Financial reporting briefs

What you need to know about this quarter's accounting, financial reporting and other developments

March 2021

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Building a better working world

Accounting update

Welcome to the March 2021 Financial reporting briefs. *This edition highlights the latest developments in financial reporting and alerts you to some important considerations for 2021.*

Interested in learning more about accounting considerations for companies that are evaluating reductions to their leased real estate footprint? We've got it covered in our Accounting update *section.*

In our Regulatory developments *section, we provide updates on SEC and PCAOB developments.*

Need more information? *Check out our* Reference library, *where we list our recent publications on the topics discussed here and provide links to them.*

Accounting considerations when evaluating reductions to leased real estate

Companies that are developing plans to reduce their real estate footprint in response to the effects of the pandemic or are implementing such plans need to consider the lease accounting implications. If they haven't already done so, they should involve accounting personnel in the development of the plan to understand the accounting implications of the plan, including the implications for lease accounting.

Lessees that have adopted the new leases guidance in Accounting Standards Codification (ASC) 842 and decide to reduce their real estate footprint may determine that their decision is an indicator that would trigger an assessment of whether the asset group that includes the right-of-use (ROU) asset is impaired. As a reminder, ROU assets are subject to the impairment guidance in ASC 360-10, *Property, Plant, and Equipment*, which requires three steps to identify, recognize and measure the impairment of a long-lived asset (asset group) to be held and used.

ASC 360-10 requires companies to consider whether there are any events or changes in circumstances that indicate that the carrying amount of the long-lived asset (asset group) might not be recoverable. A recoverability test would be triggered at any time an indicator of impairment is present.

Once a plan is approved, the company must consider whether it results in an abandonment or a change to the lease term or both (e.g., if an optional renewal period is included in the existing lease term). A lessee that decides to cease using a leased asset either immediately or at a future date must assess whether the corresponding ROU asset is or will be abandoned.

When a lessee has a contractual right to sublease the leased asset and does not currently plan to sublease or otherwise use it but may sublease it in the future, the ROU asset is not or will not be abandoned since the lessee has not yet decided that it will not sublease or otherwise use the leased asset. This may be an important consideration for companies since it may be difficult to sublease space in the current environment, but conditions may improve in the future. However, a decision to sublease the underlying asset may be an indicator of impairment or may indicate a change in the asset grouping. A plan to abandon an ROU asset is considered an indicator of impairment under ASC 360-10, which would trigger the recoverability test.

Lessees should also consider whether an approved plan affects previous assessments of whether they are reasonably certain to exercise an option to extend or terminate the lease or to purchase the underlying asset. For example, companies may consider exercising options to terminate leases early, even though they may have previously determined that they were reasonably certain to not exercise those options. If the approved plan affects a lessee's assessment, the lessee reassesses the lease term.

If there is a change to the lease term, the lessee is required to reassess lease classification and remeasure the lease liability, using revised inputs (e.g., discount rate and its allocation of contract consideration) at the reassessment date, and adjust the ROU asset.

Management also may plan to renegotiate the lease, which could result in a lease modification under ASC 842. When a lease is modified, lessees must first evaluate the modified contract to determine whether it still is a lease or still contains a lease. If a lease continues to exist, a lease modification can result in either a separate contract or a change in the accounting for the existing lease (i.e., not a separate contract).

Modifications that reduce the leased space will change the accounting for the existing lease and will not result in a separate contract. That's because ASC 842 requires a modification to be accounted for as a separate contract only when the lessee receives an additional right of use and agrees to provide additional lease payments commensurate with the standalone price of that additional right of use.

Reminders about impairments related to COVID-19

A company that determines that any economic effects of the pandemic are impairment indicators is required to perform impairment tests, and the tests must be performed in the appropriate order. Indefinite-lived intangible assets are tested first for impairment in accordance with ASC 350. Long-lived assets (or asset groups) that are held and used are then tested for impairment in accordance with ASC 360. Goodwill is tested for impairment last, and those tests are performed at the reporting unit level. Long-lived assets that are held and used include land, buildings, machinery and finite-lived intangible assets that do not meet the held-for-sale criteria. However, if a disposal group is held for sale, any goodwill included in the group is adjusted for impairment before the fair value of the group is measured.

Reference rate reform considerations

The Financial Accounting Standards Board (FASB) issued final guidance to clarify that entities can apply certain optional expedients and exceptions in its reference rate reform guidance in ASC 848 to all derivative instruments affected by the market-wide change in the interest rates used for discounting, margining or contract price alignment (commonly referred to as the discounting transition), even if they do not reference the London Interbank Offered Rate (LIBOR) or another rate that is expected to be discontinued as a result of reference rate reform. The guidance also clarifies other aspects of the relief provided in ASC 848.

While the guidance in ASC 848 should help to mitigate the cost and complexity of accounting for modified contracts and the potential for earnings volatility, companies still need to focus on operational, legal, information technology and risk management issues related to the transition. For example, companies should have controls in place over the key aspects of their transition process, including:

- Identification of all contracts that refer to LIBOR and other interbank offered rates expected to be discontinued as a result of reference rate reform (including those in hedging relationships), those that meet the criteria for applying the optional expedients and exceptions in ASC 848, and those that don't
- Operation of information systems used to perform calculations affected by reference rate reform and any changes to those systems to make sure they function as intended

Companies that elect to apply the optional expedients and exceptions should document their election and the evaluation they performed to determine that the criteria were met. They also need to consider disclosures about their transition processes. The Securities and Exchange Commission (SEC or Commission) staff has said it expects registrants to make disclosures about how they are preparing for the phaseout of LIBOR and any anticipated effects that would be material.

The recent announcement by the administrator of LIBOR of its decision to publish US LIBOR rates for many common maturities until 30 June 2023 will result in many legacy contracts maturing prior to the cessation of LIBOR and therefore should reduce the burden of the transition for some companies. In addition, the FASB has indicated that it plans to revisit the sunset date in ASC 848, which currently indicates that the transition relief cannot be applied after 31 December 2022.

Proposed accounting alternative on interim goodwill impairment triggers

The FASB decided to expand the scope of its proposed accounting alternative to allow private companies and not-for-profit (NFP) entities to assess whether triggering events for goodwill impairment have occurred only as of their reporting date any time they report financial information, including interim reports. Entities that elect this alternative would not be required to monitor for events or changes in circumstances that indicate that goodwill may be impaired between reporting dates, beginning with annual reporting for 2020.

The proposal is intended to address concerns about the cost and complexity of the monitoring and the relevance of any interim goodwill impairment test if the economic conditions that triggered the test improve by year end, as was the case for some entities in 2020.

Accounting for the conversion of debt under the new guidance

While the guidance the FASB issued recently on convertible instruments makes it less likely that issuers will recognize gains or losses upon the conversion of debt, it doesn't address the conversion accounting for a convertible debt instrument that is not accounted for as a liability in its entirety.

We generally believe (1) extinguishment accounting should be applied when the conversion feature is bifurcated and accounted for separately as a derivative under ASC 815 and (2) the new conversion accounting model should be applied in other situations (e.g., when the conversion feature is separately accounted for in additional paid-in capital under the substantial premium model), though extinguishment accounting may also be acceptable, given the lack of guidance. We also believe the choice of a method is an accounting policy election that should be consistently applied. Other considerations may apply if there is an induced conversion.

As a reminder, the guidance, which eliminates the beneficial conversion feature and cash conversion models in ASC 470-20, is effective for public business entities that are not smaller reporting companies for annual periods beginning after 15 December 2021, and interim periods therein. Early adoption is permitted in fiscal years beginning after 15 December 2020, but an entity must adopt the guidance as of the beginning of a fiscal year.

FASB simplifies nonpublic franchisors' accounting for pre-opening services

The FASB issued final guidance that provides a practical expedient for a franchisor that is not a public business entity to account for pre-opening services it provides to a franchisee as distinct from the franchise license if they are consistent with those included in the list of pre-opening services in the guidance. Franchisors that apply the practical expedient may then make an accounting policy election to account for pre-opening services on the list as a single performance obligation.

For private company franchisors that have not yet adopted ASC 606, the guidance is effective for annual periods beginning after 15 December 2019. For private company franchisors that have adopted ASC 606, it is effective for interim and annual periods beginning after 15 December 2020. Early adoption is permitted.

Regulatory developments

Reminders about changes to rules on business acquisitions and disposals

SEC registrants that acquire or dispose of businesses this year need to remember that the rules for providing financial information about these businesses have changed.

When they perform two of the three significance tests to determine which disclosures are required, most registrants will need to consider new information. The investment test now requires consideration of a registrant's worldwide market value (if available), and the income test requires a comparison of an acquired business's revenue to that of the registrant, if the amounts are material. Registrants are required to present a maximum of two years of financial statements (rather than three years) for an acquired business, and the significance threshold for a business that is disposed of is now 20% (rather than 10%), among other changes.

Under the new rules on pro forma financial information, registrants may need to change how they calculate and present certain adjustments to historical financial information and can now elect to provide forward-looking information (e.g., expected synergies and related costs).

SEC approves new NYSE direct listing rules

The SEC approved direct listing rules proposed by the New York Stock Exchange (NYSE) that allow companies to raise capital by selling new shares to the public without engaging in a traditional initial public offering (IPO) process and incurring the costs associated with it, such as underwriting fees. Previously, NYSE rules allowed companies to list only existing shares for resale by existing shareholders in a direct listing and required them to conduct an IPO to raise capital.

Separately, Nasdaq has filed a proposal with the SEC that would allow companies that qualify for its highest tier to raise capital by selling new shares in direct listings, among other things. The proposal requires SEC approval.

SEC staff provides guidance for offerings affected by extreme volatility

The SEC's Division of Corporation Finance provided an example of a comment letter that it may issue to companies seeking to raise capital in securities offerings during times of extreme market and price volatility. The SEC staff urged companies to consider the sample comments as they prepare disclosure documents that may not typically be subject to review by the staff before their use, such as automatically effective registration statements and prospectus supplements for takedowns from existing shelf registration statements.

The sample comments are intended to prompt companies raising capital under these conditions to describe them and any related risks to investors. The SEC staff believes these disclosures may be required in order to comply with the disclosure obligations imposed by the federal securities laws.

SEC creates task force focused on climate and ESG issues

The SEC created a task force in the Division of Enforcement that will develop initiatives to identify misconduct related to environmental, social and governance (ESG) issues. The Climate and ESG Task Force initially will focus on material gaps or misstatements in issuers' disclosures on climate risks and ESG issues under existing rules. It will draw from the SEC's headquarters, regional offices and Enforcement specialized units and work with other SEC divisions and offices.

"Climate risks and sustainability are critical issues for the investing public and our capital markets," Acting Chair Allison Herren Lee said in a statement. "The task force … will play an important role in enhancing and coordinating the efforts of the Division of Enforcement, the Office of the Whistleblower and other parts of the agency to bolster the efforts of the Commission as a whole on these vital matters."

Acting SEC Chair Lee orders enhanced focus on climate-related disclosure

Acting SEC Chair Allison Herren Lee directed the Division of Corporation Finance to enhance its focus on climate-related disclosure in public company filings by reviewing the extent to which public companies are addressing the topics identified in the Commission's 2010 guidance on disclosures related to climate change matters and updating that guidance to take into account developments over the last decade. As part of the process, the Division will engage with public companies and study how the market manages climate-related risks. "Now more than ever, investors are considering climate-related issues when making their investment decisions," Ms. Lee said in a statement.

The 2010 guidance provided the Commission's views on how the existing disclosure requirements (e.g., description of the business, risk factors, management's discussion and analysis) applied to climate change matters. The guidance states that disclosure obligations could be triggered by the impact of enacted or pending legislation and regulation, international accords, physical effects such as weather, and any actual or expected consequences to the business related to climate change.

Ms. Lee, who has been an SEC Commissioner since 2019, was appointed Acting Chair by President Joseph Biden. Shortly after her appointment, Ms. Lee named Satyam Khanna to the new role of Senior Policy Advisor for Climate and ESG in her office. Mr. Khanna previously served as a member of the SEC's Investor Advisory Committee (IAC) and as counsel to former SEC Commissioner Robert Jackson Jr.

Gensler nominated as SEC chair

President Biden nominated Gary Gensler to serve as chairman of the SEC, subject to confirmation by the US Senate. The Senate Committee on Banking, Housing and Urban Affairs held its nomination hearing on 2 March. During the hearing, Mr. Gensler indicated that his goal as SEC chair would be to strengthen accountability, transparency and efficiency of the markets and to make sure that both less-established and more mature companies are able to effectively raise capital. Mr. Gensler has been a professor at MIT Sloan School of Management. He previously was chairman of the Commodity Futures Trading Commission and held other government posts after working at Goldman Sachs.

Munter named Acting SEC Chief Accountant

Paul Munter was appointed Acting Chief Accountant, following the departure of Sagar Teotia in February. Mr. Munter had served as Deputy Chief Accountant since 2019, leading the international work in the agency's Office of the Chief Accountant. He will serve as the principal adviser to the Commission on accounting and auditing matters and will be responsible for assisting the Commission in overseeing the FASB and the Public Company Accounting Oversight Board (PCAOB).

New Acting Directors at SEC's Corporation Finance, Enforcement divisions

John Coates was named Acting Director of the SEC's Division of Corporation Finance. Mr. Coates, who has been a professor of law and economics at Harvard University, served on the SEC's IAC and chaired the Investor-as-Owner Subcommittee. He was previously a partner at Wachtell, Lipton, Rosen & Katz and consulted for the Department of Justice, the Department of Treasury and the NYSE.

Melissa R. Hodgman, Associate Director of the SEC's Division of Enforcement, was named Acting Director of the division. Ms. Hodgman joined the division in 2008 and has investigated and led teams pursuing and litigating numerous enforcement actions covering various securities law violations, including matters related to financial fraud and disclosure.

Brown concludes service at PCAOB

J. Robert Brown Jr. left the PCAOB in January after three years as a member of the board. During his tenure, he called for increased transparency and public accountability at the PCAOB to enhance investor trust and confidence in the capital markets.

Other considerations

Estimating the annual effective tax rate and reporting income taxes in an interim period

With companies setting their annual effective tax rates, they need to keep in mind that the tax provision in an interim period is measured using an estimated annual effective tax rate. At the end of each interim period, a company must make its best estimate of the annual effective rate for the full fiscal year and apply that rate to year-to-date ordinary income. As a reminder, the calculation of the effective tax rate can be affected by:

- Operations in multiple jurisdictions
- Expectations about whether current-year losses are realizable
- The tax benefit of an operating loss carryforward from a prior year that is realized because of current-year ordinary income
- Tax law changes enacted in the period that affect taxes payable or refundable for the current year

Companies should monitor tax law changes in the US and other jurisdictions. The effects of a change in tax laws or rates on deferred tax balances are recognized as a discrete event as of the enactment date and should not be allocated to subsequent interim periods by an adjustment to the estimated annual effective tax rate. Similarly, the effects of a change in tax laws or rates on taxes payable or refundable for a prior year should be recognized as of the enactment date.

In addition, companies that adopted the new guidance in Accounting Standards Update 2019-12, *Income Taxes (Topic 740): Simplifying the Accounting for Income Taxes*, may need to change how they determine their estimated annual effective tax rate or the amount of income tax expense or benefit they recognize in an interim period.

Summary of open comment periods

Items are FASB proposals unless otherwise noted.

Proposal	Comment period ends
Proposed Accounting Standards Update — *Business Combinations (Topic 805): Accounting for Contract Assets and Contract Liabilities from Contracts with Customers*	15 March 2021

Reference library

Click on any of the EY publications below, all of which are available free of charge on AccountingLink at www.ey.com/en_us/assurance/accountinglink.

To the Point

- FASB simplifies nonpublic franchisors' accounting for pre-opening services (1 February 2021)
- FASB clarifies the scope of relief related to reference rate reform (7 January 2021)
- Certain private companies and NFPs would not be required to evaluate interim goodwill impairment triggers (22 December 2020)
- FASB proposes guidance for revenue contracts acquired in a business combination (17 December 2020)

Technical Line

- A closer look at the FASB's accounting relief related to reference rate reform (21 January 2021)
- A closer look at the new guidance on distinguishing liabilities from equity and EPS (14 January 2021)
- How to apply the amended S-X Rule 3-14 to real estate acquisitions (14 January 2021)

Financial reporting developments

- Credit impairment under ASC 326 (14 January 2021)
- Real estate project costs (16 December 2020)
- Lease accounting: Accounting Standards Codification 842, *Leases* (15 December 2020)
- Impairment or disposal of long-lived assets (1 September 2020)

Comment letters

- FASB's proposal that certain private companies and NFPs not be required to evaluate interim goodwill impairment triggers (19 January 2021)
- Proposed changes to the SASB Conceptual Framework and SASB Rules of Procedure (6 January 2021)

Other

- Effective date matrix as of 1 March 2021 (2 March 2021)
- NAIC Bulletin – Fall 2020 edition (21 January 2021)
- 2020 Pro forma financial information – A guide for applying amended Article 11 of Regulation S-X (21 January 2021)
- Credit impairment disclosures under the new standard are evolving (19 January 2021)
- Quarterly tax developments – December 2020 (14 January 2021)
- US GAAP versus IFRS: The basics – January 2021 (14 January 2021)
- US GAAP/IFRS accounting differences identifier tool – January 2021 (14 January 2021)
- SEC in Focus – January 2021 (7 January 2021)
- Accounting pronouncements effective in 2020 (7 January 2021)
- 2021 SEC quarterly reports – Form 10-Q (16 December 2020)
- 2020 SEC annual reports – Form 10-K (16 December 2020)
- 2021 proxy statements – An overview of the requirements (16 December 2020)

On-demand webcasts

- Human capital disclosures: Strategy and considerations
- Tax in a time of global disruption
- Tax in the time of COVID-19: post-election outlook
- What you need to know for Q4 2020 financial reporting
- Where boards will focus their attention in 2021

Upcoming webcasts

- How an agile capital allocation strategy can help companies refocus and grow (16 March 2021)
- The digital M&A imperative – what companies need to get right (25 March 2021)

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