Chapter 3

US GAAP – Recent emerging issues

This article aims to:

Provide an overview of the recent emerging issues under the US GAAP.

Rapid changes in stakeholder expectations, technology and economic landscapes are creating new and enhanced risks in the financial reporting structure that are expected to affect the roles and responsibilities of management, audit committees and auditors beyond the 2019 year-end financial reporting season. The recent American Institute of Certified Public Accountants (AICPA) conference[1] on current Securities and Exchange Commission (SEC) and Public Company Accounting Oversight Board (PCAOB) developments concentrated on events of rapid change.

In this article, we will highlight some of the emerging issues discussed at the conference and which are relevant for companies to take note of.

1 The conference was held in December 2019.

Interest rate reforms

The shift in the benchmark interest rates with alternative nearly risk-free interest rates is expected to have a cascading effect beyond contract terms into the operations and financial reporting of many companies. Therefore, companies are advised not to underestimate the consequences and complexity of the reference rate reform. Also, they should focus on making appropriate disclosures about the effect of the reform.

To address some of the pre-replacement issues, in September 2019, the International Accounting Standards Board (IASB) has issued amendments to International Financial Reporting Standard (IFRS) 9, *Financial Instruments,* International Accounting Standard (IAS) 39, *Financial Instruments: Recognition and Measurement* and IFRS 7, *Financial Instruments: Disclosures.* The amendments provide targeted relief for financial instruments qualifying for hedge accounting during the lead-up to the rate reform.

On the other hand, the Financial Accounting Standards Board (FASB) is expected to issue a final Accounting Standards Update (ASU) in the first quarter of 2020 which will provide companies with optional financial reporting and accounting relief to reduce the cost and complexity associated with accounting for contracts and hedging relationships affected by reference rate reform.

New accounting standards

Companies have already implemented the new accounting standard on revenue and leases and will be implementing the credit losses standard in 2020. Some of the key observations relating to the implementation of revenue and leases standards have been outlined below.

- **Revenue recognition:** Determining whether an entity is a principal or an agent, can be an area of challenge when two parties are involved in providing services to a customer, particularly if some of the services can only be provided by a specific service provider. The issue has been discussed with the help of an example. A company had a contractual relationship with a customer but could not legally provide some of the services promised in the contract. As a result, the company had to rely on another service provider to deliver the restricted services and give that provider discretion in determining how to fulfil its obligations. Since in the given case the company could define the scope of the services to be performed on its behalf which thereby gives sufficient control over those services, it was concluded that the company was the principal in the transaction.

  Another area of judgement in applying the revenue recognition standard is determining whether promises to transfer the goods or services to a customer are separately identifiable or can be combined into one performance obligation. The issue has been analysed with the help of an example. A company has provided software and necessary updates to allow developers to build and deploy their apps on third-party platforms. In the given case, the

software and the updates to the software have been treated as a single performance obligation as the combined output of these two promises was greater than or substantively different from the individual promises. Once they are combined, they give the app developers the ability to deploy and monitise content using third-party platforms of their choice.

- **Leases:** Collectability for lessors is an important matter under the leases standard. For example, in a sales-type lease if collectability of lease payments is not probable at the inception of lease, the lessor cannot derecognise the asset and should defer from recognising any income or loss. Some of the other key areas to be considered are as follows:
  - *Lease reassessments:* Companies should understand which estimates and judgements require periodic reassessment. They can accordingly, design and implement processes and internal controls to timely identify events or changes in circumstances that trigger reassessment of lease.
  - *Right-of-Use (ROU) assets impairment:* Companies should evaluate ROU assets under ASC 360, *Property, Plant, and Equipment* framework (that applies to long-lived non-financial assets). The key considerations while incorporating the ROU assets into ASC 360 framework are as follows:
    a. Companies should make accounting policy decision (e.g. about whether to include or exclude operating lease liability under ASC 360 assets group)
    b. Determine the fair value of ROU of assets and understand the interaction between ASC 360's impairment guidance and ASC 842's reassessment requirements.

Critical Audit Matters (CAMs)

One of the most significant change made to the auditor's report is reporting of CAMs. The requirement for auditors to communicate CAMs under PCAOB standard AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* for large accelerated filers is applicable from fiscal years ended on or after 30 June 2019 and for all the other companies from fiscal year ending on or after 15 December 2020.

Following observations have been made with respect to the implementation of CAM:

- Communications that are tailored to the specific facts and circumstances of the audit are likely to be more meaningful to investors and other financial statements users. Information is more meaningful if it avoids general language about audit procedures performed, including the related control testing and instead describes the procedures performed that were responsive to the principal considerations that led the matter to be identified as a CAM.
- Investors and other financial statement users are required to understand that CAMs are intended to be unique to each individual audit, so that they should be cautious about drawing comparisons among companies.

As per a publication issued by the PCAOB, most of the CAMs reported in the audit reports belong to areas of revenue, business combinations, impairment and taxes.

Non-GAAP financial measures

Non-GAAP financial measures need to be unbiased, transparent and consistent with full disclosure of how they are calculated and how they reconcile to the GAAP measures. Further, it has been suggested that it would be inappropriate to exclude credit losses determined under the new standard from non-GAAP measures.

Audit committees

Audit committees serve a key role in protecting investors and can have a significant and positive effect on audit quality. It has been emphasised that auditor independence is fundamental to the operating of an efficient market system and should be a top priority of audit committees to ensure that they are getting an independent view of management's work. Therefore, audit committees are the front-line in ensuring auditor independence.

Technological changes

New technologies are creating opportunities and risks for companies. New sources of company-compiled data (e.g. about customer behaviour, supply chain dynamics) have gained recognition as valuable, though intangible, enterprise assets. This has fueled increased stakeholder desire for more information and an increased focus on cyber-risk management. Technological changes are also affecting audit. For example, data and analytics application affects not only how audits are conducted but

also the auditor's skills to identify an outlier. The IASB is also re-examining financial statement presentation in light of the increased digitisation of financial analysis. Accordingly, it is exploring to standardise the subtotals and other financial statement captions on the income statement.

Others

Companies can also get affected from other emerging issues such as Brexit and cybersecurity incidents.

In case of material effect from such events, companies are expected to at least make the following disclosures:

- How the risk is assessed and how it affects the operations
- How management is mitigating the risk
- Role of board of directors in evaluating the risk and monitoring management's response
- A statement that the effect of the risk is unknown and cannot be quantified at the current time, if applicable and
- The issuer's evolution – i.e. as more facts become known about the effect on operations and related risks, the disclosure should become more detailed.

Source: KPMG LLP's publication 'SEC Issues & Trends' issued in December 2019 and Quarterly Outlook – December 2019 edition.