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ACCOUNTING & AUDITING

Hot topics for 2019 year-end audits

By Maria L. Murphy Thu, Jan 9, 2020 8:36 AM

It's that time of year again: 2019 year-end audits for calendar-year companies are right around the corner. Implementing new accounting standards and related internal controls, including revenue recognition and lease accounting, are top-of-mind for auditors once again this year.

Revenue recognition

Revenue recognition under **Accounting Standards Codification Topic 606** continues to be a high priority. "Although most public companies adopted the new revenue standard last year, private companies and emerging growth companies must adopt it this year, and not all clients are fully prepared," says Sougata Banerjee, partner in charge of assurance services in California for Marcum.

"We have been meeting with our clients throughout the year to discuss the five-step process and our audit plan, starting with those who expected a change," says Michele Reagan, principal at CliftonLarsonAllen. "Our larger clients with a full accounting staff are definitely more ready than our smaller clients that only have a bookkeeper, and we are implementing new tailored audit programs on an industry basis this year-end."

Companies are dealing with the new five-step revenue recognition model for the first time and having to look at their contracts, underlying performance obligations, and revenue streams in a whole new way. "It is critical to understand what the client has promised in a contract from the customer's point of view," says Banerjee. There are many new judgments to be applied, including accounting policy elections, and documentation must be available for the auditors.

"There is a tendency for many clients to say that 606 won't have a material impact, but auditors need to assess the impacts because Big Four surveys of results for SEC filers that already adopted show 20 to 33 percent of those saw a difference in the timing and amounts of revenue recognized," says Michael Hoose, senior manager in the professional audit practices group at Cherry Bekaert.

Issues that will be especially challenging include identifying performance obligations, allocating contract price to performance obligations, accounting for variable consideration and constraints, determining whether revenue is recognized over time or at a point in time, and tracking modifications and combining of contracts. "The biggest issue is the Step 2 analysis of performance obligations, because if you get this wrong it is highly unlikely you will get revenue recognition right," says Hoose. "There is also a tendency not to want to recognize variable consideration in Step 3, which is surprising because this would accelerate revenue recognition."

Auditors must assess internal controls over revenue recognition. These include changes to systems for clients who have automated portions of their 606 accounting and reporting, procedures to ensure completeness of the population of all contracts and amendments and the overall process to account for contracts under the five-step model at inception and beyond.

Lease accounting

Another key accounting standard is accounting for leases under **ASC Topic 842**, which must be adopted by most public companies for this year-end. The area of most concern will be ensuring completeness of the lease population and tracking leases over time.

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Embedded leases within service contracts is another problem area. "This was the biggest eye opener and a reason why FASB delayed this standard's effective date," says Banerjee. Ongoing routine service contracts with vendors can include embedded leases that must be identified and accounted for. Even if the individual amounts are small, they can be material in the aggregate if there are a number of these contracts.

New disclosures

For both ASC 606 and 842, there are new disclosures to be prepared and audited. The 606 disclosures for public companies are more extensive than for private companies, but they have already been preparing them for a year. For those that have already adopted, the SEC staff has been commenting on the need for more robust disclosures. New adopters and their auditors can look to these SEC comments for guidance as disclosures are added for the first time this year-end. “The most difficult disclosures for private companies will be disaggregating revenues recognized over time versus at a point in time and describing performance obligations and judgments made,” says Hoose.

For those clients who have not yet adopted, auditors need to ensure revenue and leases, among others, are included in their SAB 74 disclosures. “We have seen robust qualitative disclosures about the use of leases and quantitative disclosures about the number of leases and how many are financing versus operating,” says Hoose. “If clients cannot quantify the impact of adoption at this point, they should include robust qualitative disclosures.” Companies adopting a new standard in an interim period next year should include disclosures in their year-end filing this year. “These companies should know the effects and disclose something, not just say they are still evaluating, and auditors must audit the disclosure even if it says there will be no material impact,” says Banerjee.

Don’t forget impairment

While revenue recognition and leases may be the most important standards to take effect in 2019, they are not the only standards on auditor’s watch lists. Impairment is always a hot topic. “Because stock market valuations are high, impairment is not a big risk for many clients this year,” says Banerjee. In certain industries with significant goodwill on the books from prior years, however, he recommends changes in regulation or declines in stock prices should be considered for impairments of goodwill or other intangibles. The vaping and cannabis industries are two timely examples.

“Impairment is a recurring PCAOB inspection deficiency and SEC comment area,” Hoose says. He notes the SEC does not like surprises and is concerned with the timing and triggers of a charge, and the PCAOB finds issues with audit procedures and evidence relating to amounts and timing of impairments.

Looking ahead

Auditors will also be planning for future standards. In November 2019, FASB issued ASU 2019-10, which delayed the effective dates for private companies’ implementation of Topic 842, Leases, and Topic 815, Derivatives and Hedging, until 2021, and Topic 326, Financial Instruments - Credit Losses (CECL), until the first quarter of 2020 for public companies and 2023 for all others. “Many of our clients are taking advantage of these deferred effective dates,” says Reagan.

Public companies will begin to implement CECL in the first quarter of 2020. This standard will have the greatest effect on financial institutions. But all companies with trade receivables and certain categories of securities need to be focusing on this standard now—including preparing SAB 74 disclosures for this year-end. Many financial institutions have been working with third-party software providers for modeling and loan loss measurements since the standard was issued, but many others are just getting familiar with what is changing.

Outside of accounting standards, auditors are including PCAOB inspection findings in year-end audit plans. The board has been focused on accounting for estimates, related party transactions, cyber-security, and digital assets, among others.

Cyber-security is an area where disclosure requirements and risks go beyond the financial statements. “Cyber-security is generally outside our audit scope, but because the PCAOB is also looking at how auditors ensured there were no incidents to disclose, beyond inquiry, we have our IT teams doing more than they would normally do for an audit,” says Banerjee.

As internet commerce, cryptocurrency, and blockchain are becoming more pervasive, the PCAOB has become more interested in audit procedures and documentation relating to valuing digital assets and revenue recognition. “If you have this type of client, the PCAOB is going to be looking more critically at your audit, and there will be even more focus going forward,” says Banerjee.

Audit committees and boards are facing more complex issues, and regulators are encouraging them to be more involved than ever with their auditors.

The new critical audit matters reporting standard is currently effective for large accelerated filers and will be effective for other filers for audits of fiscal years ending on or after Dec. 15, 2020. Although it is not yet effective for many audits, firms are preparing now. “Implementation of reporting critical audit matters will result in a lot more care in audit committee communications and making sure everyone is on the same page regarding risks, because those communications can impact CAM disclosure,” says Hoose.

And every auditor’s list of year-end audit hot topics includes resources. “We need the right people to do the job, to ensure quality work, and to deal with having enough resources to meet compressed busy season deadlines,” says Banerjee.