CAQ ALERT No. 2017-03

SAB Topic 11.M – A Focus on Disclosures for New Accounting Standards

Introduction

We are pleased to release CAQ Alert No. 2017-03, *SAB Topic 11.M – A Focus on Disclosures for New Accounting Standards* (the CAQ Alert) to encourage our members to focus on evaluating the adequacy of management's disclosure of impending changes in accounting principles. The Securities and Exchange Commission's (SEC) Staff Accounting Bulletin (SAB) No. 74 (codified in SAB 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,* (commonly referred to as "SAB 74"), requires that when a recently issued accounting standard has not yet been adopted, a registrant discuss the potential effects of the future adoption in its interim and annual SEC filings.[1]

SAB 74 addresses disclosure requirements for both the footnotes to the financial statements and Management's Discussion and Analysis (MD&A). Such disclosures may provide insight into a registrant's preparedness with respect to new accounting standards. While this CAQ Alert highlights certain areas for consideration, it should not be relied upon as definitive or all-inclusive, and should be read and considered in conjunction with the applicable rules, standards, and guidance in their entirety.

The new revenue recognition, leases, and credit losses accounting standards become effective over the next few years, and these new accounting standards are expected to present significant changes for many companies.[2] Even in situations where a new accounting standard is not expected to significantly impact a registrant's primary financial statements, the accounting standard's requirements related to footnote disclosures may still be a significant change.

SAB 74 Disclosures Communicate the Potential Impact of New Accounting Standards

SAB 74 disclosures are required to assist financial statement users in assessing the significance of the potential impact that a new accounting standard will have on the financial statements, including footnote disclosures, upon adoption. In addition to providing useful and meaningful disclosures in financial statements, registrants may want to discuss the effects of new accounting standards as part of their investor outreach activities. This process can facilitate timely absorption of the information by market participants.

Generally Accepted Accounting Principles in the United States (US GAAP) requires and regulators have commented through speeches and other public remarks that SAB 74 disclosures should be both qualitative and quantitative.[3] The SEC staff has also made clear its expectation that SAB 74 disclosures become more robust and quantitative as the new accounting standard's effective date approaches. While certain relevant SEC staff speech and public comment excerpts have been included in Appendix 1, the full text of public

1 Refer to SAB 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*. Available at, https://www.sec.gov/interps/account/sabcodet11.htm#M. See full text in Appendix 2.

2 Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, ASU No. 2016-02, *Leases (Topic 842)*, and ASU No. 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. See Appendix 3 for resources related to these accounting standards.

3 Accounting Standards Codification (ASC) 250-10-S99-6.

comments should be read and considered in conjunction with the applicable rules, standards, and guidance in their entirety.

The SEC staff, through guidance and recent comments, have suggested that they expect registrants to include the following types of SAB 74 disclosures in their financial statements in the periods before new accounting standards are effective.

- ***A comparison of accounting policies***
  A comparison of the registrant's current accounting policies to the expected accounting policies under the new accounting standard(s).

- ***Status of implementation***
  Regulators have advised that the status of the implementation process should be disclosed, including disclosures related to significant implementation matters yet to be addressed or if the implementation process is lagging.[4]

- ***Consideration of the effect of new footnote disclosure requirements in addition to the effect on the balance sheet and income statement***
  Companies may determine that a new accounting standard is not expected to materially impact the primary financial statements. However, certain new accounting standards require new, comprehensive footnote disclosures that may be significant to the financial statements and require significant judgments. Accordingly, registrants should consider the full scope of a new accounting standard, which covers recognition, measurement, presentation, and disclosure.

- ***Disclosure of the quantitative impact of new accounting standard(s) if it can be reasonably estimated***
  A registrant who can reasonably estimate the quantitative impact of the new accounting standard should disclose those amounts.

- ***Disclosure that the expected financial statement impact of new accounting standard(s) cannot be reasonably estimated***
  If the impact of a new accounting standard cannot yet be reasonably estimated, the registrant should disclose that fact. Financial statement users may incorrectly assume there is no material financial statement impact if the registrant does not state otherwise.

- ***Qualitative disclosures***
  When the expected financial statement impact is not yet known by a registrant, a qualitative description of the effect of the new accounting standard on the registrant's accounting policies should be disclosed. Understanding the registrant's qualitative views could help financial statement users better understand the impact—until it can be quantified—of adoption of a new accounting standard.

SAB 74 Disclosures Help Audit Committees and Others Focus on Implementation

Timely progress on and effective implementation of new accounting standards are critical. Preparers, their audit committees, and auditors should discuss the status of implementation, including changes in internal control over financial reporting (ICFR). Registrants should ensure implementation of new accounting standards is a high priority within the organization. It is important for companies to dedicate sufficient resources to the implementation of new accounting standards, including those needed to educate company leaders, those within the company who will be impacted (in the accounting department and beyond) and investors.

Internal Control Considerations

As part of providing robust SAB 74 disclosures, registrants should consider whether appropriate internal controls are in place.[5] Such controls are important to management's ability to address the risks that SAB 74 disclosures are inaccurate or incomplete. Auditors have a responsibility to obtain a sufficient understanding of each component of ICFR and respond

4 SEC Staff announcement at 9/22/2016 Financial Accounting Standards Board Emerging Issues Task Force meeting minutes, p. 4.
5 Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934, Section 1.b., *Identifying Controls that Adequately Address Financial Reporting Risks.*

to identified risks related to the controls over disclosures.[6] As part of the audit of ICFR, auditors are required to assess the design effectiveness and to test the operating effectiveness of these relevant controls, which may include controls over these SAB 74 disclosures.[7]

Auditor Responsibilities

Auditors are reminded, as part of performing an audit of the financial statements taken as whole, to evaluate whether adequate SAB 74 disclosures have been included in the financial statements preceding the adoption of new accounting standards. Auditors should consider reviewing SAB 74 disclosures during reviews of interim financial information. After the effective date of a new accounting standard, auditors would ordinarily inquire of management about the application of new accounting principles as part of their review of interim financial information.[8] Public Company Accounting Oversight Board (PCAOB) auditing standards require the auditor to communicate to the audit committee if concerns are identified regarding management's anticipated application of a new accounting standard.[9] In the post-effective date period, auditors are required to evaluate consistency of the financial statements with US GAAP, including newly adopted accounting principles.[10]

Conclusion

Registrants are required to communicate certain information to financial statement users regarding the impending adoption of new accounting standards. Matters to be disclosed include the status of implementation of new accounting standards as well as both the quantitative and qualitative effect, to the extent known. Timely SAB 74 disclosures regarding the expected impact of new accounting standards may benefit users of the financial statements. Auditors should focus on evaluating the adequacy of these SAB 74 disclosures and related controls.

6 AS 2110, *Identifying and Assessing Risks of Material Misstatement*, paragraph 18 and AS 2301, *The Auditor's Responses to the Risks of Material Misstatement*, paragraph 5.d, states, "Evaluating the company's selection and application of significant accounting principles. The auditor should evaluate whether the company's selection and application of significant accounting principles, particularly those related to subjective measurements and complex transactions, are indicative of bias that could lead to material misstatement of the financial statements."

7 AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, paragraph 10 which describes the role of risk assessment, including the determination of significant accounts and disclosures and relevant assertions, the selection of controls to test, and the determination of the evidence necessary for a given control.

8 AS 4105, *Reviews of Interim Financial Information*, paragraph 55.

9 AS 1301, *Communications with Audit Committees*, paragraph 13(f), states that for new accounting pronouncements the auditor should communicate to the audit committee "situations in which, as a result of the auditor's procedures, the auditor identified a concern regarding management's anticipated application of accounting pronouncements that have been issued but are not yet effective and might have a significant effect on future financial reporting."

10 AS 2820, *Evaluating Consistency of Financial Statements*, paragraph 7 states, "the auditor should evaluate a change in accounting principle to determine whether (a) the newly adopted accounting principle is a generally accepted accounting principle, (b) the method of accounting for the effect of the change is in conformity with generally accepted accounting principles, (c) the disclosures related to the accounting change are adequate, and (d) the company has justified that the alternative accounting principle is preferable."

Appendix 1: SEC Speech and Public Comment Excerpts

While certain relevant excerpts have been included below, the full text of the speeches and other public comments should be read and considered in conjunction with the applicable rules, standards, and guidance in their entirety.

"Over the next several years, updating and maintaining internal controls will be particularly important as companies work through the implementation of the significant new accounting standards. Companies' implementation activities will require careful planning and execution, as well as sound judgment from management."[11]

"Investors need time to absorb the effect of new GAAP standards."[12]

"OCA has encouraged investor outreach and emphasized investor expectations for disclosure."[13]

"The changes in the new [revenue recognition] standard will impact all companies."[14]

"If a company does not know, or cannot reasonably estimate the expected financial statement impact, that fact should be disclosed. But, in these situations, the SEC staff expects a qualitative description of the effect of the new accounting policies, and a comparison to the company's current accounting to aid investors' understanding of the anticipated impact."[15]

Companies "should also disclose the status of its implementation process and significant implementation matters yet to be addressed."[16]

"For example, some companies indicate that the impact of the new revenue standard is not expected to be material. The changes in the new standard will impact all companies. Even if the extent of change for a particular company is slight, the related disclosures to describe revenue streams may not be. The scope of the new standard addresses not only amounts and timing of revenue but also new, comprehensive disclosures about contracts with customers, including the significant judgments the registrant has made when applying the guidance. Accordingly, the basis of any statement that the impact of the new standard is immaterial should reflect consideration of the full scope of the new standard, which covers recognition, measurement, presentation, and disclosure for revenue transactions."[17]

"Particularly for companies where implementation is lagging, preparers, their audit committees and auditors should discuss the reasons why and provide informative disclosures to investors about the status so that investors can assess the implications of the information."[18]

"The changes in standards will impact all companies, and even if the extent of change for a particular industry or company is slight, the disclosures necessary to explain the changes—and when implemented, to describe revenue streams—may not be. Investors and OCA staff will be looking for increased disclosures in 2016 filings and during 2017 about the significance of the impact—whether quantitative or qualitative—of revenue recognition, among the other new standards, when those

11 June 8, 2017 Remarks before the 36th Annual SEC and Financial Reporting Institute Conference: "Advancing the Role of Credible Financial Reporting in the Capital Markets," available at https://www.sec.gov/news/speech/bricker-remarks-financial-reporting-institute-conference-060817.

12 March 24, 2017 Remarks before the University of Tennessee's C. Warren Neel Corporate Governance Center: "Advancing the Role and Effectiveness of Audit Committees," available at https://www.sec.gov/news/speech/bricker-university-tennessee-032417.

13 Ibid.

14 March 21, 2017 Remarks before the Annual Life Sciences Accounting & Reporting Congress: "Advancing Effective Internal Control and Credible Financial Reporting," available at https://www.sec.gov/news/speech/bricker-remarks-annual-life-sciences-accounting-and-reporting-congress-032117.

15 Ibid.

16 Ibid.

17 Ibid.

18 December 5, 2016 AICPA Keynote Address before the 2016 AICPA Conference on Current SEC and PCAOB Developments available at https://www.sec.gov/news/speech/keynote-address-2016-aicpa-conference-working-together.html.

standards are adopted in the future. In addition, companies may find it helpful to investors to incorporate a discussion of the anticipated effects of the standard into their investor outreach activities to foster timely absorption of the information by market participants."[19]

"SAB Topic 11.M provides the SEC staff view that a registrant should evaluate ASUs that have not yet been adopted to determine the appropriate financial statement disclosures about the potential material effects of those ASUs on the financial statements when adopted. Consistent with Topic 11.M, if a registrant does not know or cannot reasonably estimate the impact that adoption of the ASUs referenced in this announcement is expected to have on the financial statements, then in addition to making a statement to that effect, that registrant should consider additional qualitative financial statement disclosures to assist the reader in assessing the significance of the impact that the standard will have on the financial statements of the registrant when adopted. In this regard, the SEC staff expects the additional qualitative disclosures to include a description of the effect of the accounting policies that the registrant expects to apply, if determined, and a comparison to the registrant's current accounting policies. Also, a registrant should describe the status of its process to implement the new standards and the significant implementation matters yet to be addressed."[20]

19 Ibid.

20 SEC Staff announcement at September 22, 2016 Financial Accounting Standards Board Emerging Issues Task Force meeting minutes, p. 4, codified in ASC 250-10-S99-6.

Appendix 2: SAB No. 74 (codified in SAB Topic 11.M)

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

Facts: An accounting standard has been issued[5] that does not require adoption until some future date. A registrant is required to include financial statements in filings with the Commission after the issuance of the standard but before it is adopted by the registrant.

Question 1: Does the staff believe that these filings should include disclosure of the impact that the recently issued accounting standard will have on the financial position and results of operations of the registrant when such standard is adopted in a future period?

Interpretive Response: Yes. The Commission addressed a similar issue and concluded that registrants should discuss the potential effects of adoption of recently issued accounting standards in registration statements and reports filed with the Commission.[6] The staff believes that this disclosure guidance applies to all accounting standards which have been issued but not yet adopted by the registrant unless the impact on its financial position and results of operations is not expected to be material.[7] MD&A[8] requires registrants to provide information with respect to liquidity, capital resources and results of operations and such other information that the registrant believes to be necessary to understand its financial condition and results of operations. In addition, MD&A requires disclosure of presently known material changes, trends and uncertainties that have had or that the registrant reasonably expects will have a material impact on future sales, revenues or income from continuing operations. The staff believes that disclosure of impending accounting changes is necessary to inform the reader about expected impacts on financial information to be reported in the future and, therefore, should be disclosed in accordance with the existing MD&A requirements. With respect to financial statement disclosure, GAAS[9] specifically address the need for the auditor to consider the adequacy of the disclosure of impending changes in accounting principles if (a) the financial statements have been prepared on the basis of accounting principles that were acceptable at the financial statement date but that will not be acceptable in the future and (b) the financial statements will be retrospectively adjusted in the future as a result of the change. The staff believes that recently issued accounting standards may constitute material matters and, therefore, disclosure in the financial statements should also be considered in situations where the change to the new accounting standard will be accounted for in financial statements of future periods, prospectively or with a cumulative catch-up adjustment.

Question 2: Does the staff have a view on the types of disclosure that would be meaningful and appropriate when a new accounting standard has been issued but not yet adopted by the registrant?

Interpretive Response: The staff believes that the registrant should evaluate each new accounting standard to determine the appropriate disclosure and recognizes that the level of information available to the registrant will differ with respect to various standards and from one registrant to another. The objectives of the disclosure should be to (1) notify the reader of the disclosure documents that a standard has been issued which the registrant will be required to adopt in the future and (2) assist

5 Some registrants may want to disclose the potential effects of proposed accounting standards not yet issued, (*e.g.*, exposure drafts). Such disclosures, which generally are not required because the final standard may differ from the exposure draft, are not addressed by this SAB. *See also* FRR 26.

6 FRR 6, Section 2.

7 In those instances where a recently issued standard will impact the preparation of, but not materially affect, the financial statements, the registrant is encouraged to disclose that a standard has been issued and that its adoption will not have a material effect on its financial position or results of operations.

8 Item 303 of Regulation S-K.

9 *See* AU 9410.13-18.

the reader in assessing the significance of the impact that the standard will have on the financial statements of the registrant when adopted. The staff understands that the registrant will only be able to disclose information that is known.

The following disclosures should generally be considered by the registrant:

- A brief description of the new standard, the date that adoption is required and the date that the registrant plans to adopt, if earlier.

- A discussion of the methods of adoption allowed by the standard and the method expected to be utilized by the registrant, if determined.

- A discussion of the impact that adoption of the standard is expected to have on the financial statements of the registrant, unless not known or reasonably estimable. In that case, a statement to that effect may be made.

- Disclosure of the potential impact of other significant matters that the registrant believes might result from the adoption of the standard (such as technical violations of debt covenant agreements, planned or intended changes in business practices, etc.) is encouraged.

Appendix 3: Additional Resources

AICPA: *New Leases Accounting Standard—Learning and Implementation Plan*
https://www.aicpa.org/InterestAreas/FRC/AccountingFinancialReporting/leases/DownloadableDocuments/Leases_LI_Plan.pdf

AICPA: *New Revenue Recognition Accounting Standard—Learning and Implementation Plan* (September 2016)
https://www.aicpa.org/InterestAreas/FRC/AccountingFinancialReporting/RevenueRecognition/DownloadableDocuments/2014-09_LIPlan.pdf.

BDO: *Topic 842, Leases* (July 2016)
https://www.bdo.com/getattachment/7d41743b-395b-49ee-b818-f09266315053/attachment.aspx?BDO-Assurance-Practice-Aid-Leasing_7-16.pdf

BDO: *Topic 606 Revenue from Contracts with Customers* (March 2017)
https://www.bdo.com/getattachment/4495d805-f6c5-4eb5-8ade-c3b59be821af/attachment.aspx

Center for Audit Quality: *Preparing for the New Revenue Recognition Standard: A Tool for Audit Committees* (December 2016)
http://www.thecaq.org/preparing-new-revenue-recognition-standard-tool-audit-committees.

Deloitte: Heads Up, Volume 24, Issue 15, *Implementing the New Revenue Standard – How Do Your Disclosures Stack Up?* (June 2017)
https://dart.deloitte.com/resource/1/84c142bb-4a26-11e7-883d-8d29f33a5560

Deloitte: Financial Reporting Alert 16-3, *SEC Reminds Registrants of Best Practices for Implementing New Revenue, Lease, and Credit Loss Accounting Standards* (September 2016)
https://www2.deloitte.com/content/dam/Deloitte/us/Documents/audit/ASC/FRA/2016/us-aers-fra-sec-reminds-registrants-of-best-practices-for-implementing-new-revenue-lease-and-credit-loss-accounting-standards.pdf

EY: *Paving a path to success: preparing for new lease accounting standards* (June 2016)
http://www.ey.com/Publication/vwLUAssets/ey-new-leasing-standards/$FILE/ey-new-leasing-standards.pdf

KPMG: *Illustrative Disclosures - Revenue US GAAP* (May 2016)
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2016/revenue-illustrative-disclosures.pdf

PwC: *Recently issued accounting standards – Governance Considerations* (February 2017)
http://www.pwc.com/us/en/cfodirect/publications/in-the-loop/sab-74-new-accounting-standards.html