DHG
DIXON HUGHES GOODMAN LLP

EXECUTIVE BRIEFING SERIES

Accounting and Assurance Update

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Learning Objectives: What's in it for me?

- By the end of this session, you will be able to:

1. Discuss issues around recently issued accounting and auditing pronouncements and proposals.
2. Understand application of new standards and policies.
3. Better understand how the updates affect you and how the disruption may present opportunities
4. Identify opportunities from the disruption

A&A Update Game Plan!

- Significant ASUs needing immediate attention
- Significant ASUs recently issued but not effective (Since last EBS)
- Other ASUs
- Other Notable Updates
- FASB Effective Dates Table

A&A Update – Part 1

Significant ASUs Needing Immediate Attention

ASUs Needing Immediate Attention

- **2014-09, *Revenue from Contracts with Customers (Topic 606)*** (and related ASUs)
- **2016-01, *Financial Instruments – Overall (Subtopic 825-10)*:** Recognition and Measurement of Financial Assets and Financial Liabilities (and related ASUs)
- **2016-15, *Statement of Cash Flows (Topic 230)*:** Classification of Certain Cash Receipts and Cash Payments
- **2016-18, *Statement of Cash Flows (Topic 230)*:** Restricted Cash
- **2017-01, *Business Combinations (Topic 805)*:** Clarifying the Definition of a Business

ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*

EFFECTIVE NOW

- Principles based standard
- 5 steps:

1 Identify Contract	2 Identify Performance Obligations	3 Determine Transaction Price	4 Allocate to performance obligations	5 Recognize Revenue

- Significant disclosure enhancements

Some Big Ticket Differences Between ASC 605 and ASC 606

Variable Consideration

- Requires estimation and recognition
- Examples
  - Discounts
  - Consideration that can vary based on timing, performance, or outcome
  - Incentives

Costs to Obtain a Contract

- Must be directly tied to contract
- Recognition:
  - Capitalized and recognized over life of contract
- Example:
  - Commissions on the sale, but not hotel expense for sales professional

Collectability

- Considered in determining whether a contract exists

Challenges with the New Revenue Standard

- Principles based standard (i.e., significant judgment may be required)
- Potential for significant complexity
- Relevant information can be challenging to obtain and curate
- New processes and controls
- Disclosure requirements
- Coordinating with internal/external parties

What Should Private Companies Be Doing Now?

Get Smart

- Understand how the standard impacts your company
- Significant resources available
- Accounting firm can help

Resource Needs

- Knowledge and expertise
- Capacity
- Deadline

Scoping & Evaluating

- Identify revenue streams
- Gather contracts
- Determine accounting treatment

Commitment to an Action Plan & Timeline

- Document “the journey”

Where are you and your company in the journey??

2016-01, *Financial Instruments – Overall (Subtopic 825-10)*

- **History**
  - Born out of convergence project with international standards
  - Financial crisis highlighted need to modernize the financial instruments model for today's complex economic environment
- **Big Picture**
  - Financial instruments and modern markets are complex – the financial reporting needed to catch up
  - Provide financial statement users with more useful information
  - Works with measurement of credit losses (ASU 2016-13) to achieve the objectives

Financial Instruments

AMENDMENTS TO CURRENT GAAP

Assets | Liabilities | Disclosures

- Equity investments measured at each reporting period at fair value through net income, except
  - + Equity investments without readily determinable FV; only marked to observable price changes
  - + Equity method investments
  - + Equity investments that result in consolidation of investee
  - + Equity investment in federal home loan bank and federal reserve bank stock
  - + Ownership interest in an exchange
- Simplified impairment test for equity investments without readily determinable fair value
- Current GAAP retained for all other financial assets
- **Key Takeaway – Standard is likely to create additional P&L volatility**

Financial Instruments

AMENDMENTS TO CURRENT GAAP

Assets | **Liabilities** | Disclosures

- Fair Value change resulting from changes in own credit for financial liabilities measured under fair value option will be recognized through OCI rather than P&L
- Current GAAP retained for accounting for financial liabilities
- **Big Picture – Eliminates gains created under current guidance from a company's OWN credit decline**

Financial Instruments

AMENDMENTS TO CURRENT GAAP

Assets | Liabilities | **Disclosures**

- Reduced disclosures of methods and assumptions used to estimate FV for financial instruments not carried at FV on balance sheet
- Financial assets to be presented grouped by measurement category and form of instrument
- Financial liabilities to be presented grouped by measurement category

Financial Instruments – Amendments to Current GAAP (Disclosure Example)

($ in millions)		Fair Value Measurements at the End of the Reporting Period Using			
	12/31/X9	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Gains (Losses)
Description					
Recurring fair value measurements					
Equity securities [a]					
Equity securities—real estate industry	$ 93	$ 70	$ 23		
Equity securities—oil and gas industry	45	45			
Equity securities—financial services industry	150	150			
Equity securities—healthcare industry	110	110			
Equity securities—other	30	30			
Total equity securities	$ 428	$ 405	$ 23		
Available-for-sale debt securities					
Residential mortgage-backed securities	$ 149		$ 24	$ 125	
Commercial mortgage-backed securities	50			50	
Collateralized debt obligations	35			35	
U.S. Treasury securities	85	$ 85			
Corporate bonds	93		93		
Total available-for-sale debt securities	$ 412	$ 85	$ 117	$ 210	

Statement of Cash Flows (Topic 230)

ASU	2016-15, *Classification of Certain Cash Receipts and Cash Payments*	2016-18, *Restricted Cash*
WHY	• Currently diversity in practice on classification • Lack specific guidance	• Currently diversity in practice on classification of cash flows of restricted cash • Lack specific guidance
MAIN PROVISION	• Prescriptive guidance for certain cash receipts/payments + Debt extinguishment costs + Settlement of zero coupon bonds + Contingent consideration payments + Settlement of insurance claim + Proceeds from BOLI + Distributions from equity method investees • Predominance principle for when prescriptive guidance does not exist	• Statement of cash flows to explain change of cash, cash equivalents, restricted cash, and restricted cash equivalents
WHAT'S IN IT FOR ME	• Reduced diversity in practice • Enhanced comparability of cash flows	• Reduced diversity in practice • Enhanced comparability of cash flows

Clarifying the Definition of a Business – ASU 2017-01

- **Why change?**
  - Applied too broadly
  - Difficult to apply (Inputs, Processes, Outputs model)
  - Unintended outcomes
    - In substance asset acquisitions frequently meet definition of a business

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- **Why does it matter?**
  - SIGNIFICANT M&A ACTIVITY GOING ON!
  - Likely to see more asset acquisitions vs. business acquisitions – i.e., no goodwill!

Mergers and Acquisitions Activity

Based on a recent survey of 600 middle market companies

63%

Companies expect to source growth externally through M&A

Source: Citizens Capital Markets, 2019 M&A Outlook Summary

Clarifying the Definition of a Business – ASU 2017-01

MAIN PROVISIONS

- **First – New "screen" to determine if a set of assets is NOT a business**
  - + "Substantially all" value acquired in a single identifiable asset

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- **Second – If "screen" NOT met, apply updated requirements to determine if a business**
  - + Set must include an input and a substantive process that have ability to create outputs
  - + "Output" defined more narrowly
  - + Remove whether market participant could replace missing elements

Illustrations of the new definition of a business

Background: ABC Co. acquires, renovates, leases, sells, and manages real estate properties.

Scenario 1

- ABC purchases 10 single family homes and 10 in-place leases
- No employees or other assets are acquired

Scenario 2

- Same facts as scenario 1, but
- ABC also purchases 5, 6 story office buildings
- Purchase includes in-place leases, cleaning contracts, security, and maintenance contracts
- None of the seller's employees are included (sales, underwriting, leasing, tenant management, etc.)

Scenario 3

- Same facts as scenario 2, but
- ABC also acquires seller's employees for the sales, underwriting, leasing, and tenant management

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Clarifying the Definition of a Business – ASU 2017-01

BOTTOM LINE

- More stringent requirements to qualify as a business
- Presence of goodwill doesn't necessarily indicate a business
- Likely to see more asset acquisitions vs. business combinations
- Decreased cost and enhanced efficiency (if screen met)
- Impact on other GAAP
  - + VIEs
  - + Goodwill impairment

ALERT: Proposed FASB Effective Dates for Major Projects

- **Two bucket approach to stagger effective dates:**
  1. SEC filers excluding smaller reporting companies (SRC)
  2. All other entities – SRCs, PBEs that are not SEC filers, private companies, NFPs, and EBPs
- **Leases and Derivatives & Hedging – PBEs adopted so no additional time,**
  + Non-PBEs extended to Jan 1, 2021 *for calendar year-end entities*
- **CECL –**
  + Bucket one – still the same January 1, 2020
  + Bucket two – extended to January 1, 2023
- **Long-Duration Contracts –**
  + Bucket one – extended an additional year to January 1, 2022
  + Bucket two – extended to January 1, 2024

Current Expected Credit Loss (CECL) Model

IT'S COMING…

+ January 1, 2020 for PBE SEC filers except SRCs
+ January 1, 2023 for all other entities
+ Early application permitted

SCOPE

Financial assets measured at amortized cost

1. Loans
2. HTM debt securities
3. Net investment in leases
4. Trade receivables

NEW ASU'S

- ASU 2019-04 includes amendments to Topic 326
- ASU 2019-05 targeted transition relief for credit losses

SAB 74 CONSIDERATIONS

Non-Financial Industries Impact

In-Scope Items*	Notable Impacts
Loans (employee, director, etc.) and loan commitments Trade receivables and contract assets arising under Topic 605 and Topic 606 Financial guarantees (e.g., receivables factoring with recourse)	• Replacement of "incurred loss" model with "expected loss" model • Impairment no longer hinges upon the occurrence of a triggering event
HTM debt securities AFS debt securities	• Expansion of information set considered in estimating losses • Entities should consider historical information, current conditions, <u>and reasonably supportable forecasts</u>
Reinsurance recoverables Net investment in leases (sales-type and direct financing)	• Estimate must incorporate risk of loss, even if that risk is remote • Entities may not assume that the risk of nonpayment is zero.

** Does not represent an all-inclusive listing*

A&A Update – Part 2

Significant ASUs Recently Issued, But Not Effective

(Since last Executive Briefing Series)

ASUs Recently Issued, But Not Effective

- **2018-13, Fair Value Measurement (Topic 820):**
  - Disclosure Framework—Changes to the Disclosure Requirements for Fair Value Measurement

- **2018-16, 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

- **2018-17, Consolidation (Topic 810):**
  - Targeted Improvements to Related Party Guidance for Variable Interest Entities

2018-13, Fair Value Measurement (Topic 820)

Changes to the Disclosure Requirements for Fair Value Measurement

- **Background**
  - + FASB Disclosure Framework Project
    - Sets criteria to determining necessary disclosure (Generally, do the benefits outweigh the expected costs?)
  - + Fair Value Measurement was the guinea pig for the project

- **What's in it for me?**
  - + Disclosures that did not meet cost/benefit threshold were eliminated or modified (less work for preparers and practitioners)
  - + Decision useful information enhanced
  - + More value/less cost

Changes to Disclosure Requirements for Fair Value Measurement

Removals | Modifications | Additions | Effective Dates | Early Adoption

- Amount/reasons for transfers between Level 1 and Level 2
- Policy of timing of transfers between levels
- Valuation processes for Level 3 fair value measurements
- Non-PBE - disclosure of the changes in unrealized gains and losses for the period included in earnings for the recurring Level 3 fair value measurements and roll-forward of Level 3

Changes to Disclosure Requirements for Fair Value Measurement

Removals | **Modifications** | Additions | Effective Dates | Early Adoption

- Non-PBE - In lieu of Level 3 rollforward, disclose transfers in and out, and purchases and issues of Level 3 assets and liabilities
- Other minor changes

Changes to Disclosure Requirements for Fair Value Measurement

Removals | Modifications | **Additions** | Effective Dates | Early Adoption

- Non-PBEs – NONE!
- Public entities - including the changes in unrealized gains and losses included in OCI for recurring Level 3 and the range and weighted average of significant unobservable inputs used in Level 3

Changes to Disclosure Requirements for Fair Value Measurement

Removals | Modifications | Additions | **Effective Dates** | Early Adoption

- All entities: Annual periods beginning after 12/15/19

Changes to Disclosure Requirements for Fair Value Measurement

Removals | Modifications | Additions | Effective Dates | **Early Adoption**

- Early adoption is permitted
- Removals/modifications can be adopted early and additions adopted later

ASU 2018-16, *Derivatives and Hedging (Topic 815)*

Inclusion of the Secured Overnight Financing Rate (SOFR) Overnight Index Swap (OIS) as a Benchmark Interest Rate for Hedge Accounting Purposes

History	What is SOFR
• LIBOR scandal – rate fixing • LIBOR used in derivatives and other financial assets and liabilities • With sustainability of LIBOR in question, Fed created alternative benchmark interest rate – SOFR • Other permissible benchmark rates for hedge accounting + UST (US Treasuries) + OIS (Fed Funds effective rate) + SIFMA (Muni Swap Rate) + LIBOR (London Interbank Offered Rate)	• Secured Overnight Financing Rate (SOFR) • Volume-weighted median interest rate calculated daily based on overnight transactions from the prior day's trading activity of the U.S. Treasury repo market

Key Takeaway

- SOFR, based on the OIS, is now a U.S. benchmark interest rate for hedge accounting under ASC 815
- LIBOR may cease to exist after 2021
- You should:
  + Identify all LIBOR related contracts
  + Determine if fallback rate provisions exist
  + If not, consider plan of action if contracts extend beyond 2021
  + Consult an attorney

• Effective Dates (PBE): Fiscal years beginning after 12/15/18	• Effective Dates (Non-PBE): Fiscal years beginning after 12/15/19

- Early adoption is permitted

2018-17, *Consolidation (Topic 810)*

Targeted Improvements to Related Party Guidance for Variable Interest Entities

Background	What's in it for me?
• Stakeholders indicated that VIE guidance could be improved • Cost/benefit of VIE analysis for private companies under common control uncertain • Expansion of Private Company Council (PCC) Alternative for common control leasing arrangements (ASU 2014-07)	• Non-PBEs that meet certain criteria can bypass VIE analysis!
Main Provisions	
• New PCC alternative allows private company reporting entities to elect NOT to evaluate its relationship with other entities under current VIE guidance if: + Reporting entity and legal entity are under common control (KEY!) + Reporting entity and legal entity are not under common control of a PBE + Legal entity under common control is not a PBE + The reporting entity does not directly or indirectly have a controlling financial interest in the legal entity. • Still required to apply voting interest entity guidance	
• Effective Dates (Non-PBE): Annual periods beginning after 12/15/19	• Early adoption is permitted

Determining if Entities Are Under Common Control

SEC observations on EITF Issue 02-5:

- > 50% of voting ownership
- > 50% of voting ownership held by immediate family members (i.e. married couple and their children)
  - And no evidence that family members will vote shares in disagreement
- > 50% of voting ownership held by a group of shareholders
  - And written evidence of agreement to vote majority of entities' shares together

FASB & PCC's common control is broader!

- An entity owned by a grandparent and another entity owned by a grandchild could…be under common control

Determining common control requires judgment!

2018-17, *Consolidation (Topic 810)*

Targeted Improvements to Related Party Guidance for Variable Interest Entities

- **Enhanced Disclosures**
  - If PCC Alternative elected and reporting entity does not consolidate, disclosures are similar to current VIE disclosure requirements

- **Big Picture**
  - Although no longer need to evaluate if VIE, still need to provide relevant disclosure.
  - Financial reporting relief provided through elimination of the evaluation, not necessarily through reduction in disclosure

A&A Update – Part 3

Other ASUs

ASU 2017-04, INTANGIBLES- GOODWILL AND OTHER (TOPIC 350):

Simplifying the test for goodwill impairment

MAIN PROVISIONS

- Step 2 Eliminated
  - No longer required to calculate implied fair value of goodwill if Step 1 indicates impairment
- Step 0 - Qualitative Assessment
  - Implied new starting point
  - More-likely-than not assessment maintained
- Step 1 Assessment
  - Failing will result in impairment
  - Carrying value > FV = goodwill impairment
- Other Provisions
  - Eliminates requirement for reporting unit with zero or negative carrying amount to perform a qualitative assessment

EFFECTIVE DATES & TRANSITION

- Prospectively for annual and interim periods in fiscal years beginning after
  - December 15, 2019 for public business entities that file with the SEC
  - December 15, 2020 for PBEs that do not file with the SEC
  - December 15, 2021 all other entities
- Early adoption permitted for all entities

Simplifying Goodwill Impairment Testing – What's in it for me?

- Cost Implications / Efficiency Enhancements
- Qualitative assessment – "more likely than not" evaluation
- Opportunity with PCC Alternative for goodwill to "avoid" impairment testing – Trigger test vs. qualitative assessment
- Potential to reduce likelihood of future impairment when PCC Alternative elected

Part 4 – Other Notable Updates

Hosting Services – AICPA Interpretation

AICPA Independence Framework Refresher

- Do facts and circumstances create a threat to independence?
- If so, can safeguards reduce threat to an acceptable level?
- For some circumstances, no safeguards can reduce threat to an acceptable level

Hosting (as Defined)

- Acting as sole host of an information system of an attest client
- Taking custody of or storing attest client's data or records whereby that data or records are available only from the firm & otherwise incomplete
- Providing electronic security or back-up services for an attest client's data/records
- No Safeguards can reduce hosting threat to independence

No Safeguards can reduce hosting threat to an acceptable level

AICPA – Auditor Reporting (AU-C 700 Series)

Background

- AICPA looking to provide more information about the audit to users
- Closer alignment to international and public company auditing standards

Main Provisions

- Opinion paragraph to move to top of auditor's report
- Require an affirmative statement on auditor independence and ethical requirements
- Enhanced description of responsibilities of management, including identification of those responsible for oversight of financial reporting
- Expanded description of auditor's responsibilities and key features of an audit
- **Voluntary communication of Key Audit Matters (KAMs)**

Big Picture

- Audit reports are going to change
- KAMs are similar in concept to PCAOB "CAMs", but are voluntary
- Effective for audits ending after 12/15/2020 (Calendar YE 2020), no early adoption

Public Company Matters

Securities and Exchange Commission (SEC)

- FAST Act – Disclosure simplification
  - Improve readability and navigability of disclosures/reduce redundancy
  - Interim periods – statement of changes in stockholders' equity
  - Allow redaction of confidential information without request

Public Company Accounting Oversight Board (PCAOB)

- Auditor's Reporting Model
  - Auditor Tenure
  - Critical Audit Matters (CAMs)
    - New staff guidance released

SEC: Non-GAAP Measures

- 2nd most frequent SEC comment letter topic in 2018
- Common comment themes
  - Prominence of Non-GAAP measures
  - Presentation of Non-GAAP "net of tax"
  - Use of individually tailored recognition and measurement

Non- GAAP Measures Source: Audit Analytics, *A Look at Top SEC Comment Letter Issues in 2018*

Questions?