Deloitte.

Financial Reporting Alert 16-3
September 22, 2016

Contents

Internal Controls Over Financial Reporting

Maintaining Auditor Independence

Disclosures Related to Implementation Activities

Appendix — SAB Topic 11.M Disclosures

SEC Reminds Registrants of Best Practices for Implementing New Revenue, Lease, and Credit Loss Accounting Standards

In two separate venues this week, the SEC staff reminded registrants about best practices to follow in the periods leading up to the adoption of ASU 2014-09[1] (the "revenue ASU"), ASU 2016-02[2] (the "lease ASU"), and ASU 2016-13[3] (the "credit loss ASU"). The staff's comments, which reiterated themes it has addressed over the past year, focused on internal controls over financial reporting, auditor independence, and disclosures related to implementation activities.

Internal Controls Over Financial Reporting

In a speech at the 2016 AICPA National Conference on Banks & Savings Institutions on September 21, 2016, SEC Interim Chief Accountant Wesley R. Bricker remarked that as

[1] FASB Accounting Standards Update No. 2014-09, *Revenue From Contracts With Customers*.
[2] FASB Accounting Standards Update No. 2016-02, *Leases*.
[3] FASB Accounting Standards Update No. 2016-13, *Measurement of Credit Losses on Financial Instruments*.

registrants develop plans for the transition to the credit loss ASU, they should assess the adequacy of their current internal controls "to reasonably assure the reliability of the financial information reported by management." Recognizing that management may need to exercise greater judgment when applying the guidance in the credit loss ASU than it does under existing GAAP, Mr. Bricker observed that the objective of reassessing the adequacy of a registrant's current internal controls now is to identify and implement any changes to these controls that may be warranted "to support the formation and enforcement of sound judgments" under the new standard.

Editor's Note

Regulation S-K, Item 308(c),[4] requires registrants to disclose any material changes in their ICFR in a Form 10-Q or Form 10-K. Accordingly, registrants will need to be mindful of these disclosure requirements when establishing new controls and processes related to the adoption of new accounting standards.

Maintaining Auditor Independence

Mr. Bricker also touched on how an active dialogue between management and auditors — particularly regarding the implementation of new accounting standards and the accounting for complex transactions — can (1) benefit financial reporting and audit quality and (2) pose challenges to maintaining auditor independence. In his remarks, Mr. Bricker observed that "[a]s long as management, and not the auditor, makes the final determination based upon its own analysis as to the accounting used, including determination of estimates and assumptions, and the auditor does not design or implement accounting policies, such auditor involvement as an input to management's process can be appropriate."

While Mr. Bricker's comments concerned the adoption of the credit loss ASU, we observe that his remarks would apply equally to implementation activities related to the adoption of the revenue and lease ASUs.

Disclosures Related to Implementation Activities

At the September 22, 2016, EITF meeting, SEC Assistant Deputy Chief Accountant Jenifer Minke-Girard made an announcement (the "staff announcement") regarding SAB Topic 11.M.[5] Ms. Minke-Girard indicated that when a registrant is unable to reasonably estimate the impact of adopting the revenue, lease, or credit loss ASU, the registrant should consider providing additional qualitative disclosures about the significance of the impact on its financial statements. She further noted that the SEC staff would expect such disclosures to include a description of:

- The effect of any accounting policies that the registrant expects to select upon adopting the ASU(s).
- How such policies may differ from the registrant's current accounting policies.
- The status of the registrant's implementation process and the nature of any significant implementation matters that have not yet been addressed.

[4] SEC Regulation S-K, Item 308(c), "Changes in Internal Control Over Financial Reporting."
[5] SEC Staff Accounting Bulletin Topic 11.M, "Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period."

Editor's Note

Ms. Minke-Girard observed that while it would be beneficial for calendar-year-end registrants to include such disclosures in their upcoming quarterly filings, the SEC staff's objective in making this statement at the September EITF meeting was to give such registrants sufficient time to consider the staff announcement before their year-end financial reporting. She also noted that SAB Topic 11.M applies to foreign private issuers that use IFRSs. Recognizing that IFRS filers may not monitor EITF meetings, the SEC staff will consider clarifying its expectations for such filers in additional communications.

This discussion of the staff announcement is based on our observations at the EITF meeting. Readers can refer to the staff announcement, which will be available in the EITF meeting minutes once they are published.

Because the revenue ASU's adoption date is earlier than the adoption date of the lease or credit loss ASU, we suspect that many registrants have progressed further with their implementation efforts related to the revenue ASU. Accordingly, the appendix of this *Financial Reporting Alert* includes an excerpt from our forthcoming *A Roadmap to Applying the New Revenue Recognition Standard* that contains considerations related to this topic, including examples of disclosures that a registrant adopting the revenue ASU may provide, depending on its individual facts and circumstances. Registrants that expect to be significantly affected by the adoption of the lease ASU or credit loss ASU should consider whether they may need to provide similar disclosures that are tailored to the provisions of the respective ASU.

To receive our *A Roadmap to Applying the New Revenue Recognition Standard* upon its issuance, please register or update your subscription preferences.

Appendix — SAB Topic 11.M Disclosures

In a speech at at the 2016 Baruch College Financial Reporting Conference on May 5, 2016, Wesley Bricker, the then deputy chief accountant in the SEC's Office of the Chief Accountant, emphasized the importance of providing investors with transition-period disclosures in accordance with SAB 74 (codified in SAB Topic 11.M). Such disclosures should include not only an explanation of the transition method elected but also disclosures that explain the impact that the new revenue standard is expected to have on an entity's financial statements.

In providing key stakeholders with information about the expected impact of adoption on the financial statements, entities may need to develop pro forma financial statements based on their anticipated transition method (full retrospective or modified retrospective) to appropriately estimate the impact of adoption. There will not be a one-size-fits-all model for communicating the impact of adoption, but entities could consider providing (1) a short narrative that qualitatively discusses the impact of the change or, to the extent available, (2) tabular information (or ranges) comparing historical revenue patterns with the expected accounting under ASC 606.[6] If an entity elects to discuss the qualitative aspects of its expected change, the entity may provide some or all of the following types of disclosures depending on its specific facts and circumstances:

Illustrative Disclosure — Adoption of New Accounting Standard

- We expect to identify [more/less/similar] performance obligations under ASC 606 as compared with deliverables and separate units of account previously identified. As a result, we expect the timing of our revenue [to occur in earlier periods/to occur in later periods/remain the same].
- [Many/Some/A few] of our contracts [in X business unit/Y segment/Z geography] include contingent amounts of variable consideration that we were precluded from recognizing because of the requirement for amounts to be "fixed or determinable" under SAB Topic 13.[7] However, we anticipate that ASC 606 will require us to estimate these amounts. As a result, we expect to recognize revenue earlier under ASC 606 than we have done so under current guidance.
- We previously recognized revenue from [many/some/a few] of our contracts [in X business unit/Y segment/Z geography] over time by using a percentage of completion model in accordance with ASC 605-35. These contracts will not meet the criteria in ASC 606 for recognizing revenue over time. As a result, we will be required to recognize revenue from those contracts later under ASC 606 than we did under ASC 606-35.
- We previously recognized revenue from [many/some/a few] of our contracts [in X business unit/Y segment/Z geography] by using [the completed contract method under ASC 605-35/a final deliverable model], which resulted in the recognition of revenue only upon completion of the efforts associated with these contracts. In contrast, ASC 606 will require us to recognize revenue from these contracts over time. As a result, revenue from these arrangements will increase in earlier periods.

If an entity chooses to provide tabular information to key stakeholders, including information to mirror the entity's selected transition approach (i.e., either (1) the full retrospective method with restatement of prior periods under ASC 250 or (2) the modified retrospective method), stakeholders will benefit from the ability to understand the overall impact of adoption as well as from any opening adjustments to retained earnings.

In remarks delivered at the 35th Annual SEC and Financial Reporting Institute Conference in June 2016, Mr. Bricker further emphasized the importance of transition-period disclosures, noting that the preparation of these disclosures should be subject to effective internal controls and disclosure controls and procedures. Specifically, he stated that "[a]s management completes portions of its implementation plan and develops an assessment of the anticipated impact the standard will have on the company's financial statements, internal and disclosure controls should be designed and implemented to timely identify relevant disclosure content from the implementation assessments and to ensure, where necessary, that appropriately informative disclosure is made."

[6] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

[7] SEC Staff Accounting Bulletin Topic 13, "Revenue Recognition."