- Subsequent events
- Tax considerations
- Going-concern assumptions
Polling question #7

Who do you expect will win the 2017 World Series?

• Chicago Cubs
• Cleveland Indians
• Houston Astros
• Los Angeles Dodgers
• Other
Question and answer
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Acronyms used in presentation

- **AS**—Accounting Standard
- **ASC**—Accounting Standards Codification
- **ASU**—Accounting Standards Update
- **BCF**—Beneficial Conversion Feature
- **CTA**—Cumulative Translation Adjustment
- **EITF**—Emerging Issues Task Force
- **FASB**—Financial Accounting Standards Board
- **FV**—Fair Value
- **GAAP**—Generally Accepted Accounting Principles
- **PBE**—Public Business Entity
- **PCAOB**—Public Company Accounting Oversight Board
- **SEC**—Securities and Exchange Commission
- **SIFMA**—Securities Industry and Financial Markets Association
Resources

- **Heads Up - FASB Issues Standard Bringing Targeted Improvements to Hedge Accounting**
- **EITF Snapshot - July 2017**
- **Heads Up - FASB Makes Targeted Changes to Guidance on Accounting for Certain Financial Instruments with Down-round Features**
- **Roadmap – A Roadmap to Accounting for Noncontrolling Interests**
- **The new revenue standard — are you still assessing the impact?**
- **PCAOB adopts changes to the auditor's report**
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