Accounting Committee Meeting

Wednesday, March 22nd
1:15pm – 2:45pm
La Quinta Club & Resort, La Quinta, California

Moderator:
Chris Drula, VP-Financial Standards, NAREIT

Panelists:
David Augustyn, Partner-Deal Advisory, KPMG LLP
Brandon Landas, Partner-National SEC Department, BDO USA, LLP
G. Wyndham Smith, Partner, Deloitte LLP
George Yungmann, SVP-Financial Standards, NAREIT

© Copyright 2017
National Association of Real Estate Investment Trusts ®
This material is provided by NAREIT and REITWise 2017 panelists for informational purposes only, and is not intended to provide, and should not be relied upon for, legal, tax or accounting advice.

JANUARY 2016
www.bdo.com

THE NEWSLETTER FROM BDO'S NATIONAL ASSURANCE PRACTICE

BDO KNOWS: SEC

CONTENTS

SIGNIFICANT 2015 DEVELOPMENTS ..1

IMPLEMENTING LEGISLATION 2
The Dodd-Frank Act 2
The JOBS Act 7
The FAST Act... 9

OTHER COMMISSION ACTIVITIES 11
Request for Comment — Financial Disclosures about Entities Other than the Registrant 11
Concept Release on Possible Revisions to Audit Committee Disclosures 11

STAFF GUIDANCE 12
Pushdown Accounting and Rule 3-10....12
Reporting Implications of the New Consolidation Standard 12
Pro Forma Reserves and SMOG Data 13
Financial Reporting Manual.....................13
Compliance and Disclosure Interpretations.......................................13

STAFF ACTIVITIES 14
Implementing the New Revenue Standard 14
Disclosure Effectiveness Project 14

PCAOB DEVELOPMENTS 15
Final Auditing Standards and Amendments 15
Other Standard-Setting Activities 16
Guidance 17

CONTACT..17

SEC YEAR IN REVIEW

SIGNIFICANT 2015 DEVELOPMENTS

Consistent with Chair White's focus over the past few years, the Commission's 2015 agenda continued to be dominated by rulemaking required by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and the Jumpstart Our Business Startups (JOBS) Act of 2012. The Commission made progress on the backlog of Dodd-Frank rulemaking related to executive compensation matters, including a final rule on pay ratio disclosures and proposals on pay vs. performance disclosures and compensation clawback policies. In December, the Commission re-proposed a rule to require resource extraction issuers to disclose payments made to the U.S. and foreign governments. The re-proposal followed a Court decision in July 2013 to vacate the rule requiring disclosure of the same information that the SEC adopted in 2012. The Commission also completed all of the major rulemaking required by the JOBS Act, including final rules related to crowdfunding and amendments to Regulation A. The Commission and its staff now need to focus on implementing the provisions of the Fixing America's Surface Transportation (FAST) Act, which was passed in December and included provisions that amend securities laws, some of which became effective immediately.

There were several notable changes in the Commission and the staff in 2015. Daniel Gallagher (Republican) left the Commission in October. Luis Aguilar (Democrat) also announced his intention to leave the Commission at the end of December or earlier if his replacement is confirmed. The President nominated two individuals, Hester Peirce

(Republican) and Lisa Fairfax (Democrat), though they have yet to be confirmed by the Senate. At the staff level, Wes Bricker replaced Dan Murdock as a Deputy Chief Accountant in the Office of the Chief Accountant.

The SEC's Chief Accountant, James Schnurr, continued to lead the Commission's work on deciding whether, and if so, how and when, to incorporate International Financial Reporting Standards into financial reporting by domestic issuers. The idea currently being considered is to permit domestic issuers to voluntarily provide IFRS-based financial information as a supplement to their U.S. GAAP financial statements without requiring a reconciliation to U.S. GAAP (as is otherwise required when non-GAAP financial information is presented). In December, Chair White indicated that the Commissioners will be discussing this recommendation with the staff to determine the path forward.

Schnurr and his staff have also been focused on addressing implementation issues related to the new revenue accounting standard and other pending standards on leases, classification and measurement of financial instruments, and credit losses. The staff has expressed concern that many companies are not as far along as they should be in their implementation efforts and has been using speeches to encourage them to step up the pace of their activities.

The Commission and the staff remain focused on the Disclosure Effectiveness Project, a broad-based staff review of the SEC's disclosure rules designed to improve the disclosure regime for both companies and investors. In September, the Commission issued a Request for Comment about the financial disclosures of entities other than the registrant. Another disclosure topic that the Commission is revisiting is disclosures by audit committees about their activities. The rules covering these disclosures have not been updated since 1999, and the Commission is concerned that the rules may not have kept pace with the evolving role and responsibilities of audit committees. To solicit input, the Commission issued a concept release, *Possible Revisions to Audit Committee Disclosures*.

The staff issued guidance throughout the year to assist registrants and others with interpreting and complying with the SEC's rules and regulations. The staff updated its Compliance and Disclosure Interpretations (C&DIs) and the Financial Reporting Manual (FRM) and issued small business compliance guides covering the new rules adopted to implement the JOBS Act.

Looking forward to 2016, the remaining rulemaking required by the Dodd-Frank Act is expected to remain a high priority of the Commission, as well as the new rulemaking required by the FAST Act. The Commission also hopes to make a further statement about the use of IFRS by domestic issuers. The staff is expected to make progress on the Disclosure Effectiveness Project and address implementation issues and concerns related to the new revenue standard and other pending accounting standards.

This publication summarizes 2015 Commission and staff activities that affect financial reporting. We discuss rulemaking first, followed by staff guidance provided during 2015. While not the focus of this publication, we also discuss the PCAOB's 2015 standard-setting and related activities.

IMPLEMENTING LEGISLATION

THE DODD-FRANK ACT

Pay Ratio Disclosure

(Release No. 33-9877)

In August, the SEC adopted, by a 3-2 vote, a rule mandated by Section 953(b) of the Dodd-Frank Act. The rule amended Item 402 of Regulation S-K and requires issuers to disclose the following:

- The median annual total compensation of all employees except the chief executive officer;
- The annual total compensation of the CEO; and
- The ratio of the median annual total compensation of all employees to the annual total compensation of the CEO.

These disclosures are collectively referred to as the "pay ratio" disclosures and are intended to help inform shareholders when evaluating a CEO's compensation. The rule is generally consistent with the one the SEC proposed in 2013. The adopting release is available here on the SEC's website.

The pay ratio disclosures are required in any annual report, proxy, or registration statement that requires disclosure of executive compensation pursuant to Item 402 of Regulation S-K. However, emerging growth companies, smaller reporting companies, foreign private issuers, Multijurisdictional Disclosure System filers, and registered investment companies are exempt from the requirements. In addition, companies filing initial registration statements (whether in an initial public offering or on Form 10) are not required to provide the pay ratio disclosures. Certain transition relief is available for newly public companies, companies with business combination activity, and those exiting smaller reporting company or emerging growth company status.

Companies are required to provide the pay ratio disclosures for their first fiscal year beginning on or after January 1, 2017. For example, a registrant with a fiscal year ending on December 31 would be first required to include the pay ratio information relating to compensation for fiscal year 2017 in its proxy or information statement for its 2018 annual meeting of shareholders and to include or incorporate by reference this information in its 2017 Form 10-K.

The rule requires a registrant to (1) determine the employee whose annual total compensation level is the median of all of its employees except its CEO, (2) compute the median employee's total compensation, and (3) compute a ratio in which the median employee's total compensation is equal to 1 and the CEO's total compensation is a calculated number. For example, if the amount of the median employee's total compensation is $45,790 and the CEO's total compensation is $12,260,000, then the pay ratio disclosed would be "1 to 268". The ratio could also be expressed narratively, such as "the CEO's annual total compensation is 268 times that of the median of the annual total compensation of all employees."

Subject to certain exceptions described below, the median employee is identified by an analysis of the annual compensation of all persons, including all U.S. and non-U.S. full-time, part-time, seasonal, and temporary workers, employed by the registrant and its consolidated subsidiaries as of any date within the last three months of its fiscal year.[1] The individual compensation amounts used to identify the median employee may be annualized for permanent employees who were employed for less than the full fiscal year. Such amounts for seasonal and temporary workers may not be annualized. Similarly, such amounts for part-time workers may not be adjusted to the full time equivalent amount. The rule permits registrants to identify the median employee in a variety of ways. For example, a registrant is permitted to analyze its entire employee population, use a statistical sampling methodology, or any other reasonable method. Moreover, the median employee can be determined using a consistently applied compensation measure (e.g., amounts derived from the registrant's payroll or tax records), rather than each employee's total compensation. Once the median employee is identified, that person's annual total compensation pursuant to Item 402(c)(2)(x) [2] must be calculated and disclosed. The rule permits companies to make estimates when calculating the elements of annual total compensation in accordance with Item 402. Disclosure of the methodology and material assumptions and estimates used to identify the median employee and/or determine the compensation amounts is required. Registrants are permitted to supplement the disclosure with additional narrative discussion or other ratios as long as the information is clearly identified and is not given greater prominence than the prescribed pay ratio disclosures.

The final rule contains changes from the proposal that are intended to provide companies with flexibility to meet the rule's requirements in a number of other ways, including the ability to:

- Identify the median employee only once every three years. However, if there has been any change in the employee population or employee compensation arrangements which may result in a significant change to the pay ratio, the median employee should be re-identified. If the median employee's compensation significantly changes during the three year period, the company may use another employee with substantially similar compensation as the median employee.

- Exclude non-U.S. employees from countries in which obtaining the required information to calculate the pay ratio would violate the particular jurisdiction's data privacy laws or regulations (i.e., the data privacy exception). This exception can only be applied if the Company obtains a legal opinion supporting the assertion that obtaining the necessary information violates the local laws.

- Exclude up to 5% of its total employees who are non-U.S. employees (i.e., the de minimis exception), which includes any non-U.S. employees excluded under the data privacy exception. This exception can only be applied on a jurisdiction by jurisdiction basis, so that if one employee in a jurisdiction is excluded all must be excluded.

1 Independent contractors and leased employees are excluded from this population.

2 Total compensation per Item 402(c)(2)(x) includes salary, bonus, the aggregate grant date fair value of options or stock awarded during the period, earnings for services performed under non-equity incentive plans and all earnings on any outstanding awards, certain amounts related to defined benefit and actuarial pension plans, and any other compensation not included in the aforementioned categories.

- Apply an adjustment to account for differences between the cost-of-living in the CEO's jurisdiction and the cost-of-living in other jurisdictions when identifying the median employee. If applied, the same adjustment would be made to the median employee's annual total compensation used to calculate the pay ratio. However, disclosure of the compensation amount and pay ratio without the cost-of-living adjustment is still required.

Pay vs. Performance Disclosure

(Release No. 34-74835)

In April, the SEC proposed rules which would implement requirements mandated by Section 953(a) of the Dodd-Frank Act. The proposed rules would require registrants to disclose in a clear manner the relationship between executive compensation actually paid and the financial performance of the registrant. The proposed rules are intended to help shareholders to be better informed when they vote to elect directors and in connection with advisory votes on executive compensation.

Proposed Item 402(v) of Regulation S-K would require registrants to provide the table shown below comparing the (i) executive compensation actually paid to the named executive officers for whom disclosure is currently required in the Summary Compensation Table (SCT); (ii) Total Shareholder Return (TSR) for the registrant and; (iii) TSR for the selected peer group.

Year	SCT Total for Principal Executive Officer (PEO)	Compensation Actually Paid to PEO	Average SCT Total for non-PEO Named Executive Officers	Average Compensation Actually Paid to non-PEO Named Executive Officers	Total TSR	Peer Group TSR
(a)	(b)	(c)	(d)	(e)	(f)	(g)

Executive compensation actually paid will be different than the total compensation reported in the SCT. Executive compensation actually paid is total compensation as reported in the SCT for the year (i) less the change in the actuarial present value of pension benefits, (ii) less the grant-date value of any stock and option awards granted during the year that are subject to vesting, (iii) plus the actuarially determined service cost for services rendered during the applicable year, and (iv) plus the value at the vesting date of stock and option awards that vested during that year. The executive compensation would be presented separately for the PEO and as an average for the remaining named executive officers identified in the table.

TSR would use the definition included in Item 201(e) of Regulation S-K (i.e., dividends plus or minus change in share price) and TSR for the selected peer group would use the peer group identified by the company in its stock performance graph or in its compensation discussion and analysis.

Using the values presented in the table, proposed Item 402(v) would require the registrant to describe (1) the relationship between the executive compensation actually paid and registrant TSR, and (2) the relationship between registrant TSR and peer group TSR. Such disclosures would follow the table and could be presented as a narrative, graphically, or a combination of the two.

Other Highlights of the Proposed Rules

- The disclosure would be required in proxy or information statements in which executive compensation disclosure is required.
- The rules would apply to all reporting companies except for foreign private issuers, registered investment companies and emerging growth companies.
- The disclosure would be required for the last three fiscal years for smaller reporting companies and last five fiscal years for any other registrants. Smaller reporting companies would not be required to present a peer group TSR.

- The disclosure would be tagged in an interactive data format using eXtensible Business Reporting Language, or XBRL. Tagging would be phased in for smaller reporting companies, so that they would not be required to comply with the tagging requirement until the third annual filing in which the pay-versus-performance disclosure is provided.

- The phase-in period would be as follows: Smaller reporting companies would initially provide the information for two years, adding an additional year in their subsequent annual proxy or information statement that requires this disclosure. Other registrants would be required to provide the information for three years in the first proxy or information statement in which they provide the disclosure, adding another year of disclosure in each of the two subsequent annual proxy statements that require this disclosure.

The proposing release is available here. Comments on the proposal were due in July.

Clawbacks of Executive Compensation

(Release No. 33-9861)

In July, the SEC proposed a rule which would require national securities exchanges to establish standards for listed companies that would require the clawback of erroneous executive compensation. The rule would implement provisions mandated by Section 954 of the Dodd-Frank Act. These standards would force listed companies to establish and enforce policies that require executives to pay back certain incentive-based compensation that was erroneously awarded. Proposed Rule 10D-1 would substantially increase the existing requirements covering recovery of executive compensation in Section 304 of the Sarbanes-Oxley Act, which requires the CEO and CFO to reimburse an issuer for certain compensation when an accounting restatement which resulted from misconduct occurred during the preceding twelve months.

The clawback provisions of Rule 10D-1 would require a listed company, upon restating its financial statements, to calculate the difference between the amount of incentive-based compensation awarded to an executive and the amount that would have been awarded had the financial statements properly reflected the restated amounts. This calculation would be performed for the three fiscal years prior to the date that a restatement was required. The excess amount that was erroneously awarded would be recovered from both current and former executives of the listed company. The population of "executives" from which recovery would be required is broader than under the Sarbanes-Oxley Act and includes any person who performs policy-making functions for the company. For example, roles such as the company's president, principal financial officer, principal accounting officer, and any vice-president in charge of a principal business unit, division or function would be included in the definition of an executive. The proposal takes a "no fault" approach. There is no consideration of whether there was any misconduct by an executive or whether an executive had responsibility for the erroneous financial statements.

Incentive-based compensation subject to recovery includes compensation that was determined based upon the attainment of financial reporting measures. Financial reporting measures are those based upon accounting principles used in preparing the financial statements, any measures derived from that financial information, stock price, and Total Shareholder Return (TSR). Other compensation, such as compensation based upon continued employment and compensation awarded at the discretion of the board of directors, would be excluded from this provision. A company would be required to make a reasonable estimate of the effect of the erroneous accounting on the stock price and TSR.

A company that does not adopt a policy for the recovery of erroneously awarded incentive-based compensation, enforce the policy, or comply with the disclosure provisions of the rule would be subject to delisting.

Other Highlights of the Proposed Rules

- Proposed Rule 10D-1 would apply to all listed companies, except for certain registered investment companies that do not provide incentive-based compensation to their employees. Smaller reporting companies, emerging growth companies, and foreign private issuers (FPIs) would all be subject to the new listing standards.

- A company would have the discretion to not enforce the recovery of incentive-based compensation only if the costs related to the recovery are expected to exceed the amount to be recovered or, for FPIs, if the recovery violates home country laws.

- Executives could not be indemnified.

- Other proposed rule changes would require companies to disclose their recovery policies and how they have applied them. The recovery policy would be filed as an exhibit to the annual report. Additional disclosures would be required in annual reports and proxy statements when a restatement occurred or there is a continuing outstanding balance of excess incentive-based compensation that has not been recovered. These additional disclosures would include:

  - Date of restatement
  - If restatement is subject to recovery
  - Amount of the excess balance to be recovered
  - Amount remaining outstanding
  - How estimates of stock price and TSR were calculated
  - Name of individual for which the Company chose not to pursue collection
  - Name of individual that hasn't paid within 180 days

- The disclosure would be block tagged in an interactive data format using eXtensible Business Reporting Language, or XBRL.

- Following the publication of the adopted version of Rule 10D-1, the exchanges would have 90 days to file their proposed listing rules and those listing rules would be required to become effective within one year of the date Rule 10D-1 is published. The recovery policy for each listed company must be adopted within 60 days after the exchange's rule becomes effective. All excess incentive-based compensation received by current and former executives on or after the effective date of Rule 10D-1 would be subject to recovery.

The proposing release is available here. Comments on the proposed rules were due in September.

BDO OBSERVATIONS:

Many issuers' reaction to this proposal has been fairly negative particularly from the perspective of some companies who view the proposal as too broad in its reach – i.e., the expansive list of policy-making employees that the rule would apply to and the no-fault approach taken in the release. Some have questioned whether the proposal would have some unintended consequences, such as the creation of a market for "clawback insurance" to insure executives against the future loss of compensation through no fault of their own. Some wonder whether the proposal would discourage companies from tying executive compensation to company performance measures (which seems counter-productive). Others have expressed concerns about how to reasonably determine what a company's stock price or TSR would have been if the erroneous accounting had not been applied in prior periods. How the SEC will respond to these concerns remains to be seen.

Disclosure of Payments made by Resource Extraction Issuers

(Release No. 34-76620)

In December, the SEC re-proposed Exchange Act Rule 13q-1, which was mandated by Section 1504 of the Dodd-Frank Act. Congress enacted Section 1504 to combat global corruption by promoting international transparency of payments made to governments for the commercial development of oil, natural gas, and minerals. Rule 13q-1 would require resource extraction issuers to disclose information about certain payments made to the United States and foreign governments. The proposing release can be accessed here. Comments on the proposed rule are due by January 25, 2016.

The Commission initially adopted Rule 13q-1 to satisfy the Act's statutory mandate in August 2012. However, following a lawsuit to overturn the rule filed by the American Petroleum Institute, the U.S. Chamber of Commerce and two other business groups, a federal court vacated the rule in July 2013. The court ruled that the SEC misread Section 1504 of the Act to require public disclosure of such information. The court also noted that the SEC's decision to deny any exemptions from the rule was "arbitrary and capricious." In response, the SEC has rewritten and re-proposed the rule. The Commission has also filed with a court a rulemaking schedule indicating that it will vote on a final rule in June 2016.

The proposal is substantially consistent with the rule adopted in 2012. The most significant changes are:

- The term "project" was defined.

- The Commission will consider using its authority to grant requests for exemptive relief.
- As an alternative to the required report, issuers would be able to use a report prepared for foreign regulatory purposes if the SEC deems the requirements of the foreign regime to be substantially similar to the Commission's requirements.

The proposed rule would apply to "resource extraction issuers," defined as domestic and foreign issuers who are engaged in the commercial development of oil, natural gas, or minerals and are required to file an annual report under the Exchange Act. The activities that constitute "commercial development of oil, natural gas, or minerals" would include exploration, extraction, processing, export, or the acquisition of a license for any such activity.

Issuers would be required to disclose any payment (or series of related payments) to the U.S. government or foreign governments that is not de minimis (which the rule defines as equaling or exceeding $100,000 during a fiscal year) and has been made to further the commercial development of oil, natural gas, or minerals.

The disclosures would include, among other things, the type and total amount of payments made for each project and to each government.[3] As proposed, a project is contract-based and would be defined as the "operational activities that are governed by a single contract, license, lease, concession, or similar legal agreement, which form the basis for payment liabilities with a government." The proposal contains a non-exclusive list of factors to consider when determining whether two or more agreements may be treated as a single project for purposes of the disclosure.

Since Rule 13q-1 was first adopted in 2012, several international bodies and countries have adopted similar disclosure requirements. The European Union has adopted and Canada has proposed rules requiring similar disclosures. In light of these developments, the Commission proposed allowing issuers to use a report prepared for foreign regulatory purposes as discussed above.

The proposed location and timing of the disclosures are similar to the initial rule adopted in 2012. The disclosures would be filed annually in an XBRL-formatted exhibit to Form SD, which was created for the purpose of reporting the information required by this rule and the rule requiring disclosure of the use of conflict minerals. The report would be due 150 days after the end of an issuer's fiscal year. The proposed disclosures may be reported on a cash basis and would not need to be audited[4] or be subject to officer certifications.

THE JOBS ACT

Regulation A+

(Release No. 33-9741)

In March, the Commission unanimously approved amendments to Regulation A. The amendments, known as "Regulation A+," were required by Section 401 of the JOBS Act. They are intended to increase access to capital for smaller companies by modernizing Regulation A and expanding it to provide a streamlined process by which a private company can offer and sell up to $50 million of securities in a twelve-month period. The adopting release is available here. The amendments took effect on June 19.

Regulation A allows private companies to make small public offerings without having to register them with the SEC. Instead, the offering document must be reviewed and "qualified" by the SEC staff. Regulation A offerings have historically been subject to state-level registration and qualification requirements as well. Previously, Regulation A permitted offerings of up to $5 million of securities in a twelve-month period. Historically, very few offerings were made pursuant to Regulation A. The U.S. Government Accountability Office performed a study which identified the costs and complexity of state law compliance as one of the reasons for the lack of offerings using this exemption.

The amendments are intended to enhance the usefulness of Regulation A by increasing the amount of securities that can be offered in a twelve-month period to $50 million and streamlining the offering process by preempting state-level registration and qualification requirements if certain requirements are met.

3 The disclosure must include payments made by the issuer's subsidiaries or other entities it controls, by reference to the financial consolidation principles applied in the issuer's audited financial statements (e.g., a consolidated variable interest entity). Consequently, payments made by an issuer's equity method investee would generally not need to be reported.

4 Moreover, since Form SD would not include audited financial statements, auditors would not need to read the disclosures and consider whether they are materially inconsistent with the audited financial statements.

Regulation A is available to U.S. and Canadian issuers that are not Exchange Act registrants. There are several other eligibility restrictions and rules governing the offering process and the amounts of securities that can be sold to various categories of investors in various scenarios.

The amendments created two tiers of offerings:

- Tier 1 – A modernized version of the historical Regulation A, Tier 1 permits offerings of up to $20 million in a twelve-month period. State securities regulators will continue their current role in Tier 1 offerings.
- Tier 2 – This new tier permits offerings of up to $50 million in a twelve-month period. State securities law requirements are preempted by Federal securities laws for these offerings.

Because Tier 2 offerings may generally involve larger dollar amounts and less state regulation, they are subject to more stringent requirements than Tier 1 offerings. Generally, the offering process and the ongoing reporting required after a Tier 2 offering are essentially scaled down versions of the offering and ongoing reporting processes used during and after registered offerings. Following is a general overview of Regulation A's revised financial reporting requirements.

Offering Circulars

Offering circulars must comply with the information requirements of revised Form 1-A, which requires the following:

- Offering circulars must contain two years of annual financial statements for the issuer and its predecessors. The financial statements must comply with U.S. GAAP or, for Canadian companies, IFRS as issued by the IASB; however, they need not comply with the incremental requirements of Regulation S-X. Financial statements must be updated every six months after they become nine months old. For example, an issuer with a December 31, 2014 year-end would need to provide comparative half year financial statements for the six months ended June 30, 2015 if its offering circular is filed or qualified after September 30, 2015. Similarly, that issuer would need to provide 2015 annual financial statements if its offering circular is filed or qualified after March 31, 2016.
- Offering circulars must contain financial statements of certain other entities (businesses and real estate operations acquired or to be acquired, guarantors and collateral entities (but not equity method investees)) and pro forma information.
- For new accounting standards that apply to both public and non-public business entities, an issuer may elect to delay complying with the standards until the dates non-public business entities must apply them, similar to the approach emerging growth companies may use. However, issuers in Regulation A offerings are considered public business entities, so they are not eligible to use alternative accounting standards available only to non-public business entities.
- Offering circulars must be filed via the SEC's EDGAR system. Exhibits providing data in XBRL format are not required.
- Issuers may submit offering circulars to the SEC staff for review on a confidential basis before they are filed publicly, similar to the process used in registered offerings by emerging growth companies.

The audit requirements for the historical financial statements discussed above vary depending on whether the offering is a Tier 1 or a Tier 2 offering.

- In Tier 1 offerings, the financial statements must be audited only if an audit has been obtained for another purpose. Such audits may be performed (a) in accordance with U.S. GAAS or PCAOB standards, (b) by auditors who are not registered with the PCAOB, and (c) by auditors who are independent pursuant to either AICPA or SEC independence standards.
- In Tier 2 offerings, the financial statements must be audited. Similar to the audit requirements for Tier 1 offerings, such audits may be performed in accordance with U.S. GAAS or PCAOB standards and by auditors who are not registered with the PCAOB. In contrast, the auditors' report must comply with Article 2 of Regulation S-X and the auditor must meet the SEC's independence standards.

Ongoing Reporting

The only subsequent reporting required of an issuer that has conducted a Tier 1 offering is to file a new Form 1-Z. This report is due 30 days after termination or completion of the offering and provides information about the results of the offering (e.g., number of securities sold, proceeds, etc.).

An issuer that has conducted a Tier 2 offering must file the following reports on an ongoing basis:

- Annual reports on new Form 1-K – Form 1-K is due no later than 120 days after year-end. The report must contain two years of issuer audited financial statements and audited financial statements of guarantors and collateral entities. The audit requirements are the same as discussed above for a Tier 2 offering.
- Semiannual reports on new Form 1-SA – Form 1-SA is due no later than 90 days after the end of the first half of an issuer's fiscal year. The report must contain financial statements similar to those in a Form 10-Q, except only year to date financial statements are required (i.e., no quarterly financial statements are required) and the financial statements are not required to be reviewed by the issuer's auditor.
- Current reports on new Form 1-U – Similar to Form 8-K, Form 1-U requires reporting of significant current events and is due four business days after a reportable event occurs. The types of events to be reported are similar to Form 8-K, but the threshold for reporting acquisitions and divestitures is much higher and no historical or pro forma financial statements are required.
- Similar to the requirements for offering circulars, ongoing reports must be filed via the SEC's EDGAR system, exhibits providing data in XBRL format are not required, and the financial statements may not be prepared using alternative accounting standards available only to non-public business entities.

Issuers in Tier 2 offerings also use Form 1-Z, but generally for a different purpose than that for which Tier 1 issuers use it. An issuer in a Tier 2 offering uses this form to notify the SEC when its reporting obligations have terminated and it will stop ongoing reporting.

In June, the SEC staff issued a small entity compliance guide to assist companies with the application of the rule; it is available here on the SEC's website.

BDO OBSERVATIONS:

As mentioned above, very few offerings were conducted under Regulation A historically. We understand that while acceptance and use of Regulation A+ has been limited thus far, it is currently being used much more than Regulation A was used in the past.

THE FAST ACT

The President signed the Fixing America's Surface Transportation (FAST) Act into law in December.[5] While the Act is focused on providing transportation funding, certain provisions of the Act amend the securities laws. Some of the amendments are self-executing, while others require SEC rulemaking.

The amendments included in Title LXXI of the Act are intended to improve access to capital for emerging growth companies. Unless otherwise noted below, the provisions related to Title LXXI are effective immediately. These amendments:

- Reduce the number of days an EGC's confidential submissions must be made public before its IPO roadshow to 15 days. EGCs are permitted to submit an IPO registration statement confidentially for review by the SEC staff. A confidentially submitted initial registration statement and subsequent amendments were previously required to be made public 21 days prior to the IPO roadshow.
- Permit an issuer that qualifies as an EGC at the time its initial registration statement is filed or submitted to maintain its EGC status even if it is otherwise lost until the earlier of:

5 The text of the Act is available here.

- The issuer's completed initial public offering, or
- One year after the date on which the issuer lost its EGC status.

For example, if an issuer submitted its initial registration statement as an EGC but crossed the $1 billion revenue threshold before going effective, it would be permitted to maintain its EGC status until the earlier of the dates mentioned above.

- Permit an EGC to omit historical periods from its financial statements if it reasonably expects that such periods will not be included in its effective registration statement. For example, if a calendar year end EGC submits its initial registration statement in December 2015 for confidential review by the SEC staff, the SEC's rules required the EGC to present its financial statements for the years 2013 and 2014 and the nine months ended September 30, 2014 and 2015. The FAST Act allows an EGC to omit the 2013 financial statements if it reasonably expects that the 2013 period will not be included in the effective registration statement (i.e., if the registrant in this example expects to present full year 2014 and 2015 financial statements in the registration statement when it becomes effective in 2016).

The SEC staff subsequently issued two Compliance and Disclosure Interpretations related to the provision above (available here on the SEC's website). The guidance indicates an EGC:

- May omit financial statements of other entities from its filings or submissions (e.g., Rule 3-05 target financial statements) if it reasonably expects such financial statements will not be required at the time of the offering.

- May not omit interim financial statements from its filings or submissions if the interim period or longer period (interim or annual) has been or will be included in the required financial statements at the time of the offering. For example, a calendar year end EGC that expects to commence its offering in April 2016 may not omit its 2014 and 2015 nine-month interims from its filings or submissions as they relate to the annual periods that will be required at the time of the offering.

Other self-executing changes add a new exemption for secondary sales of securities that are purchased by accredited investors and revise Section 12(g) of the Exchange Act so that savings and loan holding companies are treated the same as banks and bank holding companies for purposes of registration, termination of registration or suspension of their Exchange Act reporting obligations.[6] The SEC staff subsequently issued four Compliance and Disclosure Interpretations related to this provision (available here on the SEC's website).

Other significant changes to securities laws included in the FAST Act which require SEC rulemaking or additional analysis will:

- Permit smaller reporting companies to forward incorporate information by reference into Form S-1. Consequently, these companies will be able to update an effective registration statement without filing an amendment. This will facilitate offerings such as secondary offerings by selling shareholders. However, it will not permit delayed shelf offerings by such issuers, because Securities Act Rule 415(a)(1)(x) requires such offerings to be registered on Form S-3 or F-3. The amendments to Form S-1 are required by January 18, 2016.

- Require the SEC to conduct a study on the disclosure requirements of Regulation S-K with a goal to modernize and simplify its requirements. The study and the Commission's corresponding recommendations are due to Congress by November 28, 2016.

- Require the SEC to revise Regulation S-K to determine how to scale or eliminate the requirements for filers other than large accelerated filers and eliminate duplicative, outdated, or unnecessary disclosures for all filers. These changes are required by June 1, 2016 unless further consideration is needed under the study mentioned above.

- Permit issuers to include a summary page on Form 10-K that cross-references to other sections in Form 10-K. Currently, a registrant is not prohibited from including a summary, but the FAST Act adds a provision which specifically allows it and requires cross-referencing. Rulemaking is required by June 1, 2016.

Further information on the FAST Act can be found here on the SEC's website.

6 The JOBS Act raised the number of shareholders of record a company may have before SEC registration is required from 500 to 2,000 as long as there are less than 500 shareholders who are not accredited investors. Nonpublic banks and bank holding companies are not subject to the 500 unaccredited investor threshold. The JOBS Act also raised the number of shareholders of record a bank or bank holding company must be below in order to terminate its SEC registration from 300 to 1,200.

OTHER COMMISSION ACTIVITIES

REQUEST FOR COMMENT — FINANCIAL DISCLOSURES ABOUT ENTITIES OTHER THAN THE REGISTRANT

In September, the SEC published a request for comment on the effectiveness of certain financial disclosure requirements of Regulation S-X. The request is part of the Disclosure Effectiveness Project, a broad-based staff review of the SEC's disclosure rules designed to improve the disclosure regime for both companies and investors.

The request for comment focuses on the disclosure requirements for entities other than a registrant, including those of acquired businesses (under Rule 3-05), subsidiaries not consolidated and 50 percent or less owned persons (under Rules 3-09 and 4-08(g)), guarantors and issuers of guaranteed securities (under Rule 3-10), and affiliates whose securities collateralize registered securities (under Rule 3-16). The request contains questions directed to investors and registrants about:

- How the required financial information is utilized
- What changes could be made to improve its usefulness
- What challenges registrants face in preparing such information
- Whether the bright-line tests required by some of the rules should be revised
- Whether judgment should enter into the determination to provide some of the financial information, etc.

The request for comment can be found here on the SEC's website. Comments on the project, which were due on November 30, and additional information can be found here on the SEC's website.

BDO OBSERVATIONS:

We support the Commission's initiative to review and consider ways to improve the effectiveness of the financial disclosure regime under Regulations S-X and S-K. While we ultimately defer to investors about how certain disclosures are used to make investing and voting decisions, we question the utility of some of the financial information required by rules for entities other than the registrant. Our comment letter on the request (available here) provides suggestions that we believe, if implemented, could improve or simplify the disclosure requirements without sacrificing their objectives.

CONCEPT RELEASE ON POSSIBLE REVISIONS TO AUDIT COMMITTEE DISCLOSURES

In July, the SEC issued a concept release seeking public comment regarding audit committee reporting requirements. The concept release was issued in response to views that the SEC's existing disclosure rules perhaps have not kept pace with the evolving role and responsibilities of audit committees and may not result in disclosures about audit committees and their activities that are sufficient to help investors understand and evaluate audit committee performance, which may in turn inform investors' investment or voting decisions.

Some of the more significant potential changes to reporting requirements being considered include how an audit committee discharges its responsibilities with respect to its oversight of the auditor, the process for selecting the auditor, and consideration of the qualifications of the audit firm and certain members of the engagement team when selecting the audit firm.

Comments on the release were due in September.

BDO OBSERVATIONS:

Our comment letter supports the SEC's efforts to explore ways to enhance an audit committee's disclosure about how an audit committee discharges its responsibilities. We further support the SEC's efforts to update its existing disclosure requirements to include updated references to required communications between auditors and audit committees contained in PCAOB Auditing Standards. We expressed concern that the SEC's focus on the oversight of the external auditor represents only part of the audit committee's responsibilities with respect to its oversight of a company's accounting and financial reporting process. Similar to our commentary regarding the PCAOB's concept release on Audit Quality Indicators, we expressed overall support for a flexible, voluntary approach that would allow audit committees to design disclosures in accordance with the needs of their specific investor communities. The voluntary disclosures could then correspond with the nature and extent of the organization's unique challenges and opportunities and could best reflect the scope of the audit committees' actual specific processes. This flexible and voluntary approach would also avoid the risk of "chilled communications" between the audit committee and the auditor as well as potential "boilerplate" or "check the box" disclosures that may result from mandating disclosures. We further highlighted publicized findings that indicate many audit committees are already voluntarily providing more enhanced disclosures about the execution of their duties. Additionally, where there are concurrent rule-making and standard-setting initiatives being undertaken by the SEC and PCAOB that potentially complement each other (e.g., auditor reporting and transparency, disclosure of critical audit matters, audit quality indicators, etc.), we strongly encouraged the SEC to continue to work collaboratively with the PCAOB in issuing guidance related to public companies audits. Our comment letter is available here.

STAFF GUIDANCE

Notable guidance the SEC staff provided during 2015 is discussed below. Some of the guidance was provided during meetings held with the Center for Audit Quality's (CAQ's) SEC Regulations Committee. Minutes of those meetings can be found here on the CAQ's website.

PUSHDOWN ACCOUNTING AND RULE 3-10

Last year, in connection with the FASB's issuance of ASU 2014-17, *Pushdown Accounting*, the SEC staff issued Staff Accounting Bulletin No. 115 to rescind its legacy pushdown guidance for SEC registrants in Topic 5.J, *New Basis of Accounting Required in Certain Circumstances*. Further information on the guidance in ASU 2014-17 can be found here.

Registrants should follow GAAP when preparing condensed consolidating financial information to comply with Rule 3-10. Therefore, we understand that if pushdown accounting is applied in a subsidiary's financial statements, it should also be applied when compiling the information presented under Rule 3-10(i).

REPORTING IMPLICATIONS OF THE NEW CONSOLIDATION STANDARD

In February, the FASB issued ASU 2015-02, *Amendments to the Consolidation Analysis,* which changes the consolidation analysis for all reporting entities. The changes primarily affect the consolidation of limited partnerships and their equivalents (e.g., limited liability corporations), as well as structured vehicles such as issuers of collateralized debt obligations. The amendments are effective for public business entities for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2015, although early adoption is permitted. The amendments may be applied using a modified retrospective approach or a full retrospective approach.[7] At the March meeting of the CAQ SEC Regulations Committee, the SEC staff clarified several reporting questions related to the adoption of the new standard:

- Consolidation or deconsolidation as a result of adopting ASU 2015-02 is not an event that needs to be reported under Item 2.01 of Form 8-K. Conversely, consolidation or deconsolidation as a result of reconsideration events subsequent to adoption would need to be considered for reporting under Item 2.01.

7 Further information regarding ASU 2015-02 can be found here.

- Registrants who adopt the standard retrospectively should consider the need to revise the historical financial statements when filing a new or amended registration statement or proxy statement. However, registrants need not apply the standard to periods not covered by the audited financial statements (e.g., in the earliest two years presented in the selected financial data table).

- In the initial year of consolidation, a registrant may analogize to the SEC staff guidance in FAQ #3[8] when considering whether to scope a newly consolidated entity into management's assessment of internal control over financial reporting. FAQ #3 permits a registrant to exclude a newly acquired business from its internal control assessment if the time period between the acquisition date and the assessment date is not considered adequate for management to complete its testing.

PRO FORMA RESERVES AND SMOG DATA

Accounting Standards Codification section 932-235 requires oil and gas companies to disclose supplemental information about reserve quantities and a standardized measure of discounted future net cash flows (SMOG) in the historical financial statements. Such disclosures should also be provided in the historical financial statements of acquired oil and gas businesses (based on the guidance in FRM paragraph 2065.2). Item 914 of Regulation S-K requires additional pro forma information including a pro forma statement of cash flows, pro forma book value per share, and pro forma oil and gas reserve data for roll-up transactions as defined in Item 901 of Regulation S-K.

At the June meeting of the CAQ SEC Regulations Committee, the SEC staff indicated that it also expects to see pro forma reserves and SMOG disclosures in the pro forma financial statements associated with significant acquisitions of oil and gas businesses. In practice, similar disclosures are not typically provided in pro forma financial statements related to dispositions of oil and gas businesses.

FINANCIAL REPORTING MANUAL

The staff of the SEC's Division of Corporation Finance published two updates to the *Financial Reporting Manual* (FRM) in 2015.[9] As updates are published, the staff includes a summary immediately following the FRM cover that describes the nature of the changes and lists the paragraphs that were updated. The staff also annotates the FRM to communicate the date a paragraph was most recently updated.

The January update made minor, non-substantive wording changes and other revisions to conform to the issuance of ASU 2014-17, *Pushdown Accounting*, and corresponding rescission of SAB Topic 5.J, *New Basis of Accounting Required in Certain Circumstances,* discussed above.

The August update amended paragraphs 1320.3 and 1320.4 and provided guidance for registrants with delinquent filings who seek to become current by presenting all information that would have been included in the delinquent filings in a comprehensive annual report on Form 10-K. The guidance indicates that the staff will generally not issue comments asking a delinquent registrant to file separately all of its delinquent filings if the registrant takes this approach.

The FRM is available here on the SEC's website.

COMPLIANCE AND DISCLOSURE INTERPRETATIONS

The SEC staff updated its C&DIs several times during the year. The updates provided guidance on the FAST Act, Regulation A+ and various other legal topics including those related to Securities Act rules and forms, among others.

The C&DIs are available here on the SEC's website.

8 Frequently Asked Question Number 3 on management's report on internal control over financial reporting and certification of disclosure in Exchange Act periodic reports

9 The FRM is an internal SEC staff reference document that provides general guidance covering several SEC reporting topics. While the FRM is not authoritative, it is often a helpful source of guidance for evaluating SEC reporting issues. The FRM, along with other helpful guidance, can be accessed from the Division of Corporation Finance home page, which is located here.

STAFF ACTIVITIES

During 2015, the SEC staff continued to focus on issues related to implementing the new revenue accounting standard and on the Disclosure Effectiveness Project. Other staff activities and focus areas which may not have resulted in formal staff guidance can be found in our report on the AICPA Conference on SEC and PCAOB Developments held in December.

IMPLEMENTING THE NEW REVENUE STANDARD

ASU 2014-09, *Revenue Recognition,* is now scheduled to take effect in 2018 for public entities and establishes a comprehensive revenue recognition standard for virtually all industries. The SEC staff continues to focus on issues related to implementing the new standard. In October, at the CAQ SEC Regulations Committee meeting, the staff discussed the following implementation issues related to the interaction between the standard and certain SEC rules. We understand that:

1. Consistent with current guidance,[10] registrants that adopt the new standard on a full retrospective basis should remeasure significance of equity method investees for all periods.

2. The staff will not object if companies do not recast the earliest two years presented in the ratio of earnings to fixed charges table if they adopt the standard using a full retrospective approach. That is, a company would be required to reflect the accounting change in its ratio of earnings to fixed charges table only for the three years for which it presents full financial statements elsewhere in the filing.

3. Based on the requirements of Item 11(b) of Form S-3 and consistent with existing staff guidance[11] related to retrospective adoption of a new accounting principle, companies filing a new or amended registration statement will need to revise their financial statements for periods that precede the adoption date when financial statements for periods that include the adoption date are presented.

BDO OBSERVATIONS:

The SEC staff continues to stress the importance of timely and thoughtful implementation efforts prior to the adoption date. Wes Bricker, Deputy Chief Accountant, has conveyed several key implementation messages in recent speeches (available here and as discussed in our report on the AICPA conference) which focus on upgrading registrants' resources and internal controls over financial reporting. He has also cautioned against making conclusions that are designed to preserve the current accounting. SEC staff activities related to implementation and reporting issues associated with the new revenue standard are expected to continue as the adoption date approaches.

DISCLOSURE EFFECTIVENESS PROJECT

In addition to the *Request for Comment on Financial Disclosures about Entities Other than the Registrant* discussed above, the staff continues to study other areas for improving disclosure effectiveness, including working with the FASB to eliminate duplicate disclosure requirements and evaluating the disclosure requirements of Regulation S-K. The staff also continues to promote voluntary efforts by companies to improve the effectiveness of their disclosure by removing unnecessary duplication and disclosure of immaterial or outdated information. Further information regarding remarks of the SEC staff about disclosure effectiveness can be found in our report on the AICPA conference.

10 FRM Paragraph 2410.8
11 FRM Section 13100

PCAOB DEVELOPMENTS

FINAL AUDITING STANDARDS AND AMENDMENTS

REORGANIZATION OF PCAOB AUDITING STANDARDS AND RELATED AMENDMENTS TO PCAOB STANDARDS AND RULES

In September, the SEC approved the PCAOB's proposed reorganization of PCAOB auditing standards and related changes to PCAOB rules and attestation, quality control, and ethics and independence standards. The reorganization, which was adopted by the PCAOB in March, uses a single, integrated numbering system. Under the reorganization, the individual standards are grouped into the following topical categories:

- *General Auditing Standards (section number 1000 - 1300)* —Standards on broad auditing principles, concepts, activities, and communications;
- *Audit Procedures (section number 2100 – 2900)* —Standards for planning and performing audit procedures and for obtaining audit evidence;
- *Auditor Reporting (section number 3100 – 3300)* —Standards for auditors' reports;
- *Matters Relating to Filings Under Federal Securities Laws (section number 4101 – 4105)* —Standards on certain auditor responsibilities relating to SEC filings for securities offerings and reviews of interim financial information; and
- *Other Matters Associated with Audits (section number 6101 – 6115)* —Standards for other work performed in conjunction with an audit of an issuer or of a broker or dealer.

The related amendments are technical changes that include rescinding certain interim auditing standards that the Board believes are no longer necessary and eliminating certain inoperative language or references. The amendments do not impose new requirements on auditors or change the substance of the requirements for performing and reporting on audits under PCAOB standards.

The reorganization and related amendments are effective as of December 31, 2016; however, auditors and others may use and reference the reorganized standards before the effective date. The reorganized standards are available here on the PCAOB's website.

DISCLOSURE OF ENGAGEMENT PARTNER AND CERTAIN OTHER AUDIT PARTICIPANTS

In December, the PCAOB adopted new rules (Rules 3210 and 3211) requiring audit firms to disclose the names of each audit engagement partner as well as the names of other audit firms that participated in each audit. Auditors will be required to file a new PCAOB Form AP, *Auditor Reporting of Certain Audit Participants*, for each issuer audit, disclosing:

- The name of the engagement partner;
- The names, location, and extent of participation of each other accounting firm participating in the audit whose work constituted 5 percent of the total audit hours; and
- The number and aggregate extent of participation of all other accounting firms that took part in the audit whose individual participation was less than 5 percent of the total audit hours.

The data reported on Form AP will be accessible through a searchable database on the PCAOB's website. The standard filing deadline for Form AP will be 35 days after the date the auditor's report is first included in a document filed with the SEC. In the case of initial public offerings, the Form AP filing deadline will be 10 days after the auditor's report is first included in a document filed with the SEC.

The disclosure requirement for the engagement partner will be effective for auditor's reports issued on or after January 31, 2017, or three months after SEC approval of the final rules, whichever is later. For disclosure of other audit firms participating in the audit, the requirement will be effective for reports issued on or after June 30, 2017.

PCAOB staff plans to publish guidance in 2016 relating to compliance with the reporting requirements of Form AP.

OTHER STANDARD-SETTING ACTIVITIES

STAFF CONSULTATION PAPER

In May, the PCAOB issued a Staff Consultation Paper on standard-setting activities related to the auditor's use of the work of specialists, specifically the objectivity and oversight of specialists and the use of their work in audits. The PCAOB has observed that the use and importance of specialists has increased in recent years, in part due to the increasing complexity of business transactions and the resulting complexity of information needed to account for those transactions. The consultation paper raises questions about whether PCAOB standards adequately address the auditor's use of the work of specialists, and whether more rigorous standards and specific procedures are needed to help auditors respond to the risks of material misstatement in financial statements. The staff is seeking input on possible alternatives to address the issues discussed in the paper. Furthermore, the paper requests commenters to provide relevant economic data about potential economic impacts of standard-setting in this area.

The consultation paper is available here on the PCAOB's website. The comment period closed in July. In consideration of comments received that suggested that the Board coordinate the timing of this project with its project on auditing accounting estimates, including fair value measurements and related disclosures, the PCAOB staff plans to recommend that the Board closely coordinate the development and timing of any potential rulemaking for these two projects. The staff anticipates recommending that the Board propose for public comment revisions to its current standards on the auditor's use of the work of specialists by mid-2016.

BDO OBSERVATIONS:

Our comment letter supported the Board's consideration of amendments to PCAOB standards to clarify the way in which auditors use the work of specialists and provided specific recommendations for the Board's deliberation. Our comment letter is available here.

CONCEPT RELEASE ON AUDIT QUALITY INDICATORS

In June, the PCAOB issued a concept release seeking comment on the content and possible uses of audit quality indicators ("AQIs"). The concept release seeks comment on 28 potential AQIs at both the firm and engagement level that are intended to provide additional information about whether audit work being performed is being conducted by the appropriate individuals with the requisite experience, skills, resources, and tools. The potential AQIs cover the following:

- Audit Professionals — measures dealing with the availability, competence, and focus of those performing the audit
- Audit Process — measures concerning an audit firm's tone at the top and leadership, incentives, independence, investment in infrastructure needed to support quality auditing, and monitoring and remediation activities
- Audit Results — measures relating to financial statements (such as the number and impact of restatements, and measures of financial reporting quality), internal control over financial reporting, going concern reporting, communications between auditors and audit committees, and enforcement and litigation

The concept release also asks for views on how AQIs may best be used to promote audit quality. The concept release considers how AQI data might be obtained and distributed, whether use of AQIs should be optional or required, the scope of audits and audit firms that may be subject to AQI reporting, and how AQI reporting might be implemented over time.

The concept release is available here on the PCAOB's website. The comment period closed in September but was reopened through the end of November. It is the intention of the PCAOB, based on public comment, to reduce the number of AQIs to a more manageable and effective number for consideration in a future proposal.

BDO OBSERVATIONS:

Our comment letter expressed support for the PCAOB's exploration of the use of AQIs in voluntary discussions with those concerned with the financial reporting and auditing processes, particularly the audit committee. We indicated support for a voluntary, principles-based approach to primarily engagement level AQIs that audit committees find most meaningful based on the facts and circumstances relative to the companies they serve. We strongly encouraged the PCAOB staff to conduct additional research regarding the relevance and usefulness of the proposed quantitative AQIs. In addition, we encouraged the PCAOB to further consider additional qualitative context that users of quantitative AQIs require in order to understand them. Our comment letter is available here.

GUIDANCE

AUDIT COMMITTEE DIALOGUE

In May, the PCAOB issued the first in a series of communications to audit committees intended to provide insights from inspections of public company audit engagements that may be helpful to audit committee members in overseeing their audit engagements. That communication, *The Audit Committee Dialogue*, highlights key areas of recurring issues in PCAOB inspections of large audit firms as well as certain emerging risks. The Dialogue also provides specific questions that committee members may ask their auditors on each topic. The Dialogue is available here on the PCAOB's website.

PCAOB DIALOGUES

In 2015, the PCAOB launched a podcast, PCAOB Dialogues, which features PCAOB Board members and staff speaking with audit committee members, investors, and others about auditing, investor protection, and capital markets issues. The first episode's topic was audit quality indicators. The podcast is available here.

ABOUT BDO USA

BDO is the brand name for BDO USA, LLP, a U.S. professional services firm providing assurance, tax, advisory and consulting services to a wide range of publicly traded and privately held companies. For more than 100 years, BDO has provided quality service through the active involvement of experienced and committed professionals. The firm serves clients through 63 offices and more than 450 independent alliance firm locations nationwide. As an independent Member Firm of BDO International Limited, BDO serves multi-national clients through a global network of 1,408 offices in 154 countries.

BDO USA, LLP, a Delaware limited liability partnership, is the U.S. member of BDO International Limited, a UK company limited by guarantee, and forms part of the international BDO network of independent member firms. BDO is the brand name for the BDO network and for each of the BDO Member Firms. For more information please visit: www.bdo.com.

Material discussed is meant to provide general information and should not be acted on without professional advice tailored to your firm's individual needs.

© 2016 BDO USA, LLP. All rights reserved.

CONTACT:

JEFF LENZ
312-616-3944
jlenz@bdo.com

CHRIS SMITH
310-557-8549
chsmith@bdo.com

JANUARY 2017
www.bdo.com

THE NEWSLETTER FROM BDO'S NATIONAL ASSURANCE PRACTICE

BDO KNOWS: SEC

SEC YEAR IN REVIEW

SIGNIFICANT 2016 DEVELOPMENTS

Much like last year, in 2016 the SEC's agenda related to financial reporting focused on Congressionally-mandated rulemaking (e.g., rulemaking required by the Dodd-Frank Act of 2010 and the Fixing America's Surface Transportation Act of 2015) and activities related to its Disclosure Effectiveness Initiative, a broad-based review of the SEC's disclosure rules designed to improve the disclosure regime for both companies and investors. The Commission completed all rulemaking required by the FAST Act in 2016, which included rules that permit emerging growth companies to omit certain historical periods from initial registration statements, allow smaller reporting companies to forward incorporate information by reference into Form S-1, and explicitly permit registrants to include a summary page in Form 10-K. In June, the Commission completed a final rule requiring resource extraction issuers to disclose payments made to the U.S. and foreign governments. Other than a proposal to amend the definition of a smaller reporting company, the majority of the other rulemaking and Commission activities related to the Disclosure Effectiveness Initiative. In addition to rule proposals which would eliminate outdated and redundant disclosure requirements, modernize mining company disclosures and require the use of hyperlinks in exhibits, the Commission issued a Concept Release on Regulation S-K and a Request for Comment on management, certain security holders and corporate governance disclosures. Furthermore, while not directly related to the Disclosure Effectiveness Initiative, the Commission issued a report to Congress in November which was required by

CONTENTS

SIGNIFICANT 2016 DEVELOPMENTS 1

SEC RULEMAKING 3
- The Dodd-Frank Act 3
- The FAST Act 3
- Disclosure Effectiveness Initiative 4
- Other Rulemaking 5

OTHER COMMISSION ACTIVITIES 6
- Disclosure Effectiveness Initiative 6
- SEC Order Permitting Use of Inline XBRL 7

STAFF GUIDANCE 7
- Financial Reporting Manual 7
- Compliance and Disclosure Interpretations 9

PRACTICE ISSUES 9
- Non-GAAP Financial Measures 9
- New Accounting Standards 10
- Other Accounting and Disclosure Topics 13
- Internal Control over Financial Reporting 16
- IFRS for U.S. Issuers 16
- SEC Staff Consultations and Communications 16

PCAOB DEVELOPMENTS 16
- Final Auditing Standard and Amendments 16
- Other Standard Setting Activities 17
- Inspections 19

CONTACT .... Back Cover

the FAST Act on how to modernize and simplify Regulation S-K.[1] The report includes recommendations that focus on both narrow procedural matters and more general matters, such as changing management's discussion and analysis to elicit a discussion that focuses more on trends and less on line-by-line comparisons.

There were several notable changes in key staff positions in 2016. Following a serious injury in 2016, the SEC's Chief Accountant, James Schnurr, announced his intent to retire from the agency in November. Wes Bricker, a Deputy Chief Accountant in the Office of the Chief Accountant (OCA) since 2015 and Interim Chief Accountant since July 2016, was appointed Chief Accountant in November. Also in November, Marc Panucci replaced Brian Croteau as the Deputy Chief Accountant in OCA who will lead the activities of the office's professional practice group. In December, the Director of Enforcement, Andrew Ceresney, and the Director of the Division of Corporation Finance, Keith Higgins, also announced their plans to depart the agency. Their announcements followed Chair White's similar announcement in November that she plans to leave the Commission at the end of the Obama administration in January after nearly four years of service. As 2016 came to a close, President-elect Trump has yet to nominate her replacement or other individuals to fill the two empty Commission seats, which were open for all of 2016. The two people President Obama nominated to fill the Commission seats in 2015 (Lisa Fairfax and Hester Peirce) were never confirmed by the Senate. As changes in the SEC Chair position, Commission seats, and key staff members typically accompany a change in Presidents, the turnover is not surprising. Moreover, these changes may also result in a change of the PCAOB Chair, as the term of the current Chair, James Doty, expired in October 2015. Chair White has expressed her belief that the appointment or reappointment of the PCAOB Chair should be left to a full Commission. This Commission will also need to appoint a replacement for Jay Hanson, who resigned from the PCAOB in December.

With respect to the focus areas of the Commission and staff in 2016, the use of non-GAAP financial measures has certainly been at the top of the list. In late 2015, Chair White and the Commission staff began highlighting non-GAAP measures as an area of focus given the extensive use of such measures and the overarching concern that these measures have served to supplant, not supplement, U.S. GAAP. Due to these concerns, the staff issued new non-GAAP Compliance and Disclosure Interpretations (C&DIs) in May and encouraged companies to "self-correct" their reporting of such information. The C&DIs address measures and adjustments which may be considered misleading, as well as examples of what it means to give "undue prominence" to non-GAAP measures.

The staff's other major focus area has been the implementation of and reporting issues associated with the new revenue accounting standard and other pending standards on leases, classification and measurement of financial instruments, and credit losses. In addition to the concern that many companies are not as far along as they should be in their implementation efforts (particularly as it relates to the new revenue standard), the staff is concerned that the disclosures related to the expected effects of adopting these significant new pending accounting standards have been inadequate. In light of these concerns, the staff made an announcement at the September meeting of the Emerging Issues Task Force (EITF) about its expectation for additional qualitative disclosures in registrants' upcoming 10-K filings. The staff also updated the Financial Reporting Manual (FRM) to answer various SEC-reporting questions that arise from the adoption of these new standards.

Both non-GAAP measures and implementing new accounting standards were key themes of the AICPA Conference on SEC and PCAOB Developments (the Conference) held in December. The other key theme of the Conference was the importance of effective internal control over financial reporting, as ICFR is such a critical element of financial reporting (especially in light of the significant changes in internal controls that may be required in order to implement the major new accounting standards). The staff continued to stress the importance of maintaining an open dialogue about these key focus areas among management, the auditor, and the audit committee.

The staff also issued guidance throughout the year to assist registrants and others with interpreting and complying with the SEC's rules and regulations. The staff also updated its C&DIs and the FRM for reporting matters unrelated to non-GAAP measures and new accounting standards.

Much of the Commission's rulemaking activity over the past few years has focused on adopting rules mandated by Congress. With the change in the administration and Congress, there may be mandates to revise or eliminate some of these rules. At the Conference in December, Keith Higgins suggested that proposals included in the Financial CHOICE Act[2] may be a good starting point when speculating about future SEC rulemaking. The Financial CHOICE Act calls for a repeal of certain Dodd-Frank-related disclosure rules (including those related to conflict minerals, resource extraction, mine safety, and pay ratios, among others), a narrowing of company personnel subject to the compensation clawback rules, and an expansion in the exemptions from audits of internal control over financial reporting. With Chair White's pending departure in January and two other open Commission seats, it is difficult to predict what activities will shape the Commission's agenda. We expect the staff to continue its scrutiny of non-GAAP measures and implementation and disclosure issues related to the significant new accounting standards and to continue to work on the Disclosure Effectiveness Initiative. How quickly the staff's work on the Disclosure Effectiveness Initiative will progress remains to be seen.

1 The report is available **here**.

2 The Financial CHOICE Act has been passed by the House Financial Services Committee. The Executive Summary of the Act is available **here**, while the text of the Act can be found **here**.

This publication summarizes 2016 Commission rulemaking and activities, staff activities and guidance, and other practice issues covered at the Conference that affect financial reporting.[3] We discuss rulemaking, other activities and staff guidance first, followed by practice issues. While not the focus of this newsletter, we also discuss the relevant PCAOB 2016 standard-setting, related activities and common inspection findings.

SEC RULEMAKING

THE DODD-FRANK ACT

Disclosure of Payments by Resource Extraction Issuers (Release No. 34-78167)

In June, the SEC adopted amendments to Exchange Act Rule 13q-1 and Form SD. The rule and form require resource extraction issuers to disclose information about certain payments made to United States and foreign governments for the commercial development of oil, natural gas, and minerals. The requirements were originally adopted in 2012 pursuant to the Dodd-Frank Act but were vacated after they were challenged in a federal court. In response, the SEC rewrote the requirements. The SEC's press release announcing this rulemaking can be accessed **here**, and the final rule can be accessed **here**. The rule applies to "resource extraction issuers," defined as domestic and foreign issuers that are engaged in the commercial development of oil, natural gas, or minerals and required to file an annual report under the Exchange Act. The activities that constitute "commercial development of oil, natural gas, or minerals" include exploration, extraction, processing, export, or the acquisition of a license for any such activity.

Issuers are required to disclose on Form SD any payment (or series of related payments) to the U.S. government or foreign governments, including majority-owned entities of a foreign government, that is not de minimis (which the rule defines as equaling or exceeding $100,000 during a fiscal year) and has been made to further the commercial development of oil, natural gas, or minerals. The disclosures must be reported on a cash basis, do not need to be audited[4] and are not subject to officer certifications. Issuers must comply with the final rule for fiscal years ending on or after September 30, 2018. The disclosures will be filed annually in an XBRL-formatted exhibit to Form SD. The report will be due 150 days after the end of an issuer's fiscal year. Alternatively, issuers may use a report prepared for foreign regulatory purposes if the SEC deems the requirements of the foreign regime to be substantially similar to the Commission's requirements. An issuer may generally follow the due dates of the alternative regime.

The final rule is substantially consistent with the rule the SEC proposed in December 2015.[5] The most significant changes reflected in the final rule are:

- The final rule provides a transition period for reporting payments by recently acquired entities that were not previously subject to reporting and a one year delay in reporting payments related to exploratory activities.
- In a separate **order**, the Commission recognized two EU Directives, Canada's Extractive Sector Transparency Measures Act (ESTMA) and the U.S. Extractive Industries Transparency Initiative (USEITI), in their current forms as substantially similar disclosure regimes.
- Community and social responsibility payments required by law or contract were added to the comprehensive list of payments covered by the disclosure requirements.

THE FAST ACT

(Release Nos. 33-10003 and 34-77969)

In January, the SEC issued interim final rules to implement certain securities law amendments which were part of the Fixing America's Surface Transportation (FAST) Act.[6] The adopting release is available **here** on the SEC's website.

These rules:

- Revised the general instructions to Form S-1 and Form F-1 to reflect one of the FAST Act's self-executing changes which permits an emerging growth company conducting an initial public offering to omit historical periods from its financial statements if it reasonably expects that such periods will not be required at the time of the offering.[7] The preliminary prospectus distributed to investors must contain all financial information required by Regulation S-X.

3 We have historically published two separate reports – an *SEC Year in Review* (covering Commission rulemaking, activities, and staff guidance) and an *SEC Conference Report* (covering insights and practice issues addressed at the AICPA Conference on SEC and PCAOB Developments held annually in December). These publications were combined this year to provide a broader resource covering activities and focus areas of the Commission and staff.

4 Moreover, since Form SD does not include audited financial statements, auditors do not need to read the disclosures and consider whether they are materially inconsistent with the audited financial statements.

5 For further information about the rule proposed in 2015, refer to our SEC Year in Review newsletter on significant 2015 developments (available **here**).

6 For further information about the FAST Act, refer to our SEC Year in Review newsletter on significant 2015 developments (available **here**).

7 This applies to both confidentially submitted and filed registration statements.

- Revised Item 12 of Form S-1 (and make a conforming change to Item 512(a) of Regulation SK) to permit a smaller reporting company to forward incorporate information by reference. Only smaller reporting companies that are not blank check companies, shell companies (other than business combination related shell companies) or issuers in offerings of penny stock are eligible to take advantage of this provision. This rule became effective on January 25, 2016.

As part of its rulemaking, the SEC solicited feedback on whether the amendments should be extended to other registrants or other forms.[8] However, no further rulemaking to expand these amendments to other registrants or forms was conducted in 2016.

In June, the SEC issued another interim final rule to implement a FAST Act provision. The rule added Item 16 to Form 10-K and specifically permits issuers to voluntarily include a summary in Form 10-K. The adopting release is available **here** on the SEC's website. If an issuer elects to provide a summary, each item within the summary must include a cross-reference via hyperlink to the related, more detailed disclosure in Form 10K. Registrants have historically been permitted to voluntarily provide information, such as a summary, but the FAST Act required SEC rulemaking to specifically permit the summary and require the use of cross-referencing. Item 16 provides registrants with flexibility in preparing the summary and does not specify the summary's length (other than to say it should be brief), location, or disclosure items that should be covered. The summary may only cross-reference information or exhibits that are included in Form 10-K at the time the form is filed.

The rule became effective on June 9, 2016. The SEC also solicited feedback on whether it should provide further guidance on the preparation and content of the summary, limit its length or dictate its location (among other topics). However, no further rulemaking was conducted on this topic in 2016.

DISCLOSURE EFFECTIVENESS INITIATIVE

In 2016, the SEC made notable progress on its Disclosure Effectiveness Initiative, a broad-based review of the SEC's disclosure rules designed to improve the disclosure regime for both companies and investors. The progress made in 2016 follows the SEC's Request for Comment on the effectiveness of certain financial disclosure requirements of Regulation S-X, which was published in September 2015.[9] Activity in 2016 was in the form of rulemaking, a concept release, and a request for comment. Proposed rulemaking is discussed below, while other forms of activities related to the Disclosure Effectiveness Initiative are discussed in Other Commission Activities below.

Proposed Modernization of Disclosures for Mining Registrants (Release No. 33-10098)

In June, the SEC proposed rules to modernize property disclosures made by mining registrants. The revisions would amend Item 102 of Regulation S-K, rescind Industry Guide 7 and include mining property disclosure requirements in a new subpart of Regulation S-K.

The proposed rules would:

- Provide one standard requiring registrants to disclose mining operations that are material to the company's business or financial condition.
- Require a registrant to disclose mineral resources and material exploration results in addition to its mineral reserves.
- Permit disclosure of mineral reserves to be based on a preliminary feasibility study or a final feasibility study.
- Provide updated definitions of mineral reserves and mineral resources.
- Require, in tabular format, summary disclosure for a registrant's mining operations as a whole as well as more detailed disclosure for material individual properties.
- Require that every disclosure of mineral resources, mineral reserves and material exploration results reported in a registrant's filed registration statements and reports be based on, and accurately reflect information and supporting documentation prepared by, a "qualified person."
- Require a registrant to obtain a technical report summary from the qualified person, which identifies and summarizes for each material property the information reviewed and conclusions reached by the qualified person about the registrant's exploration results, mineral resources or mineral reserves.

The proposal can be found **here** on the SEC's website. Comments were due in September.

Proposed Elimination of Outdated and Redundant Disclosure Requirements (Release No. 33-10110)

In July, the SEC proposed amendments to eliminate redundant and outdated disclosure requirements. While the proposal is consistent with the goal of the Disclosure Effectiveness Initiative, the amendments were also proposed in response to a FAST Act mandate

8 At the March meeting of the Center for Audit Quality's SEC Regulations Committee (which can be found **here** on the CAQ's website), the SEC staff noted that it is unable to extend the reporting relief described above to registrants other than emerging growth companies and to forms other than Form S-1 or Form F-1.

9 Further information regarding the Request for Comment can be found in our SEC Year in Review newsletter on significant 2015 developments (available **here**). Our comment letter can be found **here**.

which requires the SEC to eliminate provisions of Regulation S-K that are duplicative, outdated, or unnecessary disclosures.

The proposal acknowledges that certain disclosure requirements in Regulations S-K and S-X have become outdated, redundant, overlapping or superseded in light of developments in U.S. GAAP, IFRS, other SEC disclosure requirements, and changes in the information environment. The changes are intended to simplify the overall compliance process but not change the mix of information provided to investors. For example, some of these proposed changes include:

- Eliminating the income tax rate reconciliation disclosure requirement in S-X 4-08(h)(2) as such disclosure is required by ASC 740-10-50-12.
- Eliminating the requirement to provide a computation of earnings per share in S-K 601(b)(11) as such disclosure is required by ASC 260-10-50-1a.
- Deleting S-K 101(b) which requires disclosure of segment financial information, restatement of prior periods when reportable segments change, and discussion of segment performance that may not be indicative of current or future operations. Such disclosures are similar to those required by Topic 280 and S-K 303(b).
- Deleting S-K 201(d) which requires disclosure of the securities authorized for issuance under equity compensation plans. Although the U.S. GAAP requirements are not identical to those contained in S-K 201(d), they provide disclosures about the nature and terms of equity compensation arrangements which results in reasonably similar disclosures.
- Eliminating the requirement in S-K 503(d) and related forms to provide a ratio of earnings to fixed charges when an offering of debt securities is registered. The Commission believes this requirement is no longer relevant and useful.

The proposal also solicits comments on:

- Certain disclosure requirements which may overlap with U.S. GAAP but provide incremental information. The SEC plans to use the feedback received on these areas to determine whether to retain, modify, eliminate, or refer them to the FASB for potential incorporation into U.S. GAAP.
- Where disclosures appear in an SEC filing. The proposal would result in the relocation of certain disclosures within a filing. The SEC is seeking feedback on how the relocations may affect the prominence or context of certain disclosures.

The proposal can be found **here** on the SEC's website. Comments were due in October.

BDO OBSERVATIONS:

We support the Commission's efforts to update its disclosure requirements, particularly its efforts to eliminate requirements that may be outdated, overlapping or superseded. With respect to requirements that may be redundant or duplicative, we believe it is important for the Commission to update them to ensure that any inconsistencies between these requirements and similar requirements in GAAP are intentional and not inadvertent. Moving forward, we encourage the Commission to establish a formal process for reviewing and updating its disclosure requirements in light of developments in U.S. GAAP, IFRS, and Commission guidance. Our specific recommendations as it relates to the proposal can be found in our comment letter (available **here**).

Proposed Requirement to use Hyperlinks (Release No. 33-10201)

In August, the SEC proposed a rule and form amendments that would require registrants to include a hyperlink to each exhibit listed in the exhibit index of their periodic and transactional filings. The intent is to facilitate easier access to these exhibits for investors and other stakeholders.

The proposal can be found **here** on the SEC's website. Comments were due in October.

OTHER RULEMAKING

Proposed Amendments to Smaller Reporting Company Definition (Release No. 33-10107)

In June, the Commission proposed rules which would increase the financial thresholds in the smaller reporting company[10] (SRC) definition. The proposal would expand the number of companies eligible for the scaled disclosures permitted by Regulation S-K and Regulation S-X. The financial thresholds in the definition of accelerated and large accelerated filer and the related filing requirements would remain unchanged.

Under the proposal, a company with less than $250 million of public float (or less than $100 million in annual revenues, if the company has no public float) would qualify as a SRC. The proposed financial threshold for re-entering SRC status is less than $200 million of public float (or less than $80 million in annual revenues, if the company has no public float). The following table summarizes the

10 The smaller reporting company definition excludes investment companies, asset-backed issuers and majority-owned subsidiaries of a parent that is not a smaller reporting company.

proposed amendments to the SRC definition, as compared to the current definition:

Registrant Category	Current Definition	Proposed Definition
Reporting Registrant	Less than $75 million of public float at end of second fiscal quarter	Less than $250 million of public float at end of second fiscal quarter
Registrant Filing Initial Registration Statement	Less than $75 million of public float within 30 days of filing	Less than $250 million of public float within 30 days of filing
Registrant with No Public Float	Less than $50 million of revenues in most recent fiscal year	Less than $100 million of revenues in most recent fiscal year
Re-entering SRC Status Based on Public Float	Less than $50 million of public float at end of second fiscal quarter	Less than $200 million of public float at end of second fiscal quarter
Re-entering SRC Status Based on Revenues (No Public Float)	Less than $40 million of revenues in most recent fiscal year	Less than $80 million of revenues in most recent fiscal year

The current definitions of accelerated and large accelerated filer contain a provision that excludes registrants that qualify as SRCs. The proposal would eliminate that provision, while maintaining the financial thresholds in the definitions of accelerated filer (i.e. $75 million of public float) and large accelerated filer (i.e. $700 million of public float). Therefore, companies with public floats of $75 million or more, but less than $250 million,[11] that qualify as SRCs under the amended definition, would still be subject to the accelerated filing requirements, including the accelerated timing of filing periodic reports and the requirement to provide the auditor's attestation on management's assessment of internal control over reporting required by Section 404(b) of the Sarbanes-Oxley Act of 2002. However, those companies would be allowed to take advantage of the scaled disclosure system available to SRCs.

Rule 3-05 of Regulation S-X requires financial statements of businesses acquired or to be acquired. Rule 3-05(b)(2)(iv) allows registrants to omit such financial statements for the earliest of three fiscal years required if the net revenues of the business acquired or to be acquired are less than $50 million. The Commission has not proposed to amend this threshold.

11 Or less than $200 million of public float, if re-entering the SRC status.

The proposal can be found **here** on the SEC's website. Comments were due in September.

BDO OBSERVATIONS:

Overall, we support expanding the number of registrants that qualify as smaller reporting companies and thereby benefit from scaled disclosure requirements. We believe that doing so is consistent with the Commission's goals of promoting capital formation and reducing compliance costs for smaller registrants while maintaining investor protections. We also believe that the proposed public float and revenue thresholds are reasonable. However, while we agree with the Commission that the threshold for requiring audits of internal control over financial reporting should not be changed, we would like to see the Commission go further by providing more time for these same smaller registrants to file their periodic reports. Our comment letter on the proposal which includes these observations, among others, is available **here**.

OTHER COMMISSION ACTIVITIES

DISCLOSURE EFFECTIVENESS INITIATIVE

Concept Release on Regulation S-K (Release No. 33-10064)

In April, the SEC published a concept release on Regulation S-K. The release is part of the Disclosure Effectiveness Initiative described above. The release focuses on the business and financial disclosures that Regulation S-K requires in companies' periodic reports, many of which have not changed since they were first adopted over 30 years ago. The release seeks input from investors and registrants in the following areas:

- The overall disclosure framework (e.g., the concept of materiality)
- Information intended for investment and voting decisions, including:
  - Core company business information (e.g., narrative description of business)
  - Company performance, financial information, and future prospects (e.g., selected financial data and management's discussion and analysis)
  - Risk and risk management (e.g., risk factors)
  - Securities of the registrant (e.g., description of capital stock)
  - Industry guides (e.g., Guide 3 for bank holding companies)

- o Public policy and sustainability matters (e.g., environmental, social and governance concerns)
- o Exhibits (e.g., material contracts)
- o Scaled requirements for certain registrants (e.g., smaller reporting company and emerging growth company reporting relief)

- Presentation and delivery of important information (e.g., the use of hyperlinks or cross-referencing)

The concept release can be found **here** on the SEC's website. Comments were due in July.

BDO OBSERVATIONS:

We support the Commission's efforts to analyze the disclosure regime of Regulation S-K and consider ways to improve the requirements for the benefit of investors. From a broad perspective, we support a principles-based approach to disclosure outside the financial statements. We believe that using a principles-based approach would promote disclosure of information that is most meaningful and relevant. To implement this approach, we believe Regulation S-K should (a) clearly articulate disclosure objectives, (b) provide a list of related topics a registrant should consider discussing and (c) make it clear that the disclosure is only required to the extent necessary to achieve the disclosure objectives. We believe this objectives-based approach is likely to result in more useful disclosure than the line item or "check the box" type approach we observe many registrants taking in response to the current S-K disclosure regime. Our comments and recommendations related to specific S-K disclosure items can be found in our comment letter (available **here**).

Request for Comment – Management, Certain Security Holders, and Corporate Governance Disclosure Requirements (Release No. 33-10198)

In August, the SEC published a request for comment on the disclosure requirements of Subpart 400 of Regulation S-K, which relate to management, certain security holders and corporate governance matters. This request is a part of the Disclosure Effectiveness Initiative, though it is also intended to inform the Commission's study on Regulation S-K, which is required by the FAST Act.

The request for comment can be found **here** on the SEC's website. Comments were due in October.

SEC ORDER PERMITTING THE USE OF INLINE XBRL

(Release No. 34-78041)

In June, the SEC issued an order permitting issuers to voluntarily embed XBRL data directly in their financial statements using a format known as Inline XBRL in lieu of providing tagged data in a separate exhibit. The order is available **here** on the SEC's website.

Issuers have been required to provide XBRL data in an exhibit to their filings. Consequently, issuers copy their financial statement information into a separate document and tag it in XBRL. By allowing issuers to instead embed tags directly into the financial statements, this voluntary program is intended to reduce preparation costs and increase the quality of the data, thereby increasing its use by investors and other market participants.

The order permits issuers to voluntarily use Inline XBRL in their periodic and current reports through March 2020.

STAFF GUIDANCE

FINANCIAL REPORTING MANUAL

The staff of the SEC's Division of Corporation Finance published two updates to the Financial Reporting Manual (FRM) in 2016.[12] As updates are published, the staff includes a summary immediately following the FRM cover that describes the nature of the changes and lists the paragraphs that were updated. The staff also annotates the FRM to communicate the date a paragraph was most recently updated.

The staff added Topic 11 to the FRM in 2016 to address reporting issues related to the adoption of certain significant new accounting standards. The guidance summarizes the available adoption dates, transition methods for public and nonpublic business entities and other reporting guidance for the following standards:

- **The New Revenue Standard (Topic 606)** – Section 11100 was added to address reporting issues related to the adoption of the new revenue standard. The March and November updates addressed the following specific matters:
  - o *Selected Financial Data* - When reporting selected financial data, a registrant adopting the new revenue standard using a full retrospective approach need not apply the new standard to periods prior to those presented in its retroactively-adjusted financial statements (refer to FRM paragraph 11100.1).

12 The FRM is an internal SEC staff reference document that provides general guidance covering several SEC reporting topics. While the FRM is not authoritative, it is often a helpful source of guidance for evaluating SEC reporting issues. The FRM, along with other helpful guidance, can be accessed from the Division of Corporation Finance home page, which is located **here**.

However, companies are reminded to provide the information required by Instruction 2 to S-K Item 301 regarding comparability of the data presented, if applicable and material.

- o *Emerging Growth Companies* - Paragraph 11100.2 was added to communicate that a calendar year-end EGC that elects to adopt the new revenue standard for the annual period beginning on January 1, 2019 and for interim periods beginning on January 1, 2020 (i.e., the effective date for nonpublic entities) is not required to accelerate application of the standard to interim periods presented in the 2019 Form 10-K (i.e., pursuant to Item 302 of Regulation S-K). The staff noted that the EGC could provide disclosures it deems appropriate to explain why the sum of the 4 quarterly figures for 2019 presented in the annual report do not agree to the corresponding annual amount.

- o *Pro Forma Financial Statements* - Paragraph 11120.4 addresses the presentation of pro forma financial information associated with a significant acquired business in the year of adoption. If a registrant adopts Topic 606 on a full retrospective basis on January 1, 2018 and acquires a significant business in 2018, it is not required to apply the new revenue standard to pro forma financial information for periods prior to adoption (e.g., the pro forma income statement for the year ending December 31, 2017).

- **The New Leasing Standard (Topic 842)** – Section 11200 was added to address reporting issues related to the adoption of the new leasing standard. A calendar year-end registrant is required to adopt the standard on a modified retrospective basis on January 1, 2019, with an initial application date of January 1, 2017. Paragraph 11210.1 specifies that companies are not required to also retrospectively revise their 2016 financial statements if they file a registration statement on Form S-3 in 2019.[13] The guidance indicates that the reissuance of the financial statements in the Form S-3 only accelerates the requirement to recast the 2017 and 2018 financial statements, but it does not change the initial date of the standard's application.

- **The New Disclosures about Short-Duration Contracts for Insurance Entities Standard (Topic 944)** – Section 11300 was added to address reporting issues related to the adoption of ASU No. 2015-09, *Disclosures about Short-Duration Contracts*. Similar to the sections on other new standards above, the guidance summarizes the adoption dates and transition methods. Paragraph 11310.1 was added to address the disclosure requirements related to claims development tables. ASU 2015-09 requires disclosure of disaggregated claims development tables for each reportable segment which reflect re-estimates of claims by accident year for up to ten years. Consequently, the guidance indicates that Property and Casualty insurers are no longer required to separately present the consolidated ten-year loss reserve development table required by Securities Act Industry Guide 6 and Exchange Act Industry Guide 4 in their filings.

The March update amended paragraph 2410.8, which provides guidance on measuring significance of equity method investees under Rules 3-09 and 4-08(g). Previously, when a registrant retrospectively applied a new accounting principle, it was required to recompute the significance of equity method investees in prior years and redetermine the reporting requirements under Rules 3-09 and 4-08(g) when filing its next Form 10-K. This could trigger the need for investee financial statements and/or summarized financial data for prior years that had not previously been required. Under the revised guidance, registrants are no longer required to recompute significance after a change in accounting principle. Registrants should continue to recompute significance under Rules 3-09 and 4-08(g) for prior periods after a discontinued operation.

The staff also updated Topic 10 (Emerging Growth Companies) to the FRM in March to conform it to the FAST Act, which amended securities laws that impact emerging growth companies.[14]

The November update amended paragraph 10220.5, which addresses an emerging growth company's reporting requirements associated with financial statements of entities other than the registrant and pro forma financial information. An EGC is permitted to present only two years of financial statements for entities other than the registrant in its initial registration statement even if the application of the significance tests otherwise results in a requirement to present three years. Paragraph 10220.5(a) explicitly extends this relief to an EGC's acquired real estate operations under Rule 3-14. (The FRM had previously extended this relief to acquired businesses under Rule 3-05 and equity method investees under Rule 3-09.) Additionally, paragraph 10220.5(c) was amended to explicitly permit an EGC to omit pro forma financial information from its initial registration statement if it reasonably expects that such periods will not be required at the time of the offering. The guidance is consistent with securities law amendments included in the FAST Act which permit an EGC to omit historical periods from its financial statements if it reasonably expects that such periods will not be included in its effective registration statement.

The FRM is available **here** on the SEC's website.

13 Item 11(b)(ii) of Form S-3 requires companies to file restated financial statements if there has been a change in accounting principle and the change requires a material retroactive restatement of the financial statements.

14 For further information about the FAST Act, refer to our SEC Year in Review newsletter on significant 2015 developments (available **here**).

COMPLIANCE AND DISCLOSURE INTERPRETATIONS

The SEC staff updated its C&DIs several times during the year. Many of these updates were legal in nature and provide guidance on tender offers, Regulation A, Regulation AB, Regulation D, pay ratio disclosure and various Securities Act and Exchange Act rules and forms, among others. One notable interpretation relates to the financial statement requirements in a Regulation A offering. As noted above, securities law amendments included in the FAST Act permit an emerging growth company to omit historical periods from its financial statements if it reasonably expects such periods will not be included in its effective registration statement. One of the new C&DIs formally extends this reporting relief to Regulation A filers. An issuer conducting a Regulation A offering is permitted to omit financial information for historical periods (including financial information of other entities that may be otherwise required) if it reasonably expects those periods will not be required at the time Form 1-A is qualified by the SEC.

In May, the staff updated its C&DIs on non-GAAP financial measures. These updates and other staff communications related to non-GAAP measures are discussed below under Practice Issues.

PRACTICE ISSUES

In addition to the guidance discussed above, the SEC staff addressed various practice issues throughout the year. This section discusses those issues, including observations the staff made at the Conference.

NON-GAAP FINANCIAL MEASURES

As discussed in our overview, over the past year non-GAAP measures have been highlighted as an area of concern by Chair White and the SEC staff, given registrants' extensive use of them and the potential for confusion they may cause. The updates to the C&DIs referred to above primarily address the nature and presentation of adjustments or measures that may be considered misleading and therefore violate Regulation G or Item 10(e) of Regulation S-K. Specifically, the updates communicate that:

- Certain adjustments to GAAP measures may be misleading even if they are not expressly prohibited by the SEC's rules. For example, the exclusion of cash operating expenses that are normal and recurring items could be misleading.
- Non-GAAP measures can be misleading if they are presented inconsistently between periods. While a change between periods is not prohibited, the reason for any change should be clearly described and disclosed. Additionally, registrants may need to consider recasting historical non-GAAP measures to conform to the current period presentation.
- Non-GAAP measures that exclude non-recurring charges but do not exclude non-recurring gains may be misleading.
- Revenue measures that are calculated using revenue recognition and measurement methods that are different from those required by GAAP are generally not permitted. The same concept may also apply to other financial statement line items measured using tailored accounting principles. A registrant's non-GAAP adjustments and measures generally should not tailor GAAP or apply accounting methods/principles for which the registrant does not otherwise qualify under GAAP.
- While registrants may present non-GAAP performance measures on a per share basis, registrants are prohibited from presenting non-GAAP liquidity measures on a per share basis. Whether per share data is permitted depends on whether the non-GAAP measure can be used as a liquidity measure, even if management presents it solely as a performance measure. For this reason, non-GAAP measures such as EBIT and EBITDA may not be presented on a per share basis. Also, registrants should focus on the substance of the non-GAAP measure and not management's characterization of the measure to determine whether presenting the measure on a per share basis is permissible.
- If a company presents EBIT or EBITDA as a performance measure, the measure should be reconciled to net income (not operating income). Operating income is not the most directly comparable GAAP financial measure because EBIT and EBITDA make adjustments for items that are not included in operating income.
- Registrants are permitted to present a non-GAAP measure such as "free cash flow,"[15] though they should clearly describe how the measure was determined as it does not have a uniform definition across companies. Companies should not imply that the measure represents cash available to fund discretionary expenditures as the definition typically excludes debt-service and other expenditure requirements. Since it is a liquidity measure, free cash flow should not be presented on a per share basis.
- When reconciling between GAAP measures and non-GAAP measures, the income tax effects of non-GAAP measures should be reflected separately and clearly explained. Reconciling items should not be presented net of tax.

The updates also provide several examples that illustrate placing undue prominence on non-GAAP measures (which is prohibited by Item 10(e) of Regulation S-K).

15 Free cash flow is typically calculated as operating cash flows less capital expenditures.

These examples include, among others:

- Omitting comparable GAAP measures from an earnings release headline that includes non-GAAP measures;
- Presenting non-GAAP measures before the directly comparable GAAP measures;
- Describing a non-GAAP measure as "record performance" without an equally prominent description of the comparable GAAP measure; and
- Providing a discussion and analysis of the non-GAAP measures without a comparable discussion of the GAAP measures.

Furthermore, for registrants that present "funds from operations" (FFO), as defined by the National Association of Real Estate Investment Trusts (NAREIT), the staff clarified that it accepts NAREIT's definition of FFO in effect as of May 17, 2016 as a performance measure and does not object to its presentation on a per share basis. Additionally, registrants are permitted to present FFO on a basis other than as defined by NAREIT as long as the measure complies with Regulation G or Item 10(e) of Regulation S-K.

The C&DIs are available **here** on the SEC's website.

Building on staff speeches throughout the year, non-GAAP measures were a prominent theme at the Conference. The staff acknowledged the substantial progress registrants made after the issuance of the C&DIs, particularly in the prominence with which they present them. However, the staff is still concerned about the appropriateness of measures that seem to eliminate normal recurring expenses and the effectiveness of the related disclosure controls and procedures.

The staff emphasized the following:

- When providing the required reconciliation of the differences between a non-GAAP measure and the most directly comparable GAAP measure, begin the reconciliation with the GAAP amount. Presenting the non-GAAP amount first gives it undue prominence.
- The C&DIs prohibit individually tailored accounting principles, such as acceleration of revenue recognition and proportionate consolidation. However, the staff may allow certain revenue adjustments in limited circumstances (e.g. adjustments to reflect the expected impact of adopting Topic 606). In those situations, registrants should discuss the presentation with the staff in advance.
- When a registrant presents non-GAAP information in an earnings release, it should consider also including non-GAAP disclosures in MD&A, given the perceived importance of the measure to investors.
- Audit committees should understand the non-GAAP measures being utilized as well as the procedures and controls in place around those measures.

NEW ACCOUNTING STANDARDS

Staff Announcement - Disclosures Related to the Adoption of New Accounting Standards

In 2016, reporting issues related to the adoption of new, significant accounting standards have been a significant SEC staff focus area. One of these reporting issues relates to Staff Accounting Bulletin 74 disclosures (which has been codified into SAB Topic 11.M). SAB 74 addresses disclosure of the impact that recently issued accounting standards will have on the financial statements of the registrant when adopted in a future period. Since the new revenue standard was issued, the SEC staff has communicated its expectation for these disclosures to evolve over time as registrants better understand the effects that the new standard will have on their financial statements.

At the September 22, 2016 EITF meeting, the staff made an **announcement** regarding its views about SAB 74 disclosures related to:

- 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*.

The staff expects registrants that are not yet in a position to disclose the quantitative effects of these standards on their financial statements will make additional qualitative disclosures including:

1. The effect of the accounting policies that the registrant expects to apply (if determined) and a comparison to the registrant's current accounting policies and
2. The status of its process to implement the new standards and the significant implementation matters yet to be addressed

Registrants should also consider making any additional qualitative disclosures necessary to help financial statement users under the impact of these new standards. At the Conference, the staff indicated that it will be looking for these disclosures in registrants' upcoming 10-K filings and if they do not appear, companies should anticipate receiving a staff comment letter on the topic.

BDO OBSERVATIONS:

As the adoption date of the new revenue standard has drawn nearer, the staff has also expressed its concern about a perceived lack of preparedness among registrants due to lackluster SAB Topic 74 disclosures – e.g., continued disclosure that states, "We are currently evaluating the effect of the standard on our financial statements." We believe the staff announcement in September requesting additional qualitative disclosure is intended, at least in part, to get the ball rolling for registrants who have not otherwise devoted significant time and attention to the impact that the standard will have on their financial statements. Examples of such qualitative disclosures for the new revenue standard may be as follows:

- **For a software company that has begun its assessment:** "We have formed a committee to evaluate the standard's effect on our financial statements. We have historically deferred revenue for certain deliverables in our multiple-element arrangements due to a lack of vendor specific objective evidence (VSOE) for those deliverables. Our preliminary analysis indicates that we will recognize revenue for these arrangements earlier under Topic 606 than under Topic 605 due to the elimination of the VSOE requirement."
- **For a company that has historically elected to expense all contract costs under SAB 104:** "Our historical accounting policy for contract costs is to expense all costs as incurred, as permitted under SAB 104. Under Topic 606, we will be required to capitalize certain contract costs for all contracts greater than one year and amortize them as we transfer goods or services to our customers. Accordingly, we expect to recognize a deferred charge for such costs on in-process contracts upon adoption."
- **For a company that is just getting started on its evaluation:** "We are in the initial stages of evaluating the effect of the standard on our financial statements and continue to evaluate the available transition methods.

Form S-3 Considerations

Item 11(b) of Form S-3 requires a registrant to recast its annual financial statements in a new or amended registration statement after retrospective adoption of a new accounting principle, if the change is material. Consequently, a registrant that elects to adopt the new revenue standard on a full retrospective basis may be required to recast its financial statements for an additional year if it files a new or amended registration statement in 2018. For example, a registrant with a calendar year end that adopts the revenue standard on a full retrospective basis on January 1, 2018 and does not file a registration statement in 2018 would be required to recast its 2017 and 2016 financial statements for purposes of its 2018 Form 10-K. However, if the registrant files a registration statement on Form S-3 in 2018 after it has filed its first quarter Form 10-Q, it would be required to restate its 2017, 2016 *and* 2015 financial statements. However, the staff communicated[16] that registrants may consider the impracticability exception included in ASC 250-10-45-9 if, for example, a company is unable to apply the requirement to recast all periods presented in its financial statements after making every reasonable effort to do so. While not required, the staff has indicated that a registrant may wish to consult with OCA if it has concluded it would be impracticable to present one or more comparative periods.

With respect to shelf takedowns (i.e., offers made using an already effective registration statement) in 2018, the staff indicated at the Conference that it would not expect registrants to conclude that the adoption of a new accounting standard qualifies as a "fundamental change," which would trigger the need to file a post-effective amendment to the registration statement and the recasting of the financial statements for the additional year as described above.

Adoption Dates for Equity Method Investees

The FASB's definition of a public business entity (PBE) includes entities whose financial information or financial statements are included in a filing with the SEC. Consequently, entities that are otherwise privately-held may be considered PBEs solely because their financial information / statements appear in an SEC filing (e.g., financial statements of an acquired business under Rule 3-05 or an equity method investee under Rule 3-09, and financial information of equity method investees under Rule 4-08(g)).[17] The determination of whether an entity qualifies as a PBE is important, particularly because many accounting standards, including the major new accounting standards discussed in this letter, have different adoption dates for PBEs (which are typically one year earlier than non-PBEs). The staff discussed the application of the PBE definition to an insignificant equity method investee whose financial information is not included in the filing, but is used only for purposes of recording the registrant's share of the investee's earnings or losses. The staff indicated that this type of equity method investee would not be considered a PBE and therefore, would not be required to adopt the new accounting standards using the PBE adoption dates.

Revenue Recognition Standard

At the Conference, Chief Accountant Wes Bricker emphasized that revenue is "one of the single most important measures used by investors in assessing a company's performance and prospects" and

16 Refer to Wes Bricker's remarks at the 2016 Baruch College of Financial Reporting Conference here.

17 Paragraph BC12 in ASU 2013-12 specifically states that an entity whose summarized financial information is provided to comply with Rule 4-08(g) of Regulation S-X is considered a PBE.

"companies cannot afford to get the accounting wrong." Bricker's statements illustrate the importance of sufficient preparation, by all companies, to ensure successful implementation of the new principles-based revenue recognition standard. To date, the SEC staff has observed progress in readiness efforts. However, many registrants remain in the initial assessment phase. The staff encouraged registrants to discuss their current Topic 606 implementation status and ongoing activities with investors, audit committees, and auditors (while being mindful of auditor independence requirements).

While registrants prepare for the new standard, the staff is executing its own revenue implementation strategy. The staff actively monitors implementation efforts in order to understand areas of potential diversity and the types of judgments being made. Additionally, as registrants work through applying the standard, the staff continues to be available for consultations.

Bricker also provided insight into how the staff forms its views on specific transactions. The staff considers the nature, design and economic substance of the transaction by starting with the terms of the contract itself. The language in Topic 606 and the related basis for conclusions, implementation discussions such as those at the Transition Resource Group, and the objective of consistency and comparability are also contemplated. Prior to a consultation, the staff believes a registrant should fully understand their arrangements and be able to clearly articulate their basis for accounting under the new standard.

Based upon Topic 606 implementation consultations to date, the staff shared the following observations:

Definition of a contract – Certain companies may employ a loss leader pricing strategy, where they price one good or service at a discount in order to stimulate future sales of more profitable goods or services. While future sales may appear likely for economic or other reasons, the staff believes future contracts should not be accounted for as part of the existing revenue arrangement since a contract with enforceable rights and obligations does not exist.

Contract combinations –A company may enter two or more contracts at or near the same time with the same customer (or related parties of the customer). Under Topic 606, those contracts may be accounted for as a single contract, provided at least one of the following criteria is met:

- The contracts are negotiated as a package with a single commercial objective.
- The amount of consideration in one contract depends on the price or performance of the other contract.
- The goods or services that are promised in the contracts represent a single performance obligation.

The staff emphasized that the contract combination guidance should not be extended beyond the customer. For example, two interdependently priced contracts negotiated as a package at the same time would not meet the contract combination guidance unless the contracts were with the same customer.

Payments to customers – The staff noted that companies make payments to customers for a variety of reasons. To assess the accounting for such payments, a company must understand the economic reason(s) for the payments, the relevant terms of the contract, and how the payments are described to investors and other stakeholders. After gaining this understanding, the payment should be accounted for on a basis that is consistent with the substance of the transaction and the relevant accounting literature. The staff stated that the concept of "matching is not a determinative factor." Furthermore, classification of customer incentives in the income statement, particularly if a customer is not in the standard supply chain, requires judgment. The staff expects quantitative disclosures for material amounts reflected outside of revenues.

Gross versus net presentation – The control-based nature of the new revenue recognition standard may result in a change in the presentation of revenues. The staff urged registrants to take a fresh look at existing principal (gross) and agent (net) conclusions, stressing that no default or safe harbor exists under Topic 606. Rather, the specific facts and circumstances should drive the accounting conclusion.

Disaggregated disclosures – Topic 606 requires certain disclosures of revenues on a disaggregated basis (e.g. by geography, type of good/service, etc.), similar to segment disclosures. While an impracticability exception exists for segment reporting, no such exception is available in the new revenue standard. The staff indicated they will review other investor communications, such as earnings releases and company websites, in order to assess whether a company makes appropriately disaggregated disclosures. This is consistent with the staff's approach for segment disclosures.

SAB Topic 13 – The staff noted that SAB Topic 13, Revenue Recognition, applies prior to the adoption of the new revenue recognition standard. Thereafter, registrants should evaluate revenue arrangements under Topic 606. The staff will assess any implementation related consultations under Topic 606 similarly, i.e., without regard to SAB Topic 13.

Disclosing the effects of adoption – The staff also indicated a registrant that adopts the new revenue standard on a modified retrospective basis may present as supplemental pro forma information in MD&A the amounts it would have reported if full retrospective adoption had been elected. This supplemental pro forma information would be considered non-GAAP financial information subject to the applicable requirements, including a prohibition on presenting a full supplemental pro forma income

statement. In addition to supplemental pro forma revenues disclosures, registrants should also disclose the impact on other financial statement line items, such as costs of sales.

Credit Losses Standard

The SEC staff commented that "virtually every registrant will be affected" due to the range of financial assets scoped into the new credit losses standard, including loans, debt securities and trade receivables. Furthermore, the staff noted that management must determine an estimate of expected credit losses that is most reflective of the company's expectations. Since Topic 326 does not require a specific method to estimate expected credit losses, each company must develop accounting principles and methodologies that can be applied consistently from one period to another. A systematic methodology consistent with the principles of the new standard should support management's expected credit loss estimates each period. The staff emphasized that detailed documentation of policies, procedures, methodologies and decisions will continue to be necessary. SAB 102, *Selected Loan Loss Allowance Methodology and Documentation Issues*, and Financial Reporting Release No. 28, *Accounting for Loan Losses by Registrants Engaged in Lending Activities* will continue to be relevant given the need to use reasonable and supportable forecasts in the new standard.

OTHER ACCOUNTING AND DISCLOSURE TOPICS

Share-Based Awards: Grant Dates

Topic 718, Compensation – Stock Compensation, defines a grant date as the date when a mutual understanding of the key terms and conditions of a share-based payment award is reached between the employer and employee. For an equity-classified service award, a company recognizes the grant date fair value of the award over the requisite service period. Compensation cost for services provided prior to the grant date is recorded based upon the fair value of the award at each reporting date, resulting in multiple valuation dates. The SEC staff highlighted the need for careful consideration with respect to the establishment of a grant date (i.e., whether a mutual understanding has been reached) when an award includes a key discretionary condition, such as a clawback provision. A company should consider its past practices and how they have evolved over time as part of the assessment. The staff also noted that appropriate ICFR is necessary to monitor past company practices used to support grant date judgments.

Defined Benefit Plan Considerations

The following approaches for developing pension benefit obligations (PBO) and the related interest costs for single employer defined benefit pension plans have been accepted by the SEC staff:

Approach	PBO	Interest Cost
Single weighted average	The plan sponsor determines the PBO at the measurement date by discounting the projected future benefit payments at the individual duration-specific rates forecast for the time of the projected payments. The single weighted average discount rate calculated by the plan sponsor represents the rate that discounts the projected benefits payments to a present value amount that equals the PBO.	The plan sponsors use this weighted average discount rate to determine the annual interest costs for defined benefit plan reporting.
"Spot rate" or yield curve	The plan sponsor determines the PBO in the same manner as in the single weighted average approach.	The plan sponsor uses the individual, duration-specific ("spot") rates from the yield curve to calculate annual interest costs.
Hypothetical bond portfolio	The plan sponsor determines the PBO by developing a hypothetical portfolio of actual bonds with cash flows that match the projected future benefit plan payments.	The plan sponsor uses the hypothetical bond portfolio to calculate the weighted average rate, and uses this rate to calculate annual interest costs.

The single weighted-average and the spot rate approaches result in the same PBO based on the use of an identical yield curve, but the annual interest costs differ. The hypothetical bond portfolio approach results in a different PBO. The staff stressed that the same approach must be used to calculate both the PBO and interest costs as the two calculations are integrated. Consequently, if a company utilizes the hypothetical bond portfolio matching approach to develop the PBO, the spot rate approach cannot be used to calculate the interest cost.

Insurance Company Disclosures: Short Duration Contracts

Topic 944, Financial Services – *Insurance*, requires presentation of a claims development table in the footnotes to the financial statements. The SEC staff noted that retrospective restatement of

the claims development tables to capture the effects of acquisitions and dispositions would be consistent with the objectives of Topic 944. Alternatively, separate prospective presentation of the claims information for the existing business as well as the liabilities of an acquired business might also meet the objectives of the standard. The staff believes a company may capture the impact of foreign currency exchange rates by using the current-period exchange rates for all years in the claims development tables or by including a separate claims development table for each functional currency.

Fair Value Option for Financial Instruments

For financial liabilities for which a fair value option has been elected under Topic 825, Financial Instruments, as amended by ASU No. 2016-01, *Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, an entity must present separately, in other comprehensive income (OCI), the portion of the total change in the liability's fair value that results from a change in instrument-specific credit risk. The fair value option can also be elected under Topic 815, *Derivatives and Hedging*, for a hybrid financial liability (e.g., a debt obligation with an embedded derivative) for which the embedded feature otherwise would have been required to be bifurcated and accounted separately.

Under the new presentation guidance in ASU 2016-01, the SEC staff believes that similar to a fair value election under Topic 825, changes due to instrument-specific credit risk should be recorded in OCI even when an entity elects the fair value option under Topic 815. There is no requirement under GAAP to first evaluate whether an entity can elect a fair value option under the derivatives guidance in Topic 815, prior to electing a fair value option under Topic 825. Accordingly, an entity that elects a fair value option under either guidance for an eligible hybrid financial liability should follow the new presentation requirements in ASU 2016-01 regarding changes in instrument-specific credit risk.

Under the updated guidance, an entity may consider the portion of the total change in fair value that excludes amounts related to a base market risk (e.g., risk-free rate or benchmark interest rate) to be the result of a change in instrument-specific credit risk, which the staff referred to as the "base rate method." Alternatively, a company may use another method if it faithfully represents the portion of the total change in fair value resulting from a change in instrument-specific credit risk. The staff provided hypothetical examples to illustrate the judgment involved in the measurement of instrument-specific credit risk. In one scenario, payment of a nonrecourse financial liability, for which a company has elected the fair value option, is tied solely to the cash flows of the asset pledged as collateral. The staff believes that none of the change in fair value would relate to instrument-specific credit risk since the fair value is derived from the risks inherent in the collateral asset. Therefore, the entire change in the financial liability's fair value would be reflected in earnings. Under another scenario, the staff observed that the base rate method may not be appropriate for a company electing the fair value option for a debt obligation that is indexed to the price of gold and requires cash settlement since the price of gold impacts the change in fair value.

Segment Reporting

Many of the principles and objectives within the segment reporting guidance highlighted in prior years were once again discussed at the Conference. The following segment reporting issues continue to receive a substantial amount of attention from the SEC staff.

- **Operating segments** – The staff views the availability of gross margins for a component as sufficient to conclude that discrete financial information is available. The allocation of shared operating costs is not required.
- **Aggregation of operating segments** – When considering aggregation of two or more operating segments, a registrant must consider whether: (a) aggregation is consistent with the objective and basic principles in the standard, (b) operating segments have similar quantitative economic characteristics, and (c) operating segments have similar qualitative characteristics. The staff reminded registrants that economic similarity (e.g., similar margins) does not matter if operating segments are qualitatively different. Economic similarities may be coincidental. As such, a registrant should also consider qualitative factors, including the nature of the entity's activities, when contemplating aggregation.
- **Entity-wide disclosures and other general information** – The staff cautioned registrants not to overlook other disclosure requirements in their segment reporting, such as enterprise-wide disclosures and the factors used to identify reportable segments (e.g., by geography, by product, regulatory environment, etc.).

Additionally, the SEC's rules prohibit the presentation of non-GAAP information within financial statements, except for the required disclosure of the segment financial measure used by the chief operating decision maker. The staff stated that registrants should not voluntarily disclose additional segment financial measures. GAAP does not require such additional disclosures, making them non-GAAP measures. For the same reason, a registrant with one reportable segment should not present segment financial measures.

Income Taxes

The SEC staff has historically stressed the need for continued improvement in income tax disclosures in both the footnotes to the financial statements and in MD&A. At the Conference, the staff specifically mentioned that additional comment letters will be issued this year if disclosures are not enhanced. Income tax

disclosures should help a reader understand a company's complete tax situation.

Undistributed foreign earnings - Topic 740, *Income Taxes,* creates a general presumption that undistributed foreign earnings will be repatriated, resulting in a tax liability when transferred to the parent entity. A registrant may overcome the general presumption if certain criteria are met and assert that foreign earnings are indefinitely reinvested. The staff has observed disclosures outside of the financial statements, such as in MD&A, which "call into question (or potentially contradict) assumptions relied upon in accounting for undistributed earnings." Consistent use of assumptions when making complex income tax accounting judgments requires coordination among multiple business functions within a company's global organization.

MD&A disclosures – The staff also expects registrants to explain reasons for changes in effective tax rates, the extent to which historical effective tax rates are an indicator of future rates (and why or why not), the effect of uncertain tax benefits, the amount of cash in foreign jurisdictions for which deferred income taxes have not been provided, and the liquidity impact of tax obligations. Furthermore, the staff emphasized that valuation allowance related disclosures must be relevant and specific, including the sources and amounts of taxable income that the registrant relies on to avoid a valuation allowance, while avoiding "boilerplate" language.

Accounting Policy Considerations

In accordance with Topic 250, *Accounting Changes and Error Corrections*, accounting principles should be applied consistently from period to period unless a company can justify that a change is preferable. The SEC staff reminded registrants that changes in accounting principles resulting from new accounting standards do not require an evaluation of preferability. Additionally, changes due to events or transactions that are clearly different in substance from past events or transaction do not necessitate an evaluation of preferability. The staff cautioned that "identifiable differences between certain transactions or events does not necessarily equate to a clear difference in substance." A company should consider the nature of the events or transactions that lead to the current documented accounting policy as part of the assessment.

Measurement Period Adjustments

Topic 805, *Business Combinations*, requires disclosure of provisional amounts when the initial accounting for a business combination is incomplete at the end of a reporting period. A company adjusts the provisional amounts based upon new information obtained during the measurement period about facts and circumstances that existed at the acquisition date. The SEC staff reiterated that the measurement period is not one year from the acquisition date. Rather, the measurement period ends "as soon as the acquirer receives the information it was seeking about facts and circumstances that existed as of the acquisition date or learns that more information is not obtainable" and cannot exceed one year. The staff also emphasized the difference between the timing of recognition of a measurement period adjustment (during the current reporting period) and a material error correction (restatement of prior periods) as well as the need for sufficient ICFR to identify and account for adjustments and errors separately.

Loss Contingencies

The staff continues to focus on loss contingency disclosures, specifically when "surprises" occur. The staff cited timely disclosure of accruals for loss contingencies and the reasonably possible range of loss, when applicable, as commonly omitted disclosures. When a company settles a loss contingency shortly after a reporting period, the staff may inquire about the absence of related disclosures in previous filings.

Joint Ventures, Strategic Alliances, and Other Collaborative-Type Arrangements

The growing prevalence of various types of strategic alliances and the increasing complexity of these arrangements may create issues across a number of accounting topics (e.g., consolidation, gain recognition, revenue recognition, derivatives, leases, etc.). As a result, careful consideration of the facts and circumstances surrounding an arrangement is essential.

Registrants should first determine whether the activities of the strategic alliance are conducted wholly or partially within a legal entity and, if so, whether that legal entity should be consolidated. The variable interest entity (VIE) and voting interest consolidation models require a thoughtful analysis regarding decision-making authority, including the determination of which activities most significantly impact the economic performance of a VIE. The SEC staff noted that conclusions on decision-making authority should be consistent with the substance of the arrangement as well as the consolidation guidance.

When a registrant conducts activities outside of a legal entity or does not consolidate a legal entity, a company must contemplate the applicability of other accounting guidance (e.g. joint ventures and collaborative arrangements). Additionally, certain arrangements where another party receives the outputs of an entity's ordinary activities may meet the definition of a contract with a customer within Topic 606.

INTERNAL CONTROL OVER FINANCIAL REPORTING

ICFR was a pervasive topic throughout the prepared remarks of many SEC representatives at the Conference, consistent with last year. Chief Accountant Wes Bricker echoed Chair White's comments from her 2015 keynote address stating, "It is hard to think of an area more important than ICFR to our mission of providing high-quality financial information that investors can rely on." Unidentified or unaddressed deficiencies can lead to lower-quality financial reporting and restatements. Bricker also relayed investor sentiment about the significance of strong and effective controls, including audits of such controls, in establishing the credibility necessary to raise capital.

The staff relayed key takeaways from an SEC enforcement action during the year, noting that management should 1) evaluate the severity of control deficiencies, report any material weaknesses promptly, and disclose the cause of any material weakness and its potential impact on the financial statements, 2) maintain competent and adequate accounting staff, complementing them with qualified external resources where necessary, and 3) take responsibility for its ICFR assessment, as it cannot be outsourced to third parties.

As a sign of improvement, the SEC staff observed that identification of material weaknesses in advance of restatements has improved at an increasing rate. Nevertheless, frequent identification of deficiencies in ICFR audits by the PCAOB indicate issues still exist. The staff reminded registrants that those findings may also indicate deficiencies in management's controls and assessments. Placing unwarranted reliance on controls that are not designed at a level of precision to address the risk of material misstatement or controls that are dependent on the effectiveness of other controls and obtaining evidence to support conclusions on the design and effectiveness of ICFR require the attention of registrants. The staff reiterated the importance of regular ongoing dialogue among registrants, auditors and audit committees about ICFR assessments, specifically when there are changes to previous risk assessments.

The staff stressed that effective design and operation of ICFR is necessary to support the inherent judgments needed for complex accounting matters, such as consolidations and identification of operating segments, as well as when implementing new accounting standards and policies. Existing controls may no longer be appropriate. Registrants may need to implement new or re-designed controls prior to the adoption of the new accounting standards for revenue recognition, leases, and credit losses.

IFRS FOR U.S. ISSUERS

In his Conference remarks, Chief Accountant Wes Bricker touched on the use of IFRS in the United States. While he believes that the FASB's independent standard setting process and GAAP will continue to serve the needs of investors for at least the foreseeable future, he expressed support for continued collaboration between the FASB and IASB to eliminate differences between their standards. He also indicated that the staff will continue to evaluate his predecessor's idea to permit domestic issuers to voluntarily provide IFRS-based information as a supplement to their GAAP financial statements without requiring a reconciliation of that information to GAAP.

SEC STAFF CONSULTATIONS AND COMMUNICATIONS

Registrants may wish to request a waiver, accommodation, or interpretation of SEC reporting requirements from the SEC staff (i.e., review of a pre-filing letter). The staff encourages such consultations, particularly for complex reporting matters. The staff reminded registrants that pre-filing letters should focus on the relevant facts and provide support for the proposed positions. Registrants should also ensure that the pre-filing letters are provided to their auditors for feedback and review prior to their submission.

In addition, the staff reminded registrants that the SEC comment letter process is intended to create a dialogue between the registrant and the staff. When the staff asks a question, registrants should not assume that a change in the filing is necessary. Furthermore, registrants should communicate whether a staff comment relates to an immaterial matter early in the comment letter process. The staff also cautioned registrants about analogizing to fact patterns in other companies' comment letters as each staff comment and its corresponding resolution are based on facts and circumstances which may not be apparent in the publicly-available letters.

PCAOB DEVELOPMENTS

FINAL AUDTING STANDARD AND AMENDMENTS

Disclosure of Certain Audit Participants on a New PCAOB Form AP and Related Amendments to Auditing Standards

In May, the SEC approved the PCAOB's adopted Rules 3210 and 3211 that require audit firms, beginning in 2017, to file a new PCAOB Form AP, *Auditor Reporting of Certain Audit Participants*, within a specified number of days after the first time an audit report for each of the firm's issuer clients is included in a document filed with the SEC. The following information is required to be disclosed on Form AP:

Effective for auditor's reports issued on or after January 31, 2017:

- The name of the engagement partner, along with a unique 10 digit identifier for that partner.

Effective for auditor's reports issued on or after June 30, 2017:

- The names, locations, and extent of participation of other accounting firms that took part in the audit, if their work constituted five percent or more of the total audit hours; and
- The number and aggregate extent of participation of all other accounting firms that took part in the audit and that individually contributed less than 5 percent of the total audit hours.

A Form AP is required for each audit report issued for an issuer, employee benefit plan subject to PCAOB auditing standards (Form 11-K), and registered investment company. Form AP is not required by a registered public accounting firm that is referred to in an auditor's report by the principal auditor in accordance with AS 1205, *Part of an Audit Performed by Other Independent Auditors*.

The information on Form AP will be available in a searchable database on the PCAOB's website and will include unique ID numbers for both engagement partners and firms. Investors and other financial statement users will have access, in one location, to the names of engagement partners on all issuer audits. This will allow interested parties to compile information about the engagement partner, such as whether the partner is associated with restatements of financial statements or has been the subject of public disciplinary proceedings, as well as whether he or she has experience as an engagement partner auditing issuers of a particular size or in a particular industry.

Information provided on Form AP is also intended to help investors understand how much of the audit was performed by the accounting firm signing the auditor's report and how much was performed by other accounting firms. This information is expected to allow the public to determine other information about the firms identified in the form, such as whether a participating firm is registered with the PCAOB, whether it has been inspected and, if so, what the results were and whether it has any publicly available disciplinary history.

The SEC also approved the Board's adopted amendments to AS 3101, Reports on Audited Financial Statements, and AS 1205, that permit auditors to voluntarily disclose in the auditor's report the name of the engagement partner, information regarding other accounting firms, or both.

The rules and amendments are available **here**. Additionally the PCAOB recently published staff guidance, which is available **here**, to help firms comply with the requirements for filing reports on Form AP.

OTHER STANDARD-SETTING ACTIVITIES

Supervision of Audits Involving Other Auditors, and Proposed Auditing Standard, Dividing Responsibility for the Audit with Another Accounting Firm

In April, the PCAOB proposed for public comment a new auditing standard, along with related amendments, to strengthen the requirements that apply to audits that involve accounting firms and individual accountants outside the accounting firm that issues the audit report. Among other things, the proposed new standard and amendments would apply a risk-based supervisory approach, and would require more explicit procedures regarding the lead auditor's involvement in the work of other auditors through enhanced communication and more robust evaluation of the other auditors' qualifications and work.

The proposed new standard, AS 1206, *Dividing Responsibility for the Audit with Another Accounting Firm*, would supersede AS 1205. Proposed AS 1206 would retain, with modifications, many of the requirements of AS 1205, including the requirement that a lead auditor disclose in its audit report which portion of the financial statements was audited by each other auditor. However, proposed AS 1206 would also require the lead auditor to:

- Obtain a representation from each referred to auditor that they are licensed to practice under the applicable laws of the relevant country or jurisdiction.
- Determine whether each of the referred to auditors that play a substantial role in the preparation or furnishing of the lead auditor's report is registered with the PCAOB.
- Disclose the name of the other auditor in the lead auditor's report.

The proposal would also modify existing PCAOB auditing standards as follows:

- Amend AS 1215, *Audit Documentation*, to require that the lead auditor document which specific working papers of other auditors the lead auditor has reviewed, but not retained.
- Amend AS 1220, *Engagement Quality Review*, to explicitly require the engagement quality reviewer to evaluate the engagement partner's determination of his or her firm's sufficiency of participation in the audit.

- Amend AS 2101, *Audit Planning*, to incorporate and update requirements of AS 1205 to specify that they be performed by the lead auditor. For example, the proposal would incorporate and revise requirements for determining the firm's sufficiency of participation in an audit that involves other auditors.

- Amend AS 1201, *Supervision of the Audit Engagement*, to provide additional direction to a lead auditor on how to apply AS 1201's requirements to supervising other auditors. Specifically, the proposed amendments would require certain procedures to be performed by the lead auditor in supervising the work of other auditors.

The proposed auditing standard and amendments can be accessed **here**. The comment period closed in July. The PCAOB staff is currently analyzing the comments received to determine its next steps.

BDO OBSERVATIONS:

In our comment letter, we supported the PCAOB's efforts to strengthen the auditing standards relating to audits in which other auditors participate. We also encouraged the PCAOB to monitor the activities of the IAASB relating to a similar project and align with the IAASB's standards when possible to minimize unnecessary differences. Additionally, our comment letter indicated that while we support enhancing guidance in situations in which other auditors participate in an audit, we believe such enhancements should incorporate a risk-based approach in order to allow the lead auditor to apply professional judgment in developing an audit strategy. Our comment letter is available **here**.

The Auditor's Report on an Audit of Financial Statements when the Auditor Expressses an Unqualified Opinion, and Related Amendments

In May, the PCAOB reproposed for public comment the standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, and related amendments. The reproposed standard revises the PCAOB's initial proposal issued in 2013. Similar to the 2013 proposal, the reproposed standard would retain the existing "pass/fail" model in the auditor's report, but would provide additional information in the report, such as the communication of critical audit matters and new elements related to auditor independence and auditor tenure.

A "critical audit matter" (CAM), as defined in the reproposed standard, is any matter that is communicated or required to be communicated to the audit committee and that (1) relates to accounts or disclosures that are material to the financial statements, and (2) involves especially challenging, subjective, or complex auditor judgment. The auditor's report would identify the critical audit matter, describe the considerations that led the auditor to conclude that such matter is a critical audit matter, describe how it was addressed in the audit, and refer to the relevant financial statement accounts and disclosures.

The reproposed standard refines a number of aspects in the 2013 proposal, including:

- Limiting the source of potential CAMs to matters communicated or required to be communicated to the audit committee

- Adding a materiality component to the definition of a critical audit matter

- Narrowing the definition of a critical audit matter to only those matters that involved particularly challenging, subjective, or complex auditor judgment

- Revising the related documentation requirement to be consistent with the definition of a critical audit matter

- Requiring the auditor to describe in the audit report how the critical audit matter was addressed during the audit

The reproposed standard would also result in the following changes to the existing auditor's report:

- The auditor's report would include a statement regarding the requirement for the auditor to be independent.

- The phrase "whether due to error or fraud," would be added to the auditor's report when describing the auditor's responsibilities under PCAOB standards to obtain reasonable assurance about whether the financial statements are free of material misstatements.

- A statement would be included in the auditor's report regarding the number of years the auditor has served as the company's auditor

- The opinion would be required to be the first section of the auditor's report

- Section titles would be required in the auditor's report, to help guide the reader

The 2013 proposal also included another new auditing standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*, regarding the auditor's responsibilities for other information outside the financial statements. The Board has not reproposed this auditing standard but plans to determine next steps at a later date.

The reproposed standard would generally apply to audits conducted under PCAOB standards. Unlike the 2013 proposal, however, the requirements regarding CAMs would not apply to audits of brokers and dealers reporting under the Securities Exchange Act of 1934 Rule 17a-5; investment companies other than business development companies; and employee stock purchase, savings, and similar plans.

The reproposal is available **here**. The comment period closed in August. The PCAOB staff has evaluated the comments on the reproposal, and is currently drafting a final standard and an adopting release for the Board's consideration.

BDO OBSERVATIONS:

In our comment letter, we supported the PCAOB's efforts to modernize the auditor reporting model by enhancing the usefulness and informational value of the auditor's report. We also encouraged the PCAOB to align its proposed standard with the IAASB's revised suite of auditor reporting standards because of the interconnected nature of the global economy and the needs of investors for a consistent reporting framework. Additionally, we stated in our comment letter that we do not support disclosure of auditor tenure within the auditor's report, nor do we believe there is support for a regulatory requirement for such disclosure. Our comment letter is available **here**.

INSPECTIONS

The PCAOB staff noted several recurring inspection findings, especially with respect to ICFR (management review controls, reliance on controls that lack precision or controls that rely on other controls). Other audit areas that require improvement include the assessments of, and responses to, risks of material misstatement, accounting for estimates, including fair value measurements, and the implementation of AS 18 (related parties).

The staff indicated that the 2017 inspections will likely focus on the recurring audit deficiencies noted above, audit firm efforts related to the implementation of new accounting standards, including how independence is being maintained and monitored, audit areas impacted by economic trends and higher financial reporting risk (e.g., fluctuations in oil and gas prices), going concern evaluations, and multi-national audits, including mandatory auditor rotation, among other areas. Additionally, the staff indicated they will be gathering information related to auditor consideration of a registrant's non-GAAP measures.

ABOUT BDO USA

BDO is the brand name for BDO USA, LLP, a U.S. professional services firm providing assurance, tax, advisory and consulting services to a wide range of publicly traded and privately held companies. For more than 100 years, BDO has provided quality service through the active involvement of experienced and committed professionals. The firm serves clients through more than 60 offices and over 500 independent alliance firm locations nationwide. As an independent Member Firm of BDO International Limited, BDO serves multi-national clients through a global network of 67,700 people working out of 1,400 offices across 158 countries.

BDO USA, LLP, a Delaware limited liability partnership, is the U.S. member of BDO International Limited, a UK company limited by guarantee, and forms part of the international BDO network of independent member firms. BDO is the brand name for the BDO network and for each of the BDO Member Firms. For more information please visit: www.bdo.com.

Material discussed is meant to provide general information and should not be acted on without professional advice tailored to your firm's individual needs.

© 2017 BDO USA, LLP. All rights reserved.

CONTACT US

CHRISTOPHER TOWER
National Managing Partner -
Audit Quality and Professional Practice
714-668-7320 / ctower@bdo.com

BRANDON LANDAS
National Assurance Partner
312-233-1887 / blandas@bdo.com

JEFF LENZ
National Director - SEC Practice
312-616-3944 / jlenz@bdo.com

PAULA HAMRIC
National Assurance Partner
312-616-3947 / phamric@bdo.com

FIRST NAME

LAST NAME

EMAIL

PHONE

SUBJECT

MESSAGE

SUBMIT

People who know, know BDO.[SM]

JANUARY 2016
www.bdo.com

THE NEWSLETTER FROM BDO'S NATIONAL ASSURANCE PRACTICE

BDO KNOWS: SEC

THE 2015 AICPA SEC AND PCAOB CONFERENCE

The annual AICPA National Conference on Current SEC and PCAOB Developments was held on December 9-11, 2015 in Washington, DC, where representatives of the Securities and Exchange Commission and the Public Company Accounting Oversight Board shared their views on various accounting, reporting, and auditing issues. The remarks made by SEC Chair Mary Jo White and members of the Office of the Chief Accountant are available on the SEC's website, www.sec.gov, under News/Speeches.

OVERVIEW

In Chair White's opening remarks, she noted that the United States capital markets require "reliable and relevant financial information that investors can use to make informed investment decisions." The shared responsibility of preparers, auditors, audit committees, standard setters and regulators to ensure high-quality financial reporting was a theme that resonated throughout the conference. To achieve the goal of reliable and relevant financial information for investors, several topics from previous years received expanded focus.

The SEC's disclosure effectiveness project gathered momentum during 2015. The comprehensive review of Regulation S-K and S-X requirements, as well as other registrant and audit committee disclosure requirements, remains a significant priority of the SEC,

CONTENTS

click a topic for details

OVERVIEW **1**
DISCLOSURE EFFECTIVENESS **2**
INTERNAL CONTROL OVER FINANCIAL REPORTING **2**
REVENUE RECOGNITION **3**
IFRS FOR U.S. ISSUERS **4**
ACCOUNTING ISSUES **4**
Discontinued Operations 4
Share-Based Awards: Post-Vesting Restrictions 5
Defined Benefit Plan Considerations 5
Revenue Recognition: Customer Incentives 6
Consolidation and Variable Interests: Fees Paid to Decision-Makers 6
Allowance for Loan Losses 7
Fair Value Measurements 7
Other Accounting Issues 8
DISCLOSURE MATTERS **9**
Non-GAAP Measures 9
Segments 9
Income Taxes 10
Predecessor Financial Statements 10
Restatements 11
AUDIT COMMITTEES **11**
INTERNATIONAL ISSUES **11**
Venezuela 11
Cross-Border Transactions 12
Foreign Private Issuers 12
AUDITING ISSUES **13**
Going Concern Evaluations 13
Inspections 13
CONTACT **13**

and the staff continued to emphasize actions registrants can take now to improve their disclosures. Conversations about IFRS reporting alternatives for U.S. registrants continued. Additionally, the importance of the design and operation of effective internal control over financial reporting (ICFR), as well as the auditing of ICFR by audit firms, was a pervasive topic of discussion.

The discussion around the new revenue recognition standard, ASC 606, continued its shift toward implementation and transition issues. Regulators have expressed growing concern over the state of many registrants' readiness for adoption of this standard. Efforts to gain an understanding of the accounting impact of the standard and to identify necessary changes or additions to internal controls may require a significant allocation of resources – both human and financial.

The following comments provide additional insight into the SEC and PCAOB staff positions on these and other accounting, reporting, and auditing practice issues. Our companion publication, *SEC Year in Review – Significant 2015 Developments*, discusses SEC and PCAOB rulemaking, standards setting and related staff activities during 2015.

DISCLOSURE EFFECTIVENESS

Disclosure "overload" resulting from many duplicative and irrelevant disclosure requirements remains a focus of the SEC staff. During 2015, the staff continued the momentum of their disclosure effectiveness project. This undertaking includes a comprehensive review of the existing disclosure requirements within Regulations S-K and S-X. The goal of the project is to streamline disclosures where possible, identify new disclosures that may provide enhanced transparency, and provide investors with the information that is most useful. The staff solicited comments on certain Regulation S-X requirements during 2015 and continues to accept feedback.

The staff has started its review of Regulation S-K requirements. The staff acknowledged that certain requirements may be outdated and, therefore, their efforts are focused on developing an appropriate balance between prescriptive (e.g., number of employees) and principles-based disclosure requirements. Redundant disclosures, scaled disclosure requirements for EGCs, and relocating industry disclosure requirements from the industry guides to Regulation S-K are additional areas that will receive the staff's attention.

The Regulation S-X request for comment and the disclosure effectiveness project are discussed in our SEC Year in Review newsletter.

While the staff continues its work, it encourages registrants to re-evaluate existing disclosures, considering them from the perspective of a reasonable investor. Many disclosures, including those previously added as part of the SEC comment letter process, may no longer be applicable or may be immaterial to a registrant's current situation. Reducing the complexity of disclosures as well as eliminating unnecessary, immaterial and duplicative disclosures will result in more focused and effective disclosures. Similarly, certain areas, such as foreign tax disclosures, may require expanded disclosures to be clear and understandable. Enhancing these disclosures may require a discussion beyond the basic reporting requirements in order to provide investors with an understanding of material financial information.

INTERNAL CONTROL OVER FINANCIAL REPORTING

ICFR was a recurring topic throughout the conference, with a number of SEC representatives devoting portions of their prepared remarks to ICFR. Chair White set the tone early in her keynote address stating, "it is hard to think of an area more important than ICFR to our shared mission of providing high-quality financial information that investors can rely on." The SEC believes the ICFR requirements under the Sarbanes-Oxley Act have resulted in improved controls and financial reporting, both of which protect and benefit investors. Representatives of the SEC and the PCAOB also acknowledged the ongoing challenges faced by auditors and registrants with respect to the level of work and documentation required to support the assertion that controls (particularly management review controls) are operating effectively and adequately tested. They do not believe that PCAOB Auditing Standard No. 5 requires a greater level of documentation than called for by the SEC's guidance for management. They believe the requirements are aligned. They also emphasized the need for sufficient management documentation to comply with the books and records provisions of the Securities Exchange Act of 1934 as well as to facilitate auditing of ICFR.

Deficiencies in auditing ICFR continue to be one of the most frequent findings in PCAOB inspections. SEC Chief Accountant James Schnurr indicated that inspection findings should concern both auditors and registrants as evidenced by his statement that "ICFR issues identified by the PCAOB may not be just a problem of audit execution. Rather, they may, at least in part, be indicative of deficiencies in management's controls and assessments."

The SEC staff reminded registrants and auditors of the importance of properly identifying and evaluating the severity of control deficiencies, including understanding the complete population of transactions the control is intended to cover. A deficiency in ICFR that results in a reasonable possibility (likelihood) of a material misstatement (magnitude) is considered a material weakness. As such, a careful analysis of deficiencies must consider known errors as well as reasonably possible misstatements (the “could factor”). Significant judgment is required when evaluating the magnitude of a control deficiency and consideration of the “could factor” should not be an afterthought.

Signs of improvement have been noted. For example, the staff pointed out that the identification and reporting of material weaknesses that were not accompanied by a material misstatement have increased for the second straight year.

An ongoing consideration of internal controls is required, especially when implementing new accounting standards and policies, such as the new revenue recognition standard. Existing controls may no longer be appropriate and new or re-designed internal controls may need to be implemented. A registrant’s control environment should not be stagnant and should be responsive to changes in operations and risks. The staff also provided a reminder that the quarterly obligation to disclose material changes in ICFR may require disclosure of changes made as systems are changed in advance of adopting a new standard.

In response to a question on the continued use of the 1992 COSO framework (as opposed to the updated 2013 COSO framework) by a registrant to assess ICFR, the staff indicated that the use of the 1992 framework is not prohibited. However, the staff questioned the use of a framework that is no longer supported by COSO. The staff also stated that if a service provider is using the 1992 COSO framework while the registrant is using the 2013 COSO framework, disclosure would be expected and the registrant should question the reasons why the service provider is using the outdated framework.

REVENUE RECOGNITION

The new revenue recognition standard, ASC 606, was issued in May 2014, representing a significant achievement in the convergence efforts of the FASB and the IASB. Since that time, implementation and transition issues have become a priority. The SEC staff provided insight into the SEC’s monitoring of the transition activity related to the new standard. Because the new principles-based revenue standard will replace nearly all existing revenue guidance, including industry-specific guidance, all companies will experience some degree of change (which may include new business processes, systems and controls; additional estimates and judgments; and expanded disclosures). The staff’s primary areas of focus are the readiness of registrants and identifying and addressing issues that could cause potential diversity in practice prior to implementation.

The staff observed that successful implementation requires sufficient preparation and resources (both human and capital) and quoted a recent survey that indicated that the overall state of readiness may be lagging (75% of responding companies stated that they had not completed their initial impact assessment, a third of which had not even begun their assessment). As a result, the staff urged registrants to consider the need to step up their efforts. The staff observed that some companies taking a “bottoms-up” approach, which typically involves: 1) identifying individual revenue streams and contracts; 2) reviewing historical accounting policies and practices; and 3) identifying any differences that may result from applying the requirements of the new standard to those arrangements, have achieved good results.

The staff emphasized the importance of a continuing global transition resource group process, collaboration among industry groups (including those formed by the AICPA) and candid discussions among audit committees, management and auditors in order to foster comparability between domestic registrants that file under U.S. GAAP and foreign private issuers that file under IFRS.

Staff Accounting Bulletin Topic 11.M requires registrants to discuss the potential effects of adoption of recently issued accounting standards in registration statements and reports filed with the Commission. The staff expects more detailed disclosures about the expected effect the new standard will have as adoption of the standard gets closer. A registrant should disclose what they know as soon as they know it, including the expected adoption date and method. To the extent information remains unknown, a registrant may consider advising investors when the registrant’s assessment is expected to be completed.

In addition to the effect on the financial statements, the adoption of ASC 606 could affect a registrant's filing requirements. For instance, Item 11(b) of Form S-3 requires inclusion or incorporation by reference of restated financial statements in a new or amended registration statement if there has been a change in accounting principles where such change requires a material retroactive restatement of financial statements. Therefore, registrants that adopt ASC 606 using the full retrospective method would be required to recast their financial statements at the time they file a registration statement, rather than later, when they file their first Form 10-K reflecting the adoption.

In this situation, an additional year of financial statements would be revised in the registration statement. The staff emphasized that the requirements in Item 11(b) are clear and changes to those requirements would require rulemaking by the Commission. However, the staff indicated that they will continue to look at this issue and consider thoughts and suggestions.

The staff is focused on easing some of the burden of retrospective adoption, where possible. The staff previously stated publicly that selected financial data would only need to be revised for the periods covered by the financial statements included in a filing. Also, Rule 3-09 of Regulation S-X requires separate annual financial statements of an equity method investee to be provided if certain significance thresholds are met during the fiscal years presented in the registrant's financial statements. Additional staff guidance is expected with respect to the application of Rule 3-09. The guidance is expected to allow a registrant to continue to use its pre-transition significance tests for the years prior to the adoption of the standard.

IFRS FOR U.S. ISSUERS

Further use of IFRS in the United States continues to be a topic of discussion. Foreign private issuers have been permitted to include financial statements prepared in accordance with IFRS, as issued by the IASB, in SEC filings without a reconciliation to U.S. GAAP since 2007. Since that time, the number of registrants filing IFRS financial statements has grown to over 500, causing IFRS to become a significant focus of the SEC.

Chief Accountant Schnurr indicated that an alternative, which would allow domestic registrants to voluntarily provide IFRS-based information as a supplement to their U.S. GAAP financial statements without requiring a reconciliation of that information to U.S. GAAP or requiring that information to be audited, is being considered. Any supplemental IFRS-based information would be considered non-GAAP information, so the SEC's rules would require that it be reconciled to U.S. GAAP. Avoiding the reconciliation requirement as contemplated under this alternative would require rulemaking by the SEC. Chair White stated that the commissioners will discuss this alternative with the staff and consider whether to move forward with a rulemaking proposal.

The staff discussed the benefits of a single set of global accounting standards. Chair White recognized the continued progress that has been made by the FASB and the IASB in the convergence of U.S. GAAP and IFRS, with the new revenue recognition standard being a prime example. The FASB and IASB were urged to maintain their commitment to collaboration and to strive for aligned, high-quality global standards, where practical.

ACCOUNTING ISSUES

The SEC staff shared its views on various accounting issues.

DISCONTINUED OPERATIONS

Prior to the revised guidance in ASC 205-20, there were concerns about the number of dispositions that resulted in discontinued operations presentation. The SEC staff believes that the revised guidance will result in a more meaningful presentation. Under the revised guidance, a component (or group of components) that is disposed of or classified as held for sale is a discontinued operation if the disposal represents a strategic shift that has (or will have) a major effect on an entity's operations and financial results. The determination of whether a strategic shift has occurred requires judgment and ASC 205-20 provides examples to assist with this evaluation. However, the staff stressed that the quantitative thresholds in these examples do not establish bright lines or safe harbors.

The staff believes that an issuer must perform a thorough evaluation of the totality of quantitative and qualitative evidence, rather than relying on any single financial metric, when assessing whether financial results have a major effect on a company's financial results. Revenues, total assets and net income are prominent financial metrics that should be contemplated. Other metrics that a registrant has used on a consistent basis to communicate its operating and financial results may be relevant from an investor's perspective. The impact of a metric on current, historical and forecasted results should be considered as well. The staff highlighted that no single financial metric is determinative.

Qualitative evidence, such as the prominence and consistency of disclosures related to the disposed entity in periodic filings, should also be weighed. A disposition with lesser significance using quantitative metrics requires more substantial qualitative evidence to support discontinued operations presentation.

SHARE-BASED AWARDS: POST-VESTING RESTRICTIONS

Certain share-based awards have provisions that prohibit the sale of the underlying shares for a period of time subsequent to vesting. ASC 718-10-30-10 indicates that these post-vesting restrictions should be considered when estimating the grant date fair value of a share-based award. The SEC staff noted that assumptions used in the valuation of a share-based payment arrangement, including any discount resulting from the post-vesting restriction of shares, should be based on market participant attributes as opposed to attributes of the individual holding the award.

Although post-vesting restrictions must be considered, the staff does not expect any resulting discount in the grant date fair value to be significant. This line of thought is consistent with ASC 718-10-55-5, which states that "…if shares are traded in an active market, post-vesting restrictions may have little, if any, effect on the amount at which shares being valued would be exchanged."

DEFINED BENEFIT PLAN CONSIDERATIONS

The SEC staff discussed the following acceptable approaches for developing discount rates used to calculate interest costs for single-employer defined benefit plans:

- Single weighted average approach – Under this approach, the plan sponsor determines the pension benefit obligation (PBO) at the measurement date by discounting the projected future benefit payments at the individual duration-specific rates forecast for the time of the projected payments. The single weighted average discount rate calculated by the plan sponsor represents the rate that discounts the projected benefits payments to a present value amount that equals the PBO. Plan sponsors commonly use this weighted-average discount rate to determine the annual interest costs for defined benefit plan reporting under ASC 715.

- The "spot rate" or yield curve approach – The plan sponsor determines the PBO in the same manner as in the single weighted average approach. However, the plan sponsor uses the individual, duration-specific ("spot") rates from the yield curve to calculate annual interest costs.

Both approaches result in the same PBO based on the use of an identical yield curve, but the interest costs differ. The staff did not object to a sponsor changing from the use of the single weighted average approach to the spot rate approach in a recent consultation. In that consultation, the staff also did not object to the registrant accounting for the change as either a change in estimate or as a change in estimate inseparable from a change in accounting principle.

Some plan sponsors have determined their PBO and discount rates by developing a hypothetical portfolio of actual bonds with cash flows that match the projected future benefit plan payments. The staff shared some observations for registrants who are assessing whether it is permissible for a sponsor to change from a hypothetical bond matching approach to a yield curve approach to measure the benefit obligation.

The staff recognized that the measurement of the benefit obligation and the determination of interest costs are integrated concepts. However, the measurement of the pension obligation is the relevant starting point in applying the pension accounting model. The pension accounting guidance requires the use of the best rate for which the PBO could be effectively settled. As such, the staff noted that changes in methodology should only occur if, and to the extent that, the alternative market information results in better information for measuring the benefit obligation. The staff further advised that a change in the approach to developing discount rates for interest cost would not seem persuasive enough for a sponsor to change to a different source of market information for measuring the PBO. Registrants should consider prior arguments for changing from a yield curve to a bond matching approach to value the PBO before returning to a yield curve approach.

The staff has also observed the presentation of pension-related adjustments within non-GAAP disclosures. The staff emphasized that a registrant should provide clear labels and descriptions for these adjustments (i.e., actuarial gain or loss, cash contributions) rather than simply labeling the amount as a "pension adjustment." Additionally, sponsors generally settle pension obligations in cash and consequently, registrants should not describe pension-related adjustments within a non-GAAP measure as "non-cash."

REVENUE RECOGNITION: CUSTOMER INCENTIVES

ASC 605-50 provides that all payments to customers should be considered, including other parties in the vendor's distribution chain (e.g. customers of customers), in determining the proper classification of payments in the statement of income. Due to certain business models that have proliferated since ASC 605 was written, questions have arisen in practice regarding how the customer incentive guidance should be applied when evaluating whether payments made by a vendor outside the distribution chain should netted against revenue. The staff noted that reasonable judgment is required when evaluating whether net revenue accounting is appropriate while acknowledging that in certain fact patterns, companies may view those payments as an expense not subject to ASC 605 (i.e., "gross"). Careful consideration should be given as to whether: 1) the vendor was in substance granting a broad pricing concession to its customers; 2) there was a contractual requirement to pass along consideration to a direct customer's customer; and 3) whether the vendor was acting as an agent of its customer in passing through consideration to a direct customer's customer. Regardless of whether a registrant reports vendor payments on a gross or a net basis, clear disclosure of a registrant's presentation policy, assumptions and alternatives remains critical to the decision usefulness of the financial reporting.

CONSOLIDATION AND VARIABLE INTERESTS: FEES PAID TO DECISION-MAKERS

In early 2015, the consolidation guidance in ASC 810 was amended in response to concerns about the consolidation of certain legal entities. The changes primarily affect the consolidation of limited partnerships and their equivalents. The amendments also apply to the evaluation of fees paid to decision-makers as well as the effect of fee arrangements and related parties on the primary beneficiary determination.

The SEC staff provided insight into the application of the revised guidance for fees paid to a decision maker. A registrant is required to determine whether it has a variable interest in an entity that is being evaluated for consolidation. There are many types of variable interests, including certain fees paid to a decision maker (or a service provider). The revised guidance eliminated three of the six criteria that existed for evaluating whether these fees represent a variable interest. Under the amended consolidation guidance, fees paid to a decision maker would represent a variable interest unless all of the following three conditions are satisfied and there is no principal risk of loss:

- The fees are compensation for services provided and are commensurate with the level of effort required to provide those services.
- The decision maker or service provider does not hold other interests in the VIE that individually, or in the aggregate, would absorb more than an insignificant amount of the VIE's expected losses or receive more than an insignificant amount of the VIE's expected residual returns.
- The service arrangement includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length.

The evaluation of whether fees paid to a decision maker are customary and commensurate requires careful consideration and reasonable judgment. Benchmarking of the key characteristics of an arrangement against other arrangements negotiated at arm's length by the decision maker or market participants may be one method used to evaluate the terms, conditions and amounts included in arrangement. The staff stated that a decision maker should also carefully consider whether any terms, conditions or amounts would substantively affect the decision maker's role as an agent or service provider to the other variable interest holders in an entity.

Related party interests, including whether those related parties are under common control with the decision maker, also impact the consolidation analysis. The staff observed that a decision maker fee, which is not otherwise deemed to be a variable interest (i.e., the conditions above have been satisfied), should not be considered a variable interest solely because an investor under common control with the decision maker has a variable interest that would absorb more than an insignificant amount of variability. Additionally, the staff advised that the separation of power from the economics within an entity designed by a controlling party in a common control group for the purpose of avoiding consolidation would be viewed as a non-substantive separation.

Our flash report located here further discusses the three criteria for evaluating fees paid to a decision-maker and the notion of a principal risk of loss.

ALLOWANCE FOR LOAN LOSSES

The allowance for loan losses is one of the most significant estimates in the financial statements of a financial institution. This allowance should represent management's best estimate of probable incurred credit losses as of the reporting date. For auditors, this allowance often represents a significant risk of material misstatement due to the judgments and complexity involved in the determining the estimate. The continued number of PCAOB inspection findings related to the allowance for loan losses caused the SEC staff to direct registrants and their auditors to the requirements outlined in Staff Accounting Bulletin No. 102 – Selected Loan Loss Allowance Methodology and Documentation Issues (SAB 102). SAB 102 establishes expectations for management related to the development, documentation and application of a systematic methodology over the allowance for loan loss estimate.

Management review controls over the estimation process are critical. However, transactional or activity level controls would typically also be needed in order to satisfy the requirements of SAB 102. For instance, the relevance, reliability and sufficiency of source data, a critical component in estimating the allowance, must be considered and subjected to effective internal controls. The level of precision required to ensure that a material misstatement is identified would typically not be sufficient at the management review level.

Allowance adjustments require an adequate understanding of the data, and the methods and judgments applied to that data, currently being used in a registrant's loss estimation model. Factors that are not captured in the historical loss component of the allowance model are considered when making an allowance adjustment. These factors can include changes in underwriting standards, lending policies, economic trends and concentrations. SAB 102, specifically question 9, establishes the expectation that these factors be considered by management, and documentation should indicate which factors are used in the analysis and how the loss measurement was impacted as a result. Registrants should maintain documentation of the sufficient, objective evidence used to support the amount of an adjustment and to explain why the adjustment was necessary.

FAIR VALUE MEASUREMENTS

Fair value measurements and the related disclosures require significant judgment and remain a focus of the SEC staff. The principal or most advantageous market must be considered when measuring the fair value of an asset or liability. ASC 820 states that a fair value measurement assumes that the transaction to sell an asset or transfer a liability will take place in the principal market, or if there is no principal market, the most advantageous market. The principal market has the greatest volume and level of activity for the asset or liability. The most advantageous market is defined as the market that maximizes the amount that would be received to sell the asset or minimizes the amount that would be paid to transfer the liability, after considering transaction and transportation costs. Further, a registrant must have access to the principal or most advantageous market at the measurement date in order to use it in determining fair value.

The staff identified certain common characteristics to consider when relying on observable pricing inputs as part of the fair value measurement of an asset or liability. While a registrant may not be prevented from using observable prices as one input in a fair value measurement, adjustments may be required. For instance, a registrant may not be able to access a particular market price if the registrant needs to transform the asset or liability in some way to match the asset or liability in the observable market. Other factors to consider include any restrictions unique to the registrant that are not contained in the observable market asset or liability as well as any marketability or liquidity differences in the observable market relative to the registrant's asset or liability. When determining the principal or most advantageous market, the staff advised registrants to consider the initial transaction and whether the market for that transaction was different than the principal or most advantageous market.

The use of a transaction price as fair value was discussed by the staff, who noted that they have observed registrants use this initial cost basis for a period of time following the transaction when valuing illiquid assets or liabilities. Fair value is an exit price concept (based upon an orderly transaction between market participants to sell or transfer an asset or liability at the measurement date under current market conditions). Therefore, the transaction price generally does not represent fair value subsequent to the acquisition date as it is unlikely that market conditions are identical at the subsequent measurement date. Changes in current market conditions (i.e., interest rates, make up of market participants, change in expected cash flows) from those at the time the asset was acquired or liability was assumed impact the fair value. In addition to changes in market conditions, the fair value may be different as a result of changes in time value from the initial transaction to the measurement date or inclusion of transaction costs in the original value. A registrant should also consider incorporating observable market prices or observable prices of a comparable asset or liability, to the extent they exist. Quantitative and qualitative evidence supporting a fair value measurement may be applied directly or indirectly to a valuation model.

The staff also discussed fair value disclosures. Disclosures should be appropriately disaggregated by class. The staff has observed improper aggregation of investment types, pointing out that investments with different risks and characteristics should not be aggregated into the same class (e.g., U.S. treasury securities and collateralized debt obligations should not be aggregated). The staff also stressed the importance of detailed disclosures of the actual valuation techniques used during the periods presented for specific assets and liabilities as well as the inputs used within those fair value models. Boilerplate language such as "valued by a third party specialist" or "valued using the income approach" would not provide sufficient detail.

The staff stressed management's responsibility for internal controls over financial reporting covering all fair value measurements, including illiquid assets and liabilities, whether they be estimated internally by management or by using a third party service provider.

OTHER ACCOUNTING ISSUES

Additionally, consistent with prior years, a panel of technical partners from the national offices of the large accounting firms discussed a number of current practice issues. Some of the current "hot topics" discussed were:

- Statement of Cash Flows – Consistent with statements made by the SEC staff, classification and presentation issues on the statement of cash flows are one of the most common causes of restatements. The panel noted that many presentation issues result from problems with a registrant's systems and processes as well as deficiencies in the associated controls surrounding this financial statement.

- Liability vs. Equity Classification – The complexity of contracts and other agreements often contribute to practice issues in this area. Financial instruments must be evaluated in the context of ASC 480 and ASC 815 to assess whether the instrument should be considered a liability or equity. One recent example noted by the panel related to warrants sold as part of a registered offering. Generally, the underlying shares must also be registered when the warrant is exercised. As the events or actions necessary to deliver registered shares are not considered to be under a registrant's control, ASC 815 presumes that the registrant would be required to net-cash settle the contract, resulting in liability treatment for these instruments. However, there have been recent instances of warrants issued in a registered offering that require a cashless exercise in the event that the underlying shares are not registered at the exercise date. In this instance, a registrant may not be required to settle in cash, which could result in equity classification. Each evaluation requires careful consideration of the specific facts and circumstances, including relevant laws and legal views, as well as consultation with the staff, where necessary.

- Debt Modification vs. Extinguishment – Debt may be renegotiated for a variety of reasons, resulting in amendments to the loan agreement. The guidance requires a registrant to assess whether these amendments result in a modification or an extinguishment for accounting purposes. Under ASC 470, a comparison of the present value of the remaining cash flows and the present value of the cash flows under the new loan agreement is required, with a difference in excess of 10% resulting in an extinguishment. Historically, there have been two acceptable approaches used in this calculation, the net method and the gross method. The cash flow comparison under the net method uses the lowest principal balance common to the old and new debt (e.g., if the old debt balance was $10 million and the amended loan agreement provides an additional $2million – $12 million in total – then the cash flows related to $10 million would be used in the comparison). The gross method would compare the cash flows of the entire amount of borrowings before and after the amendment (e.g., compare the cash flows related to the $10 million old debt to cash flows related to the $12 million amended debt in the previous example). The panel noted that practice has evolved such that only the gross method should be used.

- Contingent Consideration in a Business Combination – Contingent payments to employees or selling shareholders may constitute contingent consideration for a business combination or compensation. This analysis requires an assessment of various factors and a detailed understanding of the transaction documents. The panel highlighted one practice issue related to contingent payments to an employee. When two events must occur in order for an employee to receive the payment it is referred to as a "double trigger." For example, under an employment agreement, an employee of a target may be entitled to a payment of $100,000 if 1) the target is acquired and 2) the employee is terminated by the acquirer within six months of the acquisition. Since both events must occur for an employee to receive a payment and the termination is an event triggered by the acquirer, this contingent payment would typically be recorded as compensation expense rather than contingent consideration.

- Consolidation and Push-Down Accounting Matters – The panel discussed the impact of non-cash contributions of assets. If a registrant contributes non-cash assets meeting the definition of a business in exchange for non-controlling equity interests in the receiving entity, ASC 810 would require deconsolidation of the business by the registrant and the equity investment would be recorded at fair value, often resulting in a gain or loss. Alternatively, a registrant must consider if other guidance applies (such as ASC 970 for real estate or ASC 845 for other nonmonetary transactions), when the non-cash assets are not a business. Additionally, a non-cash contribution of assets or

businesses between entities under common control would require the receiving entity to record the transaction at the parent's basis. The 2014 amendment to ASC 805, which made pushdown accounting optional for registrants, did not change this requirement. However, if a newco is involved and is deemed to be the acquirer, that entity would be required to apply the accounting for business combinations.

DISCLOSURE MATTERS

NON-GAAP MEASURES

Registrants often choose to use non-GAAP measures in order to provide further insight to investors. Non-GAAP measures were highlighted as an area of concern and focus for Chair White and the SEC staff given the extensive use of such measures and the potential for confusion. Chair White urged registrants to think critically about these disclosures, including a consideration of why the non-GAAP information is presented, how it provides useful information to investors (not to management), whether information is described accurately and completely, and whether appropriate internal controls over the calculation of non-GAAP measures are in place.

The staff monitors filings to ensure that non-GAAP disclosures comply with the requirements of Regulation G and, if applicable, Regulation S-K, Item 10(e). Non-GAAP disclosures should be presented consistently and be given no greater prominence than GAAP measures. Also, non-GAAP measures and related adjustments require clear labeling to ensure the information is not misleading. A registrant should exercise caution when describing non-GAAP measures to ensure that accounting terms are not used when the appropriate accounting definitions are not met.

SEGMENTS

Segment disclosures have been, and continue to be, a point of emphasis for the SEC staff as well as the PCAOB. The views presented by the staff built on the statements communicated last year. The staff relayed several observations from their consultations with registrants and filing reviews.

Some registrants have argued that segment disclosures may be "competitively harmful' or "misleading" during consultations with the staff. The staff commented that these statements are "troubling" and not persuasive. Rather, registrants should identify which information is useful to investors, why it is important, and how to appropriately report that information.

Certain principles and objectives within the segment reporting guidance were highlighted as reminders to consider during an analysis of segment disclosures.

- Chief operating decision maker (CODM) – The CODM is the individual who makes key operating decisions and may be someone closer to the day-to-day operations (e.g., it may not be a CEO, whose focus is on strategic decisions). A registrant should not default to the individual with ultimate decision-making authority as the CODM.

- Operating segments – A registrant should periodically reassess the identification of operating segments, specifically when there are changes in an organizational structure, key personnel, or significant acquisitions and dispositions.

  A periodic reporting package provided to the CODM and a registrant's organizational structure often provide insight into how the entity has been organized for purposes of making decisions and assessing performance. The staff cautioned that neither is determinative on its own. Consideration should also be given to factors such as the basis on which budgets and forecasts are prepared and the basis on which executive compensation is determined.

  On occasion, the application of the accounting standard may result in a single operating segment. The staff believes a registrant should disclose that resources are allocated and financial performance is assessed on a consolidated basis in addition to explaining the basis for such a management approach. Similarly, a description of the business as being diversified across businesses or products would not be consistent with an aggregated management approach.

  The staff also stated that discrete financial information does not have to include the allocation of all costs, such as general and administrative costs. For instance, if an analysis of gross profit is provided to the CODM, that is sufficient discrete financial information.

- Aggregation of operating segments – Aggregation is only appropriate if all of the following criteria are met: (a) aggregation is consistent with the underlying principle in the standard, (b) operating segments have similar economic characteristics, and (c) operating segments are similar in each of five specific areas.

  When considering aggregation of two or more operating segments, a registrant should consider whether a reasonable investor would find these segments similar. The importance of the first criterion, that aggregation must be consistent with the principles in ASC 280, is often overlooked by registrants. The staff also stated that economic similarity (e.g., similar margins) does not matter if operating segments are qualitatively different. Further, an expectation of similar economic characteristics in the future does not outweigh a lack of similarity in current and past economic performance.

The staff stressed that an effective design and operation of internal controls is necessary to support the inherent judgments needed in segment reporting.

In the event that the staff disagrees with a registrant's segment disclosures, the staff indicated that they will generally not object to a prospective presentation of the amended segment disclosures (i.e., in future filings). However, if the change to segment reporting would materially impact goodwill impairment in the historical period, a restatement would be required.

INCOME TAXES

The complexity of income taxes, especially when foreign jurisdictions are involved, often requires a registrant to provide expanded disclosures in order to paint a clear and transparent picture to investors. The SEC staff called attention to the need for continued improvement in income tax disclosures in the footnotes to the financial statements and in MD&A, specifically mentioning disclosures related to indefinitely reinvested foreign earnings and the income tax rate reconciliation.

When a registrant has asserted that foreign earnings are indefinitely reinvested and the registrant also maintains significant cash balances in foreign jurisdictions which would create a tax liability if repatriated, the staff has requested those registrants to disclose the amount of cash held overseas in the liquidity section of MD&A. The disclosure of foreign cash balances would highlight the amount of cash that is not available for U.S. operations.

The staff has historically observed that additional disclosures with respect to foreign earnings, such as taxes and tax rates by jurisdiction, may help investors understand a registrant's consolidated tax position. Consistent with these past observations by the staff, the FASB reached tentative disclosure decisions during 2015, which would require additional disaggregated disclosures by jurisdiction. The FASB continues to evaluate these tentative decisions for inclusion in future proposed accounting standards.

The staff also suggested that linking the income tax rate reconciliation to the qualitative discussion may help reduce confusion. A registrant should consider each component of the reconciliation and explain one-time or other significant events and their current and future impact on the effective tax rate in the results of operations section of MD&A. To the extent that a component is impacted by multiple factors, such as a "foreign tax rate differential," a disaggregated reconciliation may be a more meaningful presentation in the footnotes to the financial statements.

PREDECESSOR FINANCIAL STATEMENTS

When a registrant succeeds to substantially all of the business of another entity and the registrant's own operations before the succession appear insignificant relative to the operations assumed or acquired, an acquired business would be considered a predecessor. Certain transactions, such as carve-outs, put-together transactions, and spin-offs, may require the presentation of predecessor financial statements and other financial information, such as MD&A and selected financial data. Predecessor financial statements must be full financial statements audited in accordance with PCAOB standards in accordance with Rules 3-01 and 3-02 of Regulation S-X. These requirements for a predecessor are more comprehensive than the financial statement requirements of an acquiree under Rules 3-05 and 3-14 of Regulation S-X.

The SEC staff stated that it would be rare not to have a predecessor, even when a newly formed company is considered substantive and deemed to be the accounting acquirer. The identification of more than one predecessor is also possible. The staff also offered the following non-exclusive list of factors to consider when determining a predecessor:

- Order in which entities are acquired
- Size of the entities
- Fair value of the entities
- Ongoing management structure

RESTATEMENTS

The three most commonly identified topics in restatements are liability/equity accounting, statement of cash flows classifications, and income tax accounting. The SEC staff noted that the restatements were generally a result of misapplication of the standards as opposed to misinterpretations of the standards. A continuous assessment of a registrant's resources, competence and availability of training programs to support high quality financial reporting was suggested by the staff.

AUDIT COMMITTEES

Chair White and the SEC staff discussed the critical role that audit committees play in the financial reporting process. There are growing concerns about the amount of work placed on some audit committees. Audit committee workloads continue to expand beyond the duties required by the SEC and the listing exchanges, which include the selection and oversight of independent auditors, oversight of management's design and implementation of internal controls, establishment of an appropriate system for complaints about accounting, and reporting to shareholders. It is common for audit committees to assume additional roles for entity risks such as cybersecurity. Additionally, Chair White questioned the effectiveness of directors that serve on multiple boards and multiple audit committees. Audit committees should take care to ensure members have the requisite time and experience.

Auditor independence – in both fact and appearance – is critical to safeguarding an auditor's objectivity and providing credibility to the financial statements. The staff believes that auditors, management, and audit committee members all share responsibility for auditor independence. Consistent with prior years, the staff encouraged management and audit committee members to consider whether appropriate policies and procedures are in place (and consistently executed) to thoroughly evaluate threats to auditor independence from any potential non-audit services. Any proposed non-audit service should be evaluated against the four principles in Rule 2-01(c) and ongoing monitoring policies should be in place to ensure that expansions or changes in services ("scope creep") do not result in impermissible services that would impair auditor independence.

The staff also noted that in connection with the implementation of the new revenue recognition standard, or any other standard, an auditor may provide guidance about the proper application of accounting principles, including important factors to be considered in making judgments that may become critical in the accounting process, without violating the Commission's independence rules. However, registrants must take responsibility for accounting decisions and policies as well as internal controls. An auditor must avoid auditing his/her own work and acting as management, such as having direct involvement in the development of specific revenue recognition policies under the new standard.

INTERNATIONAL ISSUES

VENEZUELA

Venezuela's highly-inflationary economy continues to be in a state of flux. The further decline in oil prices and oil production in 2015 compounded the country's economic struggles. Governmental currency controls have resulted in multiple exchange rates and companies continue to have difficulty accessing U.S. dollars. The SEC staff has previously indicated that, when multiple exchange rates exist, registrants should use the rate that is appropriate to the unique facts and circumstance of the registrant and its transactions for remeasurement purposes. This may result in the use of multiple rates and disclosure of the rates used and basis for selecting such rates should be disclosed.

Additionally, ASC 810 indicates that a majority-owned subsidiary shall not be consolidated if control does not rest with the majority owner – for instance, if the subsidiary operates under foreign exchange restrictions, controls, or other governmentally imposed uncertainties so severe that they cast significant doubt on the parent's ability to control the subsidiary. In accordance with this guidance, some registrants have concluded that they no longer have a controlling financial interest in certain subsidiaries domiciled in Venezuela, resulting in deconsolidation of those subsidiaries. In these instances, careful consideration should be given to whether a deconsolidated subsidiary is a variable interest entity because power may no longer reside with the holders of equity at risk. The staff reminded registrants that they should provide appropriate disclosures about the judgments around, and the financial reporting impacts of, deconsolidation as well as the required disclosures for variable interest entities that are not consolidated.

Further, the staff expects consistency in judgment to be applied in the event that exchangeability improves or governmental restrictions lessen, such that registrants may need to consolidate these subsidiaries again. Internal controls must be in place to allow for continuous reassessment of exchange restrictions and government controls.

CROSS-BORDER TRANSACTIONS

The SEC staff participated in a discussion about considerations in cross-border transactions. In these transactions, the status of a registrant and its target (e.g., U.S. domestic filer, foreign private issuer, or foreign business) are critical to determining the age and basis of financial statements to be provided upon acquisition (Rule 3-05) or as required for an equity method investment (Rule 3-09). A foreign business is defined in Rule 1-02 of Regulation S-X as an entity that is 1) majority-owned (greater than 50%) by persons who are not residents or citizens of the U.S., 2) not organized under the laws of the U.S., and 3) either more than 50% of its assets are located outside the U.S. or the majority of executive officers and directors are not U.S. residents or citizens. If financial statements of an entity that does not qualify as a foreign business are required under Rule 3-05 or Rule 3-09, those financial statements must be prepared under U.S. GAAP or reconciled to U.S. GAAP. Alternatively, financial statements of a foreign business may also be prepared under IFRS, as issued by the IASB, with no reconciliation requirements. In all cases, financial statements of an acquired company cannot be audited under local jurisdictional rules.

The staff noted that they have observed instances where a joint venture was owned 50% by a U.S. investor and 50% by a non-U.S. investor. In this case, the joint venture would not qualify as a foreign business since foreign ownership was not a majority, even if all other criteria were met.

Further, unlike the rules governing foreign private issuers, SEC rules do not specify the date on which the foreign business assessment must be made. Instead, the staff stated that a registrant should use the "date that makes the most sense" (e.g., registration filing date, date of an Item 2.01 Form 8-K, date immediately prior to the acquisition, date of the prior year end, etc.).

For acquisitions, the pro forma financial information is based on the comprehensive body of accounting used by the registrant (e.g., U.S. GAAP, IFRS as issued by the IASB) and the age of financial statements requirements applicable to the registrant. In certain circumstances, pro forma information of a foreign target may be necessary for a period more current than the required historical financial statements. The staff reminded domestic registrants that Regulation S-X permits the use of a combination of periods that involve overlaps or gaps in the information of the target company by up to 93 days as long as the periods are the same length as required by the registrant. For example, assume that upon acquisition of a foreign target in early 2016, a domestic registrant is required to present pro forma information for fiscal year 2014 and the nine months ended September 30, 2015. If the September 30, 2015 interim financial statements of the foreign target are not available because they were not yet required, the registrant could use the combined information for the six months ended June 30, 2015 and the three months ended December 31, 2014 for use in the September 30, 2015 pro forma financial statements (resulting in nine months of information, but excluding information for the three months ended September 30, 2015).

FOREIGN PRIVATE ISSUERS

Foreign private issuers are required to assess their status at the end of the second quarter of their fiscal year. The SEC staff noted that a foreign private issuer will continue to be subject to the foreign private issuer requirements after losing foreign private issuer status until the first day of the subsequent fiscal year. In that subsequent fiscal year, all requirements of a domestic filer would be required (Rule 3-09 financial statements, three years for audits using U.S. GAAP, etc.).

The SEC has not yet approved a XBRL taxonomy for IFRS filers.

AUDITING ISSUES

GOING CONCERN EVALUATIONS

The FASB has adopted a requirement for management to make a going concern evaluation, which is defined differently than in the existing PCAOB standards. The PCAOB staff reminded auditors to continue to follow AU 341, even if the entity being audited adopts the FASB going concern standard early. There has been significant outreach and research into the effectiveness of existing going concern reporting and whether it is giving investors the information they need on a timely basis as well as reconciling the difference in the definition of "substantial doubt" in the auditing and accounting standards.

INSPECTIONS

The PCAOB staff noted that in many respects, the state of audit quality has improved over the last 13 years. The staff also noted the five key areas where improvements were seen: tone at the top, training (including targeted training on complex audit areas), new practice aids and checklists, coaching and support to audit teams and monitoring the quality of work performed. The audit areas that continue to require improvement include internal controls, fair value, revenue recognition, effective remedial action, root cause analysis, consistent execution of a global audit methodology and monitoring of independence.

The staff also indicated that 2016 inspections will likely focus on the implementation of the new Auditing Standard No. 18, recurring audit deficiencies (such as ICFR), segment disclosures, mergers and acquisitions, income taxes, going concern, technology risks (such as cybersecurity), and economic and environmental risks, among other areas.

The staff has historically been barred from performing inspections in certain foreign jurisdictions. PCAOB Chair James Doty cited that progress has been made with respect to these global inspection issues, citing several additional countries that now have bilateral agreements to allow inspection access. The global inspection process continues to be a challenge, particularly in China. The PCAOB continues to negotiate to expand their inspection reach.

ABOUT BDO USA

BDO is the brand name for BDO USA, LLP, a U.S. professional services firm providing assurance, tax, advisory and consulting services to a wide range of publicly traded and privately held companies. For more than 100 years, BDO has provided quality service through the active involvement of experienced and committed professionals. The firm serves clients through 63 offices and more than 450 independent alliance firm locations nationwide. As an independent Member Firm of BDO International Limited, BDO serves multi-national clients through a global network of 1,408 offices in 154 countries.

BDO USA, LLP, a Delaware limited liability partnership, is the U.S. member of BDO International Limited, a UK company limited by guarantee, and forms part of the international BDO network of independent member firms. BDO is the brand name for the BDO network and for each of the BDO Member Firms. For more information please visit: www.bdo.com.

Material discussed is meant to provide general information and should not be acted on without professional advice tailored to your firm's individual needs.

© 2016 BDO USA, LLP. All rights reserved.

CONTACT:

JEFF LENZ
312-616-3944
jlenz@bdo.com

CHRIS SMITH
310-557-8549
chsmith@bdo.com

BRANDON LANDAS
312-233-1887
blandas@bdo.com

Tel: 312-856-9100
Fax: 312-856-1379
www.bdo.com

330 N. Wabash Ave., Suite 3200
Chicago, IL 60611

July 20, 2016

Office of the Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: File No. S7-06-16
Business and Financial Disclosure Required by Regulation S-K

Dear Office of the Secretary:

This letter is the response of BDO USA, LLP to the Concept Release referred to above.

We support the Commission's efforts to analyze the disclosure regime of Regulation S-K and consider ways to improve the requirements for the benefit of investors. We provide our comments based on our experience working with registrants on their filings and from our perspective as auditors. However, we believe that companies and investors are best positioned to provide feedback on the issues raised in the Release, and we urge the Commission to place the most weight on the feedback they provide.[1]

From a broad perspective, we support a principles-based approach to disclosure outside the financial statements. We believe that using a principles-based approach would promote disclosure of information that is most meaningful and relevant. To implement this approach, we believe Regulation S-K should (a) clearly articulate disclosure objectives, (b) provide a list of related topics a registrant should consider discussing and (c) make it clear that the disclosure is only required to the extent necessary to achieve the disclosure objectives. We believe this approach would help preparers assess whether their disclosures are necessary and adequate. For example, a revised disclosure requirement related to a registrant's description of its business could lay out the overall objective of the business section and provide examples of topics to be addressed when relevant and material to the issuer's business (e.g., people, facilities, contracts, regulatory, etc.). We believe this objectives-based approach is likely to result in more useful disclosure than the line item or "check the box" type approach we observe many registrants taking in response to the current S-K disclosure regime. In the same vein, we support the Commission's outreach related to the level of investor sophistication that should be assumed for purposes of disclosure. We believe that clarifying the investor (whether sophisticated or novice) will also help registrants better assess and guide their disclosures.

[1] We also urge the Commission to weigh the comments of investors who own securities more heavily than those of other users, since those investors ultimately pay the cost of providing the information they say they want.

BDO USA, LLP, a Delaware limited liability partnership, is the U.S. member of BDO International Limited, a UK company limited by guarantee, and forms part of the international BDO network of independent member firms.

BDO is the brand name for the BDO network and for each of the BDO Member Firms.

Our comments and recommendations related to specific S-K disclosure items are discussed below.

Item 101 Description of Business

As noted above, we believe the most useful approach to Item 101 would be to identify the overall objective of the disclosure and to provide examples of items that should be discussed to the extent they are relevant to the registrant, such as employment practices, properties, and service contracts that are material to operations, regulatory environment, competitive environment, etc.

In addition, Item 101(c)(viii) requires disclosure of the dollar amount of backlog orders as of a recent date and as of a comparable date in the preceding fiscal year. In many cases, registrants comply with this requirement with one line item in the business section stating such amounts. Given what we perceive is the intent of the requirement, i.e., to provide information about the prospects for the future (not just the size of the backlog, which an investor might use to make assumptions about how it affects the way the business is run), it appears more logical that backlog disclosure and corresponding discussion of its impact on the expected results of the company would appear in management's discussion and analysis when it's relevant and material. We also believe the discussion should be provided for items that are conceptually similar to backlog but described using different terminology.

Item 301 Selected Financial Data

The SEC staff generally expects that all periods presented in selected financial data will be presented on a basis consistent with the annual financial statements, including information for the fourth and fifth back years.[2] We have observed that retrospective application of new accounting standards is required, or at least permitted, in a growing number of circumstances. Depending on the accounting standard, it can be very difficult for registrants to revise amounts for the fourth and fifth back years. Given the difficulties and lower perceived importance of those back years, we recommend providing relief when appropriate. We would support an approach that generally requires recasting unless doing so would require significant effort or expense. If the fourth and fifth back years are not recast, a registrant should ensure there is clear and appropriate disclosure about the difference in presentation (via footnote to the table or otherwise).

Additionally, the Release questions whether auditor involvement should be required for the disclosures contained in selected financial data. We note that the auditing standards (AS 2710[3]) require the auditor to read the information contained in the table and consider whether it, or its manner of presentation, is materially inconsistent with the information contained in the audited financial statements. We also note that an auditor may report on selected financial data in accordance with AS 3315.[4] Accordingly, the current standards already provide an avenue for auditor reporting on selected

[2] Division of Corporation Finance *Financial Reporting Manual* paragraph 1610.1.

[3] PCAOB AS 2710, Other Information in Documents Containing Audited Financial Statements

[4] PCAOB AS 3315, Reporting on Condensed Financial Statements and Selected Financial Data

financial data. However, in our experience, engagements of this nature are very rare and we perceive little to no demand for this level of auditor involvement.

Item 302(a) Selected Quarterly Financial Data

The Release questions whether the Commission should retain the requirement to disclose selected quarterly financial data (SQFD) and, if so, whether it should modify the requirements. Our sense is that investors find the SQFD useful. We sense that investors find it useful to see fourth quarter results presented discretely, rather than having to infer them based on the annual results and the interim results through the third quarter. When the data is changed from that previously reported, presenting the revised data in the annual report enables investors to understand the effects of the changes sooner than if the changed data was not required to be communicated until it is presented for comparative purposes in subsequent quarterly reports. Even when the data is not changed, our sense is that investors find it useful to see the quarterly results presented sequentially. A sequential presentation is not required in quarterly reports, which report only current quarter and year-to-date results. In that regard, we note that since management's discussion and analysis in quarterly reports only discusses the operating results reflected in the financial statements, there is no specific requirement to discuss results for the current quarter as compared to the preceding quarter. We wonder whether this results in unanswered questions for investors, particularly when the sequential data is presented in the annual report, and suggest that the Commission consider whether some sort of discussion of quarterly results as compared to the preceding quarter, especially when there are material variations, should be required.

The Release also questions whether auditor involvement should be required for the disclosures contained in SQFD. For periods other than the fourth quarter, we note that SQFD is derived from financial information contained in Form 10-Q, the rules of which require auditor involvement via an AS 4105[5] review of the interim period financial statements. In addition, the auditing standards require an auditor to perform a review of the fourth quarter financial information even though it does not appear in a Form 10-Q. Since we perceive that there is a high level of interest in registrants' quarterly results, we believe this level of auditor involvement in such information is warranted.

Item 303 Management's Discussion and Analysis and Item 503(c) Risk Factors

Consolidation of MD&A Guidance

As highlighted in the Release, there are various sources of Commission and staff guidance on MD&A disclosure. Considering the volume of guidance and that MD&A is generally considered one of, if not the most, important disclosures in a periodic report or registration statement, we recommend consolidating the guidance appearing in the Commission releases, sections of the Financial Reporting Manual, and Compliance and Disclosure Interpretations into a single source. We believe that doing so may better facilitate compliance with the guidance and result in improved MD&A disclosure.

[5] PCAOB AS 4105, Reviews of Interim Financial Information

Executive-Level Overview

The Release questions whether the Commission should require an executive-level overview in MD&A. We believe that the need for an overview should be left to the discretion of registrants. If an overview is required, we expect that it will often add little to the filing but redundancy, which would be an undesirable outcome.

Risks and Uncertainties

Item 503(c) requires disclosure of factors that make an *offering* risky, while Item 303(a) requires disclosure of known trends and uncertainties that are reasonably likely to affect the registrant's liquidity, capital resources or results of operations in a material way. Consequently, elements of a registrant's risk-related disclosure are often required to be addressed in both Item 503 risk factor disclosure and Item 303 MD&A disclosure. In our experience, while risk factor disclosures are fairly comprehensive, registrants sometimes struggle with disclosing known trends and uncertainties in MD&A, especially when the disclosures are redundant with risk factor disclosures. We encourage the Commission to consider ways to possibly reduce the redundancy caused by the overlapping objectives of risk factor and MD&A disclosures.

Item 503(c) requires disclosure of factors that make an *offering* risky, e.g., a lack of an operating history or profitable operations. We suggest that much of what is typically disclosed in response to this requirement is already obvious and does not provide investors with meaningful insight to use in making an investment decision. We suggest that risk factor disclosure that is most useful is the disclosure that focuses on *business* risks and encourage the Commission to rewrite the instruction to elicit disclosure of *business* risks.

We also suggest that simply communicating a risk does not tell an investor all that he or she would like to know. After reading about a risk, an investor's next questions are likely to be, "What is the company doing to mitigate the risk," and "How successful does the company expect to be?" We understand the concerns about competitive harm to which the Commission refers in the Release and believe the Commission should respect those concerns if it decides to change the disclosure requirements related to risk mitigation strategies. However, we believe the benefits of discussing risk mitigation strategies outweigh concerns that such discussion could dilute investors' perception of the magnitude of the risk.

We also note that the disclosure in MD&A of a known trend or uncertainty is based on assessment of whether it is "reasonably likely to occur," a threshold that we believe is not interpreted uniformly by preparers. Preparers sometimes interpret "reasonably likely to occur" to mean "more likely than not," which we understand is not the intended threshold for disclosure. We suggest that it would be helpful to clarify the definition of "reasonably likely to occur" to elicit appropriate and more consistent disclosure across registrants.

Liquidity and Capital Resources

Some preparers interpret the term "capital resources" differently or find the disclosure requirement, as written in S-K 303(a)(2), to be confusing. Some preparers interpret the words to require disclosure of the registrant's sources of capital, while others interpret them to require disclosure of the sources of capital assets used in the registrant's business. We suggest the Commission revise the instruction to more clearly communicate what is required.

We have observed that some registrants focus only on short-term liquidity needs (i.e., funding sources for the next fiscal year) in their liquidity disclosures. We sense that this is due, at least in part, because registrants aren't clear on what is supposed to be said about meeting long-term liquidity needs, particularly in cases where they face significant short-term liquidity challenges and addressing longer term liquidity issues is a far lower priority. While the need to discuss liquidity on a long-term basis is mentioned in the instructions to Item 303, we suggest that the Commission rewrite the instruction to more clearly communicate this objective and provide examples of how to address the objective. We also suggest that the Commission revise the instructions to Item 303 to call for the short-term liquidity discussion to focus on the period covered in ASU 2014-15[6] for which GAAP requires a similar evaluation, i.e., the period that ends one year after the date the financial statements are issued. As discussed below, we also suggest that moving the table of contractual obligations into the discussion of liquidity would help to improve disclosures about long-term liquidity.

The Release questions whether the S-K requirements elicit adequate disclosure of short-term borrowings. In our experience, registrants appropriately assess and discuss short-term liquidity in their filings so we do not believe that additional short-term borrowing disclosure requirements are necessary. We note that the Commission proposed, but did not adopt, short-term borrowings disclosure rules in 2010. Our impression is that the lack of disclosures called for by that proposal has not created a deficiency in registrants' discussion of liquidity.

Auditor Involvement

The Release questions whether auditor involvement in MD&A should be required. We note that the auditing standards (AS 2710) require the auditor to read the information contained in MD&A and consider whether it, or its manner of presentation, is materially inconsistent with the information contained in the audited financial statements. We also note that an auditor may examine or review MD&A in accordance with AT 701.[7] Such engagements are very rare and we do not get the impression there is a demand for this level of auditor involvement in MD&A.

Contractual Obligations

We recommend that the Commission consider moving the table of contractual obligations into the discussion of liquidity. As we believe the table is intended to be an

---

[6] ASU 2014-15, Presentation of Financial Statements – Going Concern

[7] PCAOB AT 701, Management's Discussion and Analysis

element of a registrant's discussion of its liquidity, integrating the disclosure requirement within liquidity may facilitate enhanced discussion of liquidity, particularly longer-term liquidity needs as discussed above.

We also recommend that the Commission revise the rule requiring purchase obligations to be disclosed in the table. There are obligations for which there is more than one reasonable way to present them in the table. Our sense is that generally practice has evolved to the point where as long as the approach used provides investors with the information they need, the use of alternative approaches does not harm investors or create practice problems. We believe, however, that improvements should be made in the way purchase obligations are presented. Some companies include some, but not all, of the obligations that have already been incurred and are reflected as liabilities on the balance sheet. Most include only obligations that are not yet reflected as liabilities. We recommend revising the definition to make it clear that purchase obligations include only obligations for executory contracts. Further, we question the usefulness of presenting purchase obligations related to essentially non-discretionary operating expenses. We suggest that it may be more meaningful to define purchase obligations as amounts to be paid under executory contracts for purchases of assets.

Critical Accounting Estimates

In our experience, many registrants struggle with disclosures related to critical accounting estimates. We suspect that this may be because they struggle to envision what should be disclosed or try to cover too many estimates, rather than just the most material ones. We suggest that disclosure might improve if the requirement was stated within Item 303 and, as discussed above, the instruction clearly communicated the objective of the disclosure and provided examples of how to address the objective.

Materiality Judgments

We do not believe a registrant should be required to disclose materiality judgments that form the basis for disclosure. Materiality is different for all registrants and may vary from period to period. Similarly, we do not believe a registrant should be required to disclose its assessment immaterial errors that were not recorded. Such a disclosure would be contrary to the overall notion that registrants should address matters which are material to their business and would likely provide useless information.

Item 305 Quantitative and Qualitative Disclosures about Market Risk

In our view, the disclosure requirements within Item 305 are lengthy and overly complex for non-financial services registrants. Many registrants find the requirements to be confusing and our impression is that the related disclosures are not as relevant for non-financial services registrants. We believe the Commission should consider restricting these requirements to financial services registrants. Consistent with our view expressed above, the Commission should also consider taking a principles-based approach to disclosures of market risk for all other registrants, including incorporating that discussion into MD&A.

Exhibits

Duplicative and Outdated Disclosures

Certain exhibits call for disclosures that duplicate disclosures required by GAAP (e.g., the computation of earnings per share required by Item 601(b)(11)) or disclosures that we perceive to be outdated (e.g., the ratio of earnings to fixed charges required by Item 503(d) and the related exhibit required by Item 601(b)(12)).We agree with the approach the Commission is taking in the rule amendments it proposed in Release 33-10110, *Disclosure Update and Simplification*.

Preferability letters –

When the Commission amended Form 10-Q in 1975 to require an accountant's letter stating whether a change in accounting principle is, in the accountant's judgment, preferable, an auditor's review of a registrant's interim period financial statements included in Form 10-Q was not required. Accordingly, the requirement to file a preferability letter in a Form 10-Q caused registrants to involve their independent auditors when making voluntary changes in accounting principles during interim periods. However, in 2000, the Commission adopted rules requiring independent auditor review of quarterly financial statements. Hence, auditors now evaluate the preferability of changes in accounting principles when they perform these reviews. Moreover, as referenced in the Concept Release, there are now more prescriptive accounting and auditing standards such as ASC 250[8] and AS 2820.[9]

In light of these developments and improvements in the consideration and reporting of voluntary changes in accounting principles, the objective of the preferability letter is met by the requirements of GAAP and PCAOB reporting standards. When registrants change an accounting principle, they are already required to establish preferability and auditors are required to assess the change as part of their interim reviews and audits of the financial statements. Accordingly, we believe preferability letters are no longer needed.

Scaled Disclosures and Filer Categories

Over the years (as highlighted in the Release), the Commission has developed a disclosure system which provides for reduced disclosure requirements and different periodic reporting timetables for certain smaller registrants. We believe the proliferation of filer categories (e.g., smaller reporting company, non-accelerated filer, emerging growth company, etc.) has complicated the compliance process. Moreover, the transition rules related to a registrant's change in filing status are not consistent and appear more complex than necessary. For example, a company exiting non-accelerated filer status must do so at the time it files its next annual report. A company exiting smaller reporting company status is not required to comply with the larger reporting company disclosure requirements until the first quarter after the end of the fiscal year in which its status changed. Thus a calendar year-end smaller reporting company whose

[8] ASC 250, Accounting Changes and Error Corrections
[9] PCAOB AS 2820, Evaluating Consistency of Financial Statements

public float exceeded $75 million on June 30, 20X1 would be permitted to file its 20X1 annual report in accordance with the smaller reporting company scaled disclosure requirements but must file it within 75 days of December 31, 20X1 (i.e., the Form 10-K due date for accelerated filers). Further, the tests to determine whether a company is an accelerated filer are not made until year-end. Therefore, a company whose public float was less than $50 million as of the end of its second fiscal quarter cannot exit accelerated filer status until it files its next annual report. In contrast, a company entering smaller reporting company status may do so immediately. Thus a calendar year-end company whose public float dropped below $50 million on June 30, 20X1 would be permitted to file its June 30 and September 30, 20X1 Forms 10-Q in accordance with the smaller reporting company disclosure requirements but must file them within 40 days of quarter-end (i.e., the Form 10-Q due date for accelerated filers). We recommend harmonizing the requirements where possible, particularly at the dates when the requirements of a new filing status take effect.

* * * * * * * * * * * * * *

We appreciate this opportunity to express our views to the Commission. We would be pleased to answer any questions the Commission or its staff might have about our comments. Please contact Jeff Lenz, National Director – SEC Practice, at (312) 616-3944 or via email at jlenz@bdo.com, or Chris Smith, Accounting and Audit Professional Practice Leader, at (310) 557-8549 or via email at chsmith@bdo.com.

Very truly yours,

BDO USA, LLP

Deloitte.

Real Estate

Accounting and Financial Reporting Update

December 2, 2016

Contents

Foreword iv

Acknowledgments and Contact Information v

Introduction vi

Updates to Guidance 1

Revenue Recognition 2

Leases 10

Financial Instruments 13

Impairment 13

Classification and Measurement 17

Measurement-Period Adjustments 18

Simplifying the Transition to the Equity Method of Accounting 20

Consolidation — Interests Held Through Related Parties That Are Under Common Control 21

Employee Share-Based Payment Accounting Improvements 22

Classification of Deferred Taxes 27

Alternatives for Private Companies 28

Statement of Cash Flows: Classification of Certain Cash Receipts and Cash Payments 30

Restricted Cash 33

On the Horizon 35

Financial Instruments 36

Hedging 36

Liabilities and Equity — Targeted Improvements 39

Simplifying the Balance Sheet Classification of Debt 41

Goodwill and Business Combinations 43

Subsequent Accounting for Goodwill for Public Business Entities and Not-for-Profit Entities, Including Goodwill Impairment 43

Clarifying the Definition of a Business 44

Accounting for Identifiable Intangible Assets in a Business Combination 46

Accounting for Derecognition and Partial Sales of Nonfinancial Assets 46

Modification Accounting for Share-Based Payment Arrangements 48

Nonemployee Share-Based Payment Accounting Improvements 51

Disclosures by Business Entities About Government Assistance 52

Disclosure Framework **53**
FASB's Decision Process 53
Entity's Decision Process 54
Topic-Specific Disclosure Reviews 54
Next Steps 54
Fair Value Measurement 55
Income Taxes 58
Defined Benefit Plans 61

Other Topics **62**
SEC and AICPA Updates **63**
Summary of Accounting Pronouncements Effective in 2016 **74**

Appendixes **78**
Appendix A — Glossary of Standards and Other Literature **79**
Appendix B — Abbreviations **87**

Foreword

December 2, 2016

To our clients and colleagues in the real estate sector:

We are pleased to announce our ninth annual accounting and financial reporting update. Some of the notable standard-setting developments that occurred since the previous edition were the issuance of (1) new guidance on the accounting for leases and the impairment of financial instruments, (2) new guidance to clarify the classification of certain cash receipts and payments in the statement of cash flows, and (3) refinements to the FASB's new guidance on the recognition of revenue from contracts with customers.

This publication is divided into three sections: (1) "Updates to Guidance," which highlights changes to accounting and reporting standards that real estate entities need to start preparing for now; (2) "On the Horizon," which discusses standard-setting topics that will affect real estate entities as they plan for the future; and (3) "Other Topics" that may be of interest to entities in the real estate sector.

The annual accounting and financial reporting updates for the banking and securities, insurance, and investment management sectors are available (or will be available soon) on US GAAP Plus, Deloitte's Web site for accounting and financial reporting news.

As always, we encourage you to contact your local Deloitte office for additional information and assistance.

Sincerely,

Chris Dubrowski
Real Estate Industry
Professional Practice Director
Deloitte & Touche LLP

Bob O'Brien
Global Real Estate Leader
Deloitte & Touche LLP

Acknowledgments and Contact Information

We would like to thank the following individuals for their contributions to this publication:

Johnnie Akin
Teri Asarito
Alex Braser
Ermir Berberi
Mark Bolton
Lynne Campbell
Ashley Carpenter
Chris Cryderman
Amy Davidson
Jamie Davis
Joe DiLeo
Geri Driscoll
David Eisenberg
Trevor Farber
Mark Fischer
John Franco
Rachel Grandovic
Emily Hache
Eric Hatch
Ben Johnson
Colin Kronmiller
Michelle Lacey
Michael Lorenzo
Mat Lorie
Stephen McKinney
Peter McLaughlin
Morgan Miles
Adrian Mills
Emily Montgomery
Rob Morris
Jeff Nick
Magnus Orrell
Jeanine Pagliaro
Amy Park
Taylor Paul
Lauren Pesa
Christine Reicheneder
Shahid Shah
Inderjeet Singh
Stefanie Tamulis
PJ Theisen
Andrew Warren
John Wilde
Karen Wiltsie
Andrew Winters
Sandy Zapata

If you have any questions about this publication, please contact any of the following Deloitte industry specialists:

Chris Dubrowski
Real Estate Industry
Professional Practice Director
+1 203 708 4718
cdubrowski@deloitte.com

James Brant
Real Estate Industry
Deputy Professional Practice Director — Engineering and Construction
+1 513 784 7348
jbrant@deloitte.com

Bob O'Brien
Global Real Estate Leader
+1 312 486 2717
robrien@deloitte.com

Wyn Smith
Real Estate Industry
Deputy Professional Practice Director
+1 469 417 2209
gesmith@deloitte.com

Susan L. Freshour
Financial Services Industry
Professional Practice Director
+1 212 436 4814
sfreshour@deloitte.com

Introduction

The real estate market continued its modest recovery from 2013 through 2016, but it may be approaching the peak of the recovery cycle. Looking ahead, we believe that the impact of financial regulations under the Dodd Frank Act and Basel III will likely create a challenging financing environment for many individuals looking to invest in real estate. Higher interest rates and risk are expected outcomes of the new regulations. Through the third quarter of 2016, the national home price index gained single-digit year-to-date returns compared with double-digit growth in 2013. We can expect this growth to further decrease as interest rates increase.

Accounting Changes

In February 2016, after working many years on a new lease accounting standard, the FASB issued ASU 2016-02. The guidance is intended to address concerns related to off-balance sheet financing, as it brings most leases onto the balance sheets of lessees. From a lessor perspective, accounting for lease revenue will essentially be unchanged under the new standard, and most real estate leases will continue to be classified as operating leases.

In June 2016, the FASB issued ASU 2016-13, which provides guidance on the impairment of financial instruments. The ASU introduces the current expected credit loss model, which is an impairment model based on expected rather than incurred losses. This new impairment model is intended to result in more timely recognition of impairment losses since it requires an entity to recognize its estimate of expected credit losses at the earliest reporting date such expectations arise.

In August 2016, the FASB issued ASU 2016-15, which adds clarifying guidance on the classification of certain cash payments and receipts on the statement of cash flows. This guidance was based on a project of the FASB's Emerging Issues Task Force (EITF) that focused on eight types of cash flows including (1) debt prepayment or debt extinguishment costs, (2) settlement of zero-coupon bonds, (3) contingent consideration payments made after a business combination, (4) proceeds from the settlement of insurance claims, and (5) distributions received from equity method investees. The purpose of this project was to reduce diversity in practice and provide specific guidance for classification of these cash flows.

In November 2016, the FASB issued ASU 2016-18, which amends ASC 230 to clarify the guidance on the classification and presentation of restricted cash. The ASU was based on consensuses reached by the EITF.

The FASB is also currently working on projects that real estate entities should continue to monitor, including (1) clarifying the definition of a business, (2) clarifying the scope of asset derecognition in transactions with non-customers, (3) accounting for partial sales of nonfinancial assets, and (4) hedging of financial instruments.

For additional information about industry issues and trends, see Deloitte's *2016 Financial Services Industry Outlooks*.

Updates to Guidance

Revenue Recognition

Background

In May 2014, the FASB issued ASU 2014-09, which outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance (e.g., certain sections of ASC 360-20 and ASC 970-605). For additional information about ASU 2014-09 as issued, see Deloitte's May 28, 2014, *Heads Up* and July 2014 *Financial Services Spotlight*.

In response to concerns the FASB received related to applying the ASU's requirements, the Board in 2016 issued the following four ASUs, which amend the ASU's new revenue recognition guidance:

- *ASU 2016-08,* Principal Versus Agent Considerations (Reporting Revenue Gross Versus Net) — The ASU addresses issues related to how an entity should assess whether it is the principal or the agent in contracts that include three or more parties. The amendments provide guidance on (1) how to determine the unit of account, (2) whether the indicators in ASU 2014-09 are intended to help entities perform a single evaluation of control or represent an additional evaluation, and (3) how certain indicators are related to the general control principle. The ASU also clarifies that an entity should evaluate whether it is the principal or the agent for each good or service specified in a contract and thus whether an entity could be both the principal and agent for different performance obligations in the same contract. See Deloitte's March 22, 2016, *Heads Up* for more information.
- *ASU 2016-10,* Identifying Performance Obligations and Licensing — The ASU's amendments clarify the guidance on an entity's identification of certain performance obligations. Changes include guidance on immaterial promised goods and services and separately identifiable promises as well as (1) a policy election for shipping and handling fees incurred after control transfers and (2) clarifications related to licenses. See Deloitte's April 15, 2016, *Heads Up* for more information.
- *ASU 2016-11,* Rescission of SEC Guidance Because of Accounting Standards Updates 2014-09 and 2014-16 Pursuant to Staff Announcements at the March 3, 2016 EITF Meeting (SEC Update) — The ASU rescinds the following guidance, which is based on announcements made by the SEC staff at the Emerging Issues Task Force's (EITF's) March 3, 2016, meeting, upon an entity's adoption of ASU 2014-09:
  - Revenue and expense recognition for freight services in process (ASC 605-20-S99-2).
  - Accounting for shipping and handling fees and costs (ASC 605-45-S99-1).
  - Accounting for consideration given by a vendor to a customer (ASC 605-50-S99-1).
  - Accounting for gas-balancing arrangements (ASC 932-10-S99-5).

- *ASU 2016-12,* Narrow-Scope Improvements and Practical Expedients — The guidance (1) clarifies how to assess whether collectibility is probable in certain circumstances to support the existence of a contract, (2) adds a practical expedient for the presentation of sales taxes on a net basis in revenue, (3) clarifies how to account for noncash consideration at contract inception and throughout the contract period, and (4) establishes a practical expedient to address contract modifications upon transition. See Deloitte's May 11, 2016, ***Heads Up*** for more information.

In addition to the ASUs above, the FASB on May 18, 2016, and September 19, 2016, issued proposed ASUs that would make technical corrections (i.e., minor changes and improvements) to certain aspects of ASU 2014-09 related to the following topics:

- *Contract costs — impairment testing* — The proposed amendments "would clarify that when performing impairment testing an entity should (a) consider expected contract renewals and extensions and (b) include both the amount of consideration it already has received but has not recognized as revenue and the amount the entity expects to receive in the future."
- *Disclosure of remaining performance obligations* — The proposed amendments would (1) "provide practical expedients to the disclosure requirement for remaining performance obligations for specific situations in which an entity need not estimate variable consideration in order to recognize revenue" and (2) "expand the information disclosed when an entity applies one of the practical expedients."
- *Contract modifications example* — The proposed amendments "would improve the alignment of Example 7 and the [contract modifications] principles in Topic 606."
- *Cost capitalization for advisers to private and public funds* — The proposed amendments "would align the cost-capitalization guidance for advisors to both public funds and private funds in Topic 946."
- *Loan guarantee fees* — The proposed amendments "would clarify that guarantee fees within the scope of Topic 460 (other than product or service warranties) are not within the scope of Topic 606."
- *Contract asset versus receivable* — The proposed amendments "would provide a better link between the analysis in Example 38, Case B and the receivables presentation guidance in Topic 606."
- *Advertising costs* — The proposed amendments "would reinstate the guidance on the accrual of advertising costs."

The amendments are being proposed in response to feedback received from several sources, including the transition resource group (TRG) for revenue recognition, and would clarify, rather than change, the new revenue standard's core revenue recognition principles. The Board discussed the proposed technical corrections at its August 31, 2016, and October 19, 2016, meetings. See Deloitte's September 1, 2016, and October 21, 2016, journal entries for more information on the Board's discussions.

Thinking It Through

ASU 2014-09 will significantly affect the accounting for real estate sales. The ASU eliminates the bright-line guidance that entities currently apply under ASC 360-20 when evaluating when to derecognize real estate assets and how to measure the profit on the disposal. It will change the accounting for both real estate sales that are part of an entity's ordinary activities (i.e., real estate transactions with customers) and real estate sales that are not part of the entity's ordinary activities. While the ASU eliminates the guidance in ASC 360-20 on real estate sales, entities will still need to apply ASC 360-20 to sales of real estate that are part of sale-leaseback transactions until their adoption of the new leasing standard.

Key Accounting Issues

Some of the key accounting issues and potential challenges as a result of the new revenue guidance are discussed below.

Financing Arrangements (Existence of a Contract)

Under current guidance, when the seller of real estate also provides financing to the buyer, the seller must consider the buyer's initial and continuing investments in the property to determine whether they constitute a stake sufficient to ensure that the risk of loss will motivate the buyer to honor its obligation to the seller. If the specified investment requirements are not met, the seller accounts for the sale by using the installment method, the cost recovery method, or the deposit method.

Under ASU 2014-09, an entity will need to evaluate several criteria to determine whether a contract exists. One particularly challenging criterion related to evaluating whether a real estate contract exists is that it must be "probable that the entity will collect the consideration to which it will be entitled." To make this determination, the entity should consider the buyer's ability and intention to pay the amount of consideration when it is due. The ASU does not retain the specific initial and continuing investment thresholds under current U.S. GAAP for performing this evaluation; however, some factors to consider may include the loan-to-value ratio of the property and the purchaser's intended use of the property.

Thinking It Through

The collectibility criterion should be evaluated on the basis of the amount to which the entity expects to be entitled, which may not be the stated transaction price. For example, these two amounts may differ because an entity anticipates offering the customer a price concession. Accordingly, entities should carefully assess the facts and circumstances to determine whether, on the basis of their assessment of the customer's credit risk (for example), they expect to grant a price concession.

If a seller determines that a contract does not exist, it would account for any amounts received as a deposit (even if such payments are nonrefundable). In addition, the seller would continually evaluate the amounts received to determine whether the arrangement subsequently qualifies as a valid contract under the ASU's criteria. Once it becomes probable that the seller will collect the consideration to which it will be entitled, the seller would evaluate the arrangement under the derecognition criteria in the ASU. If, instead, the contract is terminated, the seller would then recognize any nonrefundable deposits received as a gain.

Identifying Performance Obligations

Sometimes, a seller remains involved with property that has been sold (e.g., by providing additional services such as construction or development activities). Under current guidance, profit is generally

deferred if a seller has continuing involvement with the sold property. Sometimes, instead of accounting for the transaction as a sale, the seller may be required to (1) apply the deposit method to the transaction or (2) account for the transaction as a financing, leasing, or profit-sharing arrangement. The current guidance focuses on whether the seller retains substantial risks or rewards of ownership as a result of its continuing involvement with the sold property.

In contrast, under the ASU, if the arrangement includes ongoing involvement with the property, the seller must evaluate each promised good or service under the contract to determine whether it represents a "separate performance obligation," constitutes a guarantee, or prevents the transfer of control.[1] Goods and services are distinct (and considered separate performance obligations) if the two criteria in ASC 606-10-25-19 are met, including the requirement that goods or services are distinct in the context of the contract. Alternatively, an entity would bundle goods or services until they are distinct. Further, ASC 606-10-25-21 provides guidance on when goods or services would be distinct in the context of the contract. If a promised good or service is considered a separate performance obligation, an allocated portion of the transaction price should be recognized as revenue when (or as) the entity transfers the related good or service to the customer.

Thinking It Through

After the issuance of ASU 2014-09, stakeholders questioned how real estate developers should account for contracts under which it is expected that certain amenities or common areas will be provided in a community development (to be owned either by a homeowners association or by the local municipality). Some stakeholders believed that a developer that intends to provide common areas (e.g., a community center, parks, tennis courts) to a homeowners association as part of a development would generally not consider such an arrangement to represent a promise to deliver goods or services in the separate contract to sell the real estate (e.g., a single-family home) to its other customers. That is, the agreement with the homeowners association would not be combined with the agreement to sell the real estate to a separate customer. Therefore, the arrangement with the homeowners association to provide the common areas would not be considered a performance obligation in the real estate contract with the separate customer. Others, however, believed that arrangements to develop common areas are separate performance obligations in the real estate contract with the customer to which a portion of the consideration received for the sale of real estate would be allocated and deferred until control of the common areas transfers to the homeowners association. As part of implementation activities, the industry discussed this situation with standard setters and others to establish consistent application of the revenue standard. It is our understanding that the FASB did not intend to change current practice related to these activities (i.e., generally the provision of common area items to a homeowners association would not constitute separate performance obligations). Note that the ASU did not amend the guidance in ASC 970 that requires a developer to use a cost accrual approach upon sale of the real estate to account for costs of the common areas.

[1] Certain forms of continuing involvement would not constitute a separate performance obligation. For example, an option or obligation to repurchase a property is specifically addressed by the ASU and would preclude derecognition of the property. Further, a seller obligation that qualifies as a guarantee under ASC 460 would be outside the scope of the ASU.

Contracts with entities in the real estate industry — such as construction and engineering entities — often include deliverables that are completed over a number of phases. Such phases often are engineering, design, procurement, and construction of a facility or project. Stakeholders have raised questions and have had differing views about whether phases of a project (e.g., in typical design-and-build contracts) are distinct performance obligations or part of one combined performance obligation because they may not be distinct in the context of the contract.

Thinking It Through

Under the new standard, it may be difficult to assess whether phases of engineering, design, procurement, and construction are part of one combined performance obligation (e.g., because the phases are highly dependent and highly interrelated or part of a significant service of integration) or are distinct performance obligations. Such difficulty may also affect the way revenue is recognized (e.g., point in time or over time and the measure of progress if revenue is recognized over time). Accordingly, entities will need to exercise significant judgment and consider the specific facts and circumstances of each contract. Entities are also encouraged to monitor the AICPA's Engineering & Construction Contractors Revenue Recognition Task Force implementation activities, particularly the working draft of the implementation paper that addresses the identification of performance obligations. The working draft, which was exposed for public comment in July 2016, indicates that, when identifying performance obligations, entities should consider the following:

- "[T]he risk the entity assumes in performing the integration service [and whether that risk] is inseparable from the risk relating to the transfer of the other promised goods or services."
- "[W]hether the integration service is significant."

The working draft also contains an example illustrating the identification of performance obligations for a "design, build and maintenance contract," which entities may find helpful.

Determining the Transaction Price

Under the new revenue standard, the determination of the transaction price includes an assessment of not only the stated contract price but also future events (e.g., exercise of contract options, issuance of change orders, filing of claims or incurrence of penalty or incentive payments). For example, a sales contract may allow the seller to participate in future profits related to the underlying real estate. Under current U.S. GAAP, the amount of revenue recognized is generally limited to the amount that is not contingent on a future event. Any additional revenue would be recorded only when the contingent revenue is realized. Under the ASU, some or all of the estimated variable consideration is included in the transaction price (and therefore eligible for recognition) to the extent that it is probable that the cumulative amount of the revenue recognized will not be subject to significant reversal (the "constraint").

Accordingly, an entity will need to estimate the portion of the contingent (or variable) consideration to include in the transaction price, which may be recognized up front. As a result, revenue may be recognized earlier under the ASU than under current requirements.

The working draft of the implementation paper issued by the AICPA's Engineering & Construction Contractors Revenue Recognition Task Force provides insights on evaluating variable consideration and includes several illustrative examples.

The ASU also requires entities to adjust the transaction price for the time value of money when the arrangement gives either the buyer or the seller a significant benefit of financing the transfer of real estate to the buyer. In such instances, the seller will be required to adjust the promised amount of consideration to reflect what the cash selling price would have been if the buyer had paid cash for the promised property at the time control was transferred to the buyer. In calculating the amount of consideration attributable to the significant financing component, the seller should use an interest rate that reflects a hypothetical financing-only transaction between the seller and the buyer. As a practical expedient, the ASU does not require entities to account for a significant financing component in a contract if, at contract inception, the expected time between substantially all the payments and the transfer of the promised goods and services is one year or less.

Accordingly, if an entity enters into a contract that either requires an up-front deposit before the transaction date or gives the buyer the right to defer payments for a significant period from the transaction date, it will need to determine whether the contract's payment terms (1) give the buyer or the seller a significant benefit of financing the transfer of the real estate or (2) are intended for other purposes (e.g., to ensure full performance by the seller or the buyer).

Recognizing Revenue When (or as) Performance Obligations Are Satisfied

When evaluating whether the disposal of real estate qualifies for sale accounting under current U.S. GAAP, entities focus on whether the usual risks and rewards of ownership have been transferred to the buyer.

Under the ASU, a seller of real estate would evaluate whether a performance obligation is satisfied (and the related revenue recognized) when "control" of the underlying assets is transferred to the purchaser.[2] An entity must first determine whether control is transferred over time or at a point in time. If control is transferred over time, the related revenue is recognized over time as the good or service is transferred. If control is transferred at a point in time, revenue is recognized when the good or service is transferred.

Under ASU 2014-09, control of a good or service (and therefore satisfaction of the related performance obligation) is transferred over time when at least one of the following criteria is met:

- "The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs."
- "The entity's performance creates or enhances an asset . . . that the customer controls as the asset is created or enhanced."
- "The entity's performance does not create an asset with an alternative use to the entity . . . and the entity has an enforceable right to payment for performance completed to date."

The working draft of the implementation paper issued by the AICPA's Engineering & Construction Contractors Revenue Recognition Task Force addresses acceptable measures of progress for contracts that meet the criteria for over-time revenue recognition. Selecting a measure of progress is not a free choice but requires an entity to select the measure that most appropriately depicts the pattern of transfer. Accordingly, the paper describes several attribution models and gives examples of when the use such models may be appropriate.

[2] ASC 606-10-25-25 (added by the ASU) states that "[c]ontrol of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset" and "includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset."

Thinking It Through

Real estate sales in most jurisdictions (including the United States) will typically not meet the criteria to be recognized as revenue over time because it is uncommon for the seller to either (1) have an enforceable right to payment for its cost plus a reasonable margin if the contract were to be canceled at any point during the construction period or (2) be legally restricted from transferring the asset to another customer, even if the contract were canceled at any point during the construction period. ASU 2014-09 contains an example[3] in which a real estate developer enters into a contract to sell a specified condominium unit in a multifamily residential complex once construction is complete. In one scenario in this example, the seller does recognize revenue over time; however, the example indicates that this conclusion is based on legal precedent in the particular jurisdiction where the contract is enforceable.

If a performance obligation does not meet any of the three criteria for recognition over time, it is deemed satisfied at a point in time. Under ASU 2014-09, entities would consider the following indicators in evaluating the point in time at which control of real estate has been transferred to the buyer and when revenue should be recognized:

- "The entity has a present right to payment for the asset."
- "The customer has legal title to the asset."
- "The entity has transferred physical possession of the asset."
- "The customer has the significant risks and rewards of ownership of the asset."
- "The customer has accepted the asset."

While entities will be required to determine whether they can derecognize real estate by using a control-based model rather than the risks-and-rewards model under current U.S. GAAP, the FASB decided to include "significant risks and rewards" as a factor for entities to consider in evaluating the point in time at which control of a good or service is transferred to a customer. Accordingly, although a seller of real estate would evaluate legal title and physical possession to determine whether control has transferred, it should also consider its exposure to the risks and rewards of ownership of the property as part of its "control" analysis under the ASU.[4]

Contract Modifications and Claims

Real estate entities that are involved with construction and engineering projects should consider how the ASU may affect the accounting for contract modifications, including unpriced change orders and claims. Examples of items that an entity will need to carefully assess before recognizing revenue related to such modifications include whether (1) the customer has approved scope or price changes and (2) the entity has an enforceable right to additional consideration (i.e., whether it has a legal basis for its claim). Examples such as these may indicate that the entity should include the change order or claim in its transaction price (i.e., as variable consideration under step 3 of the new revenue model) to the extent that it is probable that such an amount is not subject to significant revenue reversal in the future (i.e., the variable consideration constraint).

[3] ASC 606-10-55-173 through 55-182.

[4] An entity would not consider parts of a contract that are accounted for under guidance outside the ASU (e.g., guarantees within the scope of ASC 460) when determining whether control of the remaining goods and services in the contract has been transferred to a customer.

Thinking It Through

As a result of the ASU, revenue related to claims and unapproved change orders may be accelerated.

Other issues that are often subject to significant judgment under the ASU and may result in a change from current practice for real estate entities (particularly engineering and construction entities) include (1) the treatment of uninstalled materials; (2) gross versus net presentation of revenue (i.e., whether an entity is the principal or agent in a transaction with three or more parties); (3) the identification and recording of significant financing components (i.e., time value of money considerations) and warranties; (4) application of variable consideration guidance to milestone payments and what are commonly referred to in the real estate industry as "extras," "add-ons," and "back charges"; and (5) the types and amounts of costs that would meet the recognition criteria for capitalizing precontract costs.

These and other issues are the subject of several papers that have been written by the AICPA's Engineering & Construction Contractors Revenue Recognition Task Force. A list of all of the issues currently on the task force's agenda for discussion and their respective statuses is available on the AICPA's Web site, which also contains the working drafts of the implementation papers discussed above.

Effective Date and Transition

In August 2015, as a result of stakeholder concerns, the FASB issued ASU 2015-14, which delays the effective date of ASU 2014-09. Accordingly, the ASU is effective for public business entities for annual reporting periods (including interim reporting periods within those periods) beginning after December 15, 2017. Early adoption is permitted as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within those annual periods.

For nonpublic entities, the standard is effective for annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019. Nonpublic entities can also elect to early adopt the standard as of the following:

- Annual reporting periods beginning after December 15, 2016, including interim periods.
- Annual reporting periods beginning after December 15, 2016, and interim periods within annual reporting periods beginning one year after the annual reporting period of initial application of the new standard.

Implementation and Transition Activities

A number of groups are involved in implementation activities related to the new standard, including the TRG (see Deloitte's *TRG Snapshot* newsletters), the AICPA's revenue recognition task forces, various firms, the SEC,[5] and the PCAOB. Preparers should continue to monitor the activities of these groups before adoption of the new guidance. See Deloitte's January 14, 2016, *Heads Up* for additional adoption and transition observations.

[5] The SEC has indicated that it plans to review and update the revenue recognition guidance in SAB Topic 13 in light of the ASU. The extent to which the ASU's guidance will affect a public entity will depend on whether the SEC removes or amends the guidance in SAB Topic 13 to be consistent with the new revenue standard.

Thinking It Through

Real estate entities will need to reassess their historical accounting for all real estate disposals and construction contracts to determine whether any changes are necessary. Further, they will need to consider the guidance in ASU 2014-09 when accounting for repurchase options (the seller may be required to account for the transaction as a lease, a financing, or a sale with a right of return) as well as any guidance issued as a result of the FASB's project on partial sales (i.e., phase 2 of the Board's project on clarifying the definition of a business). In that project, the FASB has tentatively decided that any retained noncontrolling interest in a partial sale would be recorded at fair value and that the unit of account in the evaluation of whether control has transferred in a partial sale would be the underlying asset (see the FASB's project update page for more information). In addition, entities will most likely be required to dual track revenue balances during the transition period, given the potential difficulty associated with retroactively recalculating revenue balances when the ASU becomes effective.

Under the ASU, entities must also provide significantly expanded disclosures about revenue recognition, including both quantitative and qualitative information, regarding (1) the amount, timing, and uncertainty of revenue (and related cash flows) from contracts with customers; (2) the judgment, and changes in judgment, entities used in applying the revenue model; (3) the assets recognized from costs to obtain or fulfill a contract with a customer; and (4) information about unsatisfied performance obligations, including (a) "the aggregate amount of the transaction price allocated to the [unsatisfied] performance obligations" and (b) "an explanation of when the entity expect[ed] to recognize" that amount as revenue. To comply with the ASU's new accounting and disclosure requirements, real estate entities may want to consider whether they need to modify their systems, processes, and controls for gathering and reviewing information that may not have previously been monitored.

Leases

Background

After working for almost a decade, the FASB issued its new standard on accounting for leases, ASU 2016-02, in February 2016. The primary objective of issuing the new leases standard was to address the off-balance-sheet treatment of lessees' operating leases. The standard's lessee model requires lessees to adopt a right-of-use (ROU) asset approach that brings substantially all leases, with the exception of short-term leases (i.e., those with a lease term of less than 12 months), on the balance sheet. Under this approach, a lessee would record an ROU asset representing its right to use the underlying asset during the lease term and a corresponding lease liability (in a manner similar to the current approach for capital leases).

The development of the new leases standard began as a convergence project between the FASB and the IASB. Although the project was a convergence effort and the boards conducted joint deliberations, there are several notable differences between the boards' respective leases standards.[6] One of the more significant differences is related to the classification of a lease. Under the FASB's standard, an entity may classify a lease as either an operating lease or a finance lease. Under the IASB's standard, however, an entity would classify all leases as finance leases.

[6] The IASB issued IFRS 16, *Leases*, in January 2016.

Thinking It Through

A lessee would include in the calculation of the ROU asset any initial direct costs related to a lease. A lessor would continue to account for initial direct costs in a manner consistent with the current requirements. However, the definition of an initial direct cost is more restrictive under the new standard and includes only those costs incremental to the arrangement and that the entity would not have incurred if the lease had not been obtained. The definition is consistent with that for incremental cost in the new revenue recognition standard (ASC 606). Thus, costs such as commissions and payments made to existing tenants to obtain the lease would be considered initial direct costs. By contrast, costs such as allocated internal costs and costs to negotiate and arrange the lease agreement (e.g., professional fees such as those paid for legal and tax advice) would be excluded from the definition. As a result, practice is likely to change for many real estate lessors.

Lease and Nonlease Components

Lessees and lessors are required to separate lease components and nonlease components (e.g., any services provided) in an arrangement and allocate the total transaction price to the individual components. Lessors would perform the allocation in accordance with the guidance in the new revenue recognition standard, and lessees would do so on a relative stand-alone price basis (by using observable stand-alone prices or, if the prices are not observable, estimated stand-alone prices). However, the ASU states that as "a practical expedient, a lessee may, as an accounting policy election by class of underlying asset, choose not to separate nonlease components from lease components and instead to account for each separate lease component and the nonlease components associated with that lease component as a single lease component." The ASU also permits a similar accounting policy election from the lessor perspective, noting that it would "be reasonable for lessors to account for multiple components of a contract as a single component if the outcome from doing so would be the same as accounting for the components separately (for example, a lessor may be able to conclude that accounting for an operating lease and a related service element as a single component results in the same accounting as treating those two elements as separate components)." However, a lessor would need to consider presentation and the disclosure requirements under other U.S. GAAP, as applicable (e.g., ASU 2014-09).

Thinking It Through

If an amount is identified as a lease component, the amount is included in the measurement of the ROU asset and liability. When evaluating whether an activity should be a separate nonlease component, an entity should consider whether the activity transfers a separate good or service to the lessee. For example, maintenance services (including common area maintenance services) and utilities paid by the lessor but consumed by the lessee would be separate nonlease components because the lessee would have been required to otherwise contract for these services separately. However, payments for property taxes or insurance would most likely be considered a part of the lease component because they do not transfer a separate good or service to the lessee.

Lessee Accounting

While the boards agreed that a lessee should record an ROU asset and a corresponding lease liability when the lease commences, they supported different approaches for the lessee's subsequent accounting. The FASB chose a dual-model approach under which a lessee classifies a lease by using criteria similar to the lease classification criteria currently in IAS 17. Under IAS 17, there are no "bright lines" such as those under current U.S. GAAP (e.g., the 90 percent fair value test in ASC 840). For leases that are considered finance leases (many current capital leases are expected to qualify as finance leases), the lessee would account for the lease in a manner similar to a financed purchase arrangement. That is, the lessee would recognize interest expense and amortization of the ROU asset, which typically would result in a greater expense during the early years of the lease. For leases that are considered operating leases (many current operating leases are expected to continue to qualify as operating leases), the lessee would recognize a straight-line total lease expense. For both types of leases, the lessee would recognize an ROU asset for its interest in the underlying asset and a corresponding lease liability.

Thinking It Through

Under the FASB's dual-model approach, a lease would be classified as a finance lease if any of the following criteria are met at the commencement of the lease:

- "The lease transfers ownership of the underlying asset to the lessee by the end of the lease term."
- "The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise."
- "The lease term is for the major part of the remaining economic life of the underlying asset."
- "The present value of the sum of the lease payments and any residual value guaranteed by the lessee . . . equals or exceeds substantially all of the fair value of the underlying asset."
- "The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term."

Each criterion except the last is essentially the same as (but not identical to) the existing lease classification criteria in ASC 840. The FASB decided to revise the criteria by eliminating their bright-line thresholds — namely, whether the lease term is for 75 percent or more of the economic life of the asset or whether the present value of the lease payments (including any guaranteed residual value) is at least 90 percent of the fair value of the leased asset. The elimination of the bright-line thresholds could affect a lease's classification. Also, while the last criterion is new, we generally would not expect it to be met in isolation because a lessor would be likely to structure a lease that compensates for the asset's having no alternative use (thereby satisfying another criterion).

Although the classification criteria are similar to those under current U.S. GAAP, some differences affect the real estate industry. First, the ASU requires entities to account for land and other elements separately unless the effects of not doing so are immaterial. Under current U.S. GAAP, the lease classification of land is evaluated separately from the building if its fair value at lease inception is 25 percent or more of the fair value of the leased property and the lease does not meet either the criteria related to transfer of ownership or the bargain purchase option criterion. This change may result in more bifurcation of real estate leases into separate land and building elements that are required to be evaluated separately for lease classification purposes and accounted for separately.

Lessor Accounting

The boards considered constituent feedback and decided not to make significant changes to the existing lessor accounting model. Rather, they agreed to adopt an approach that is similar to the existing capital/finance lease and operating lease models in ASC 840 and IAS 17. However, the FASB decided to align the U.S. GAAP classification requirements with the criteria in IAS 17. In addition, the FASB decided that for leases that are similar to current sales-type leases, the lessor would only be permitted to recognize the profit on the transaction if the arrangement would have qualified as a sale under the new revenue recognition guidance (ASC 606).

Thinking It Through

The inability to recognize profit on a transaction that would not have qualified as a sale under the new revenue recognition guidance is not likely to significantly affect real estate lessors since they typically do not enter into sales-type leases. However, the effect of the ASU's changes to conform the U.S. GAAP classification requirements to those under IFRSs may be similar to the effect discussed above for lessees. In addition, the new guidance requires real estate lessors to disclose more information.

Effective Date and Transition

ASU 2016-02 is effective for public business entities for annual years beginning after December 15, 2018, including interim periods therein. For all other entities, the standard is effective for annual periods beginning after December 15, 2019, and interim periods thereafter. Early adoption is permitted. Lessees and lessors are required to use a modified retrospective transition method for existing leases. Accordingly, they would apply the new accounting model for the earliest year presented in the financial statements.

For discussion of additional implementation considerations, see Deloitte's March 1, 2016, *Heads Up* and March 2016 *Real Estate Spotlight* (updated July 2016).

Financial Instruments

Impairment

Background

In June 2016, the FASB issued ASU 2016-13, which amends guidance on the impairment of financial instruments. The ASU adds to U.S. GAAP an impairment model (known as the current expected credit loss (CECL) model) that is based on expected losses rather than incurred losses. Under the new guidance, an entity recognizes as an allowance its estimate of expected credit losses, which the FASB believes will result in more timely recognition of such losses. The ASU is also intended to reduce the complexity of U.S. GAAP by decreasing the number of credit impairment models that entities use to account for debt instruments.

Once effective (see the "Effective Date" discussion below), the new guidance will significantly change the accounting for credit impairment. Banks and certain asset portfolios (e.g., loans, leases, and debt securities) will need to modify their current processes for establishing an allowance for loan and lease losses and other-than-temporary impairments to ensure that they comply with the ASU's new requirements. To do so, they may need to make changes to their operations and systems associated with credit modeling, regulatory compliance, and technology.

Key provisions of the ASU are discussed below. For additional information, see Deloitte's June 17, 2016, *Heads Up*.

Thinking It Through

In late 2015, the FASB established a TRG for credit losses. Like the TRG for the new revenue recognition standard, the credit losses TRG does not issue guidance but provides feedback to the FASB on potential implementation issues. By analyzing and discussing such issues, the TRG helps the Board determine whether it needs to take further action (e.g., by clarifying or issuing additional guidance).

The CECL Model

Scope

The CECL model applies to most[7] debt instruments (other than those measured at fair value), trade receivables, net investments in leases, reinsurance receivables that result from insurance transactions, financial guarantee contracts,[8] and loan commitments. However, available-for-sale (AFS) debt securities are excluded from the model's scope and will continue to be assessed for impairment under the guidance in ASC 320 (the FASB moved the impairment model for AFS debt securities from ASC 320 to ASC 326-30 and has made limited amendments to the impairment model for AFS debt securities, as discussed below).

Recognition of Expected Credit Losses

Unlike the incurred loss models in existing U.S. GAAP, the CECL model does not specify a threshold for the recognition of an impairment allowance. Rather, an entity will recognize its estimate of expected credit losses for financial assets as of the end of the reporting period. Credit impairment will be recognized as an allowance — or contra-asset — rather than as a direct write-down of the amortized cost basis of a financial asset. However, the carrying amount of a financial asset that is deemed uncollectible will be written off in a manner consistent with existing U.S. GAAP.

Thinking It Through

Because the CECL model does not have a minimum threshold for recognition of impairment losses, entities will need to measure expected credit losses on assets that have a low risk of loss (e.g., investment-grade held-to-maturity (HTM) debt securities). However, the ASU states that "an entity is not required to measure expected credit losses on a financial asset . . . in which historical credit loss information adjusted for current conditions and reasonable and supportable forecasts results in an expectation that nonpayment of the [financial asset's] amortized cost basis is zero." U.S. Treasury securities and certain highly rated debt securities may be assets the FASB contemplated when it decided to allow an entity to recognize zero credit losses on an asset, but the ASU does not so indicate. Regardless, there are likely to be challenges associated with measuring expected credit losses on financial assets whose risk of loss is low.

[7] The following debt instruments would not be accounted for under the CECL model:
- Loans made to participants by defined contribution employee benefit plans.
- Policy loan receivables of an insurance entity.
- Pledge receivables (promises to give) of a not-for-profit entity.
- Loans and receivables between entities under common control.

[8] The CECL model does not apply to financial guarantee contracts that are accounted for as insurance or measured at fair value through net income.

Measurement of Expected Credit Losses

The ASU describes the impairment allowance as a "valuation account that is deducted from the amortized cost basis of the financial asset(s) to present the net carrying value at the amount expected to be collected on the financial asset." An entity can use a number of measurement approaches to determine the impairment allowance. Some approaches project future principal and interest cash flows (i.e., a discounted cash flow method) while others project only future principal losses. Regardless of the measurement method used, an entity's estimate of expected credit losses should reflect those losses occurring over the contractual life of the financial asset.

When determining the contractual life of a financial asset, an entity is required to consider expected prepayments either as a separate input in the determination or as an amount embedded in the credit loss experience that it uses to estimate expected credit losses. The entity is not allowed to consider expected extensions of the contractual life unless it reasonably expects to execute a troubled debt restructuring with the borrower by the reporting date.

An entity must consider all available relevant information when estimating expected credit losses, including details about past events, current conditions, and reasonable and supportable forecasts and their implications for expected credit losses. That is, while the entity is able to use historical charge-off rates as a starting point for determining expected credit losses, it has to evaluate how conditions that existed during the historical charge-off period may differ from its current expectations and accordingly revise its estimate of expected credit losses. However, the entity is not required to forecast conditions over the contractual life of the asset. Rather, for the period beyond which the entity can make reasonable and supportable forecasts, the entity reverts to historical credit loss experience.

Thinking It Through

It will most likely be challenging for entities to measure expected credit losses. Further, one-time or recurring costs may be associated with the measurement, some of which may be related to system changes and data collection. While such costs will vary by institution, nearly all entities will incur some costs when using forward-looking information to estimate expected credit losses over the contractual life of an asset.

AFS Debt Securities

The CECL model does not apply to AFS debt securities. Instead, the FASB decided to make targeted improvements to the existing other-than-temporary impairment model in ASC 320 for certain AFS debt securities to eliminate the concept of "other than temporary" from that model.[9] Accordingly, the ASU states that an entity:

- Must use an allowance approach (vs. permanently writing down the security's cost basis).
- Must limit the allowance to the amount at which the security's fair value is less than its amortized cost basis.
- May not consider the length of time fair value has been less than amortized cost.
- May not consider recoveries in fair value after the balance sheet date when assessing whether a credit loss exists.

[9] The amendments do not apply to an AFS debt security that an entity intends to sell or will more likely than not be required to sell before the recovery of its amortized cost basis. If an entity intends to sell or will more likely than not be required to sell a security before recovery of its amortized costs basis, the entity would write down the debt security's amortized cost to the debt security's fair value as required under existing U.S. GAAP.

PCD Assets

For purchased financial assets with credit deterioration (PCD assets),[10] the ASU requires an entity's method for measuring expected credit losses to be consistent with its method for measuring expected credit losses for originated and purchased non-credit-deteriorated assets. Upon acquiring a PCD asset, the entity would recognize its allowance for expected credit losses as an adjustment that increases the cost basis of the asset (the "gross-up" approach). After initial recognition of the PCD asset and its related allowance, the entity would continue to apply the CECL model to the asset — that is, any changes in the entity's estimate of cash flows that it expects to collect (favorable or unfavorable) would be recognized immediately in the income statement. Interest income recognition would be based on the purchase price plus the initial allowance accreting to the contractual cash flows.

Disclosures

Many of the disclosures required under the ASU are similar to those already required under U.S. GAAP as a result of ASU 2010-20. Accordingly, entities must also disclose information about:

- Credit quality.[11]
- Allowances for expected credit losses.
- Policies for determining write-offs.
- Past-due status.
- Nonaccrual status.
- PCD assets.
- Collateral-dependent financial assets.

Effective Date and Transition

For public business entities that meet the U.S. GAAP definition of an SEC filer, the ASU is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years.

For public business entities that do not meet the U.S. GAAP definition of an SEC filer, the ASU is effective for fiscal years beginning after December 15, 2020, including interim periods within those fiscal years.

For all other entities, the ASU is effective for fiscal years beginning after December 15, 2020, and interim periods within those fiscal years beginning after December 15, 2021.

In addition, entities are permitted to early adopt the new guidance for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

For most debt instruments, entities must record a cumulative-effect adjustment to the statement of financial position as of the first reporting period in which the guidance is effective. However, the ASU provides instrument-specific transition guidance on other-than-temporarily impaired debt securities, PCD assets, and certain beneficial interests within the scope of ASC 325-40.

[10] The ASU defines PCD assets as "[a]cquired individual financial assets (or acquired groups of financial assets with similar risk characteristics) that, as of the date of acquisition, have experienced a more-than-insignificant deterioration in credit quality since origination, as determined by an acquirer's assessment."

[11] Short-term trade receivables resulting from revenue transactions within the scope of ASC 605 and ASC 606 are excluded from these disclosure requirements.

Classification and Measurement

Background

ASU 2016-01 amends the guidance on the classification and measurement of financial instruments. The amendments contain changes related to the following:

- Accounting for equity investments (apart from those that are accounted for under the equity method or those that are consolidated).
- Recognition of changes in fair value attributable to changes in instrument-specific credit risk for financial liabilities for which the fair value option has been elected.
- Disclosure requirements for financial assets and financial liabilities.

The ASU's key provisions are discussed below. For more information, see Deloitte's January 12, 2016, *Heads Up*.

Classification and Measurement of Equity Investments

The amendments will require entities to carry all investments in equity securities at fair value, with changes in fair value recorded through earnings (FVTNI), unless the equity investments are accounted for under the equity method or are consolidated. For equity investments that do not have a readily determinable fair value, the guidance will permit a practicability exception under which the equity investment would be measured at cost less impairment, if any, plus or minus observable price changes in orderly transactions. This practicability exception would not be available to reporting entities that are investment companies or broker-dealers in securities.

An entity that has elected the practicability exception for equity investments that do not have a readily determinable fair value is required to assess whether the equity investment is impaired by qualitatively considering the indicators described in ASC 321-10-35-3. If, on the basis of the qualitative assessment, the equity investment is impaired, an entity would be required to record an impairment equal to the amount by which the carrying value exceeds fair value. The entity should no longer evaluate whether such impairment is other than temporary.

Thinking It Through

Under current U.S. GAAP, marketable equity securities that are not accounted for as equity-method investments are classified as either held for trading, with changes in fair value recognized in earnings, or AFS with changes in fair value recognized in other comprehensive income (OCI). For AFS investments, changes in fair value are accumulated in OCI and not recognized in earnings until the investment is sold or has an other-than-temporary impairment. Investments in nonmarketable equity securities other than equity method investments are measured at cost (less impairment) unless the fair value option is elected. Under the new guidance, since equity securities can no longer be accounted for as AFS or cost method investments and will need to be recorded at FVTNI, real estate entities holding such investments could see more volatility in earnings under the new guidance.

Changes in Fair Value of a Liability Attributed to Changes in Instrument-Specific Credit Risk

For financial liabilities (excluding derivative instruments) for which the fair value option has been elected, the amendments will require an entity to separately recognize in OCI any changes in fair value associated with instrument-specific credit risk. The guidance indicates that the portion of the total change in fair value that exceeds the amount resulting from a change in a base market risk (such as a risk-free interest rate) may be attributable to instrument-specific credit risk, but also acknowledges that there may be other methods an entity may use to determine instrument-specific credit risk.

Changes to Disclosure Requirements

For nonpublic business entities, the amendments eliminate the requirement to disclose the fair value of financial instruments measured at amortized cost. In addition, for such financial instruments, public business entities would not be required to disclose (1) the information related to the methods and significant assumptions used to estimate fair value or (2) a description of the changes in the methods and significant assumptions used to estimate fair value. The guidance also clarifies U.S. GAAP by eliminating the provisions in ASC 825 that had been interpreted to permit an "entry" price notion for estimating the fair value of loans for disclosure purposes. The amendments require a public business entity to disclose the fair value in accordance with the exit price notion in ASC 820. In addition, all entities are required to disclose in the notes to the financial statement all financial assets and financial liabilities grouped by (1) measurement category (i.e., amortized cost or fair value — net income or OCI) and (2) form of financial asset (i.e., securities and loans/receivables).

Effective Date and Transition

For public business entities, the new standard is effective for fiscal years beginning after December 15, 2017, including interim periods therein. For all other entities, the standard is effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early adoption of certain of the standard's provisions is permitted for all entities. Nonpublic business entities are permitted to adopt the standard in accordance with the effective date for public business entities.

Measurement-Period Adjustments

Background

In September 2015, the FASB issued ASU 2015-16, which amended the guidance in ASC 805 on the accounting for measurement-period adjustments. The ASU was issued as part of the FASB's simplification initiative in response to stakeholder feedback that restating prior periods to reflect adjustments made to provisional amounts recognized in a business combination adds cost and complexity to financial reporting but does not significantly improve the usefulness of the information provided to users. Key provisions of the ASU are discussed below. For more information, see Deloitte's September 30, 2015, *Heads Up*.

Key Provisions of the ASU

Under previous guidance, when an acquirer identified an adjustment to provisional amounts during the measurement period, the acquirer was required to revise comparative information for prior periods, including making any change in depreciation, amortization, or other income effects recognized in completing the initial accounting, as if the accounting for the business combination had been completed as of the acquisition date.

The ASU requires an acquirer to recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined. The effect on earnings of changes in depreciation or amortization, or other income effects (if any) as a result of the change to the provisional amounts, calculated as if the accounting had been completed as of the acquisition date, must be recorded in the reporting period in which the adjustment amounts are determined rather than retrospectively.

Thinking It Through

Although the ASU changes the accounting for measurement-period adjustments, it does not change the definition of a measurement-period adjustment, which is an adjustment to the amounts provisionally recognized for the consideration transferred, the assets acquired, and the liabilities assumed as a result of "new information obtained about facts and circumstances that existed as of the acquisition date that, if known, would have affected the measurement of the amounts recognized as of that date." Errors, information received after the measurement period ends, or information received about events or circumstances that did not exist as of the acquisition date are not measurement-period adjustments.

Disclosure Requirements

The ASU also requires that the acquirer present separately on the face of the income statement, or disclose in the notes, the portion of the amount recorded in current-period earnings by line item that would have been recorded in previous reporting periods if the adjustment to the provisional amounts had been recognized as of the acquisition date.

Effective Date and Transition

For public business entities, the ASU is effective for fiscal years beginning after December 15, 2015, including interim periods within those fiscal years. For all other entities, the ASU is effective for fiscal years beginning after December 15, 2016, and interim periods within fiscal years beginning after December 15, 2017. The ASU must be applied prospectively to adjustments to provisional amounts that occur after the effective date. Early application is permitted for financial statements that have not been issued.

The only disclosures required at transition will be the nature of and reason for the change in accounting principle. An entity should disclose that information in the first annual period of adoption and in the interim periods within the first annual period if there is a measurement-period adjustment during the first annual period in which the changes are effective.

Simplifying the Transition to the Equity Method of Accounting

The FASB issued ASU 2016-07 in March 2016 as part of its simplification initiative. Under the guidance in U.S. GAAP before the ASU's amendments, an investor that meets the conditions for applying the equity method of accounting is required to retrospectively apply such method to all prior periods in which it had historically accounted for the investment under the cost method or as an AFS security. The ASU removes the requirement to retrospectively apply the equity method of accounting. It also requires entities to recognize unrealized holding gains or losses in accumulated other comprehensive income (AOCI) related to an AFS security that becomes eligible for the equity method of accounting in earnings as of the date the investment qualifies for the equity method of accounting.

The guidance is effective for all entities for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. The guidance must be applied prospectively to increases in the level of ownership interest or degree of influence occurring after the ASU's effective date. Early adoption is permitted.

Also as part of its simplification initiative, the FASB issued a proposed ASU in June 2015 that would have eliminated the requirement to separately account for basis differences (i.e., the difference between the cost of an investment and the amount of underlying equity in net assets). The proposed guidance would have also eliminated the requirement for an investor to allocate basis differences to specific assets and liabilities of the investee and account for them accordingly (e.g., additional depreciation for basis differences assigned to tangible assets). However, many commenters on the proposed ASU indicated that eliminating the allocation of basis differences could create different complexities and result in inflated values of investments that would no longer be amortized over time as well as increase the likelihood of impairment in future periods. Accordingly, in May 2016, the FASB decided to remove the project from its agenda because of "insufficient support to change the equity method of accounting."

Thinking It Through

Application of the existing accounting requirements (i.e., before the ASU's amendments) can be particularly onerous because investments are often structured as partnerships or limited liability corporations, which may require use of the equity method at a relatively low ownership percentage, and investments in projects may evolve over time depending on stages of development, investment strategy, or changes in portfolio focus. For public companies, the existing U.S. GAAP requirements have been compounded by the SEC's guidance requiring registrants to provide (1) separate or summarized financial statements for prior periods once the equity method of accounting is applied to a significant investment (see paragraph 2405.5 of the SEC's *Financial Reporting Manual*) or (2) retroactively adjusted annual financial statements reflecting the equity method of accounting if a registration statement is filed after the first quarter in which the change to the equity method of accounting is reported but before the next annual report on Form 10-K is filed (see Topic 13 of the *Financial Reporting Manual*).

Accordingly, the ASU provides welcome relief from complex accounting considerations and SEC reporting requirements related to a transition to the equity method of accounting. However, the new ASU will also introduce new complexities after such transition. For example, application of the new method may result in additional basis differences if the earnings that would have affected the cost basis under existing U.S. GAAP are not recognized retrospectively.

Consolidation — Interests Held Through Related Parties That Are Under Common Control

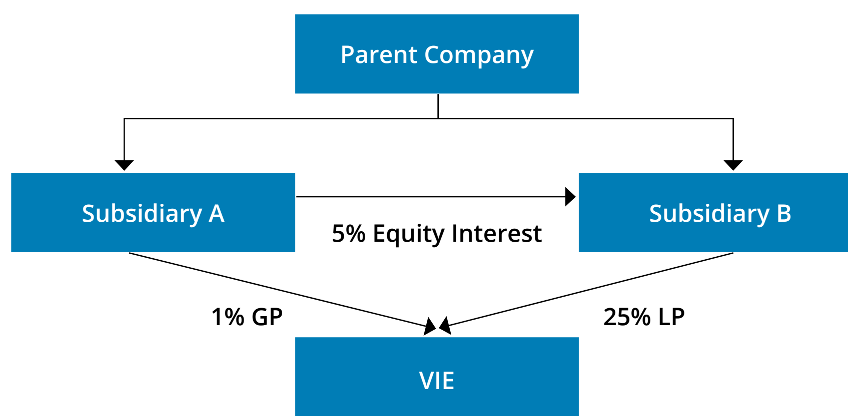
Background

In February 2015, the FASB issued ASU 2015-02, which amends the guidance in ASC 810-10 to require, among other things, a reporting entity that is a single decision maker to consider interests held by its related parties only if the reporting entity has a direct interest in the related parties. If the related parties and the reporting entity are not under common control, the indirect economic interests in a variable interest entity (VIE) held through related parties would be considered on a proportionate basis in the determination of whether the reporting entity is the primary beneficiary of the VIE. Alternatively, if the related parties and the reporting entity are under common control, the reporting entity would be required to consider the interests of the related parties in their entirety (not on a proportionate basis). As a result, the reporting entity may satisfy the "power" criterion (i.e., the ability to direct the activities that most significantly affect the VIE's economic performance) in the consolidation analysis even if it has a relatively insignificant economic interest in the VIE.

In October 2016, the FASB issued ASU 2016-17 to remove the last sentence of ASC 810-10-25-42, which states, "Indirect interests held through related parties that are under common control with the decision maker should be considered the equivalent of direct interests in their entirety." As a result of the ASU, a reporting entity would consider its indirect economic interests in a VIE held through related parties that are under common control on a proportionate basis in a manner consistent with its consideration of indirect economic interests held through related parties that are not under common control.

Example

A limited partnership (VIE) is formed to acquire a real estate property. The partnership has a GP (Subsidiary A) that holds a 1 percent interest in the partnership, an LP owned by the parent company of the GP (Subsidiary B) that holds a 25 percent interest in the partnership, and various unrelated investors that hold the remaining equity interests. In addition, A holds a 5 percent interest in B, and both A and B are wholly owned subsidiaries of Parent Company. Subsidiary A is the property manager and has full discretion to buy and sell properties, manage the properties, and obtain financing.



Under the guidance before ASU 2016-17, A and B must consider their own interests before evaluating which entity is the primary beneficiary of the VIE. Accordingly, A would conclude that it meets the power criterion as well as the economics criterion (i.e., the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE) because A must treat B's 25 percent interest in the VIE as its own since A has an interest in B, and both are under the common control of Parent Company.

Example (continued)

Under the ASU, A will still conclude that it meets the power criterion on its own. However, in the evaluation of the economics criterion, since A owns a 20 percent interest in B, and B owns a 5 percent subordinated interest in the VIE, Subsidiary A will conclude that it has a 1 percent indirect interest in the VIE a result of its interest in B (20 percent interest in B multiplied by B's 5 percent interest in the VIE). Therefore, A will be unlikely to meet the economics criterion on its own. However, since A and B are under common control and as a group will satisfy the power and economics criteria, they will need to perform the related-party tiebreaker test to determine which party is most closely associated with the VIE.

Thinking It Through

As a result of the ASU, the related-party tiebreaker test will be performed more frequently because, as illustrated in the example above, it will be less likely for the decision maker to meet the economics criterion on its own when considering its exposure through a related party under common control on a proportionate basis.[12] Many decision makers view the ASU's guidance favorably because they would otherwise consolidate a legal entity with a small indirect interest. The ASU will instead require the decision maker to consider which party (the single decision maker or the related party under common control) is most closely associated with the VIE and therefore should consolidate. This guidance may have a significant impact on the individual financial statements of real estate subsidiaries because it could change which subsidiary consolidates a VIE.

Effective Date and Transition

For all reporting entities, the guidance will be effective for annual periods beginning after December 15, 2016. Reporting entities that have not yet adopted the guidance in ASU 2015-02 will be required to adopt ASU 2016-17's amendments at the same time they adopt those in ASU 2015-02. Early adoption, including adoption in an interim period, is permitted as of October 26, 2016 (the ASU's issuance date).

Employee Share-Based Payment Accounting Improvements

Background

In March 2016, the FASB issued ASU 2016-09, which simplifies several aspects of the accounting for employee share-based payment transactions for both public and nonpublic entities, including the accounting for income taxes, forfeitures, and statutory tax withholding requirements, as well as classification in the statement of cash flows. The new guidance, which is part of the Board's simplification initiative, also contains practical expedients for nonpublic entities.

[12] This outcome is because the FASB has proposed to change only the guidance in ASC 810-10-25-42. The Board also considered amending the guidance on determining whether fees paid to a decision maker or service provider represent a variable interest in the evaluation of a decision maker's indirect interests held through related parties under common control. While the proposal would retain that guidance, the Board will consider clarifying it, as well as other aspects of the guidance on common-control arrangements, as part of a separate initiative. The proposal therefore only affects the decision maker's consideration of indirect interests held through related parties under common control in the primary-beneficiary assessment.

Key Provisions of the ASU

Accounting for Income Taxes

Under current guidance, when a share-based payment award is granted to an employee, the fair value of the award is generally recognized over the vesting period, and a corresponding deferred tax asset (DTA) is recognized to the extent that the award is tax-deductible. The tax deduction is generally based on the intrinsic value at the time of exercise (for an option) or on the fair value upon vesting of the award (for restricted stock), and it can be either greater (excess tax benefit) or less (tax deficiency) than the compensation cost recognized in the financial statements. All excess tax benefits are recognized in additional paid-in capital (APIC), and tax deficiencies are recognized either in the income tax provision or in APIC to the extent that there is a sufficient "APIC pool" related to previously recognized excess tax benefits.

Under the ASU, an entity recognizes all excess tax benefits and tax deficiencies as income tax expense or benefit in the income statement. This change eliminates the notion of the APIC pool and significantly reduces the complexity and cost of accounting for excess tax benefits and tax deficiencies. In addition, excess tax benefits and tax deficiencies are considered discrete items in the reporting period in which they occur and are not included in the estimate of an entity's annual effective tax rate.

The ASU's guidance on recording excess tax benefits and tax deficiencies in the income statement also has a corresponding effect on the computation of diluted earnings per share (EPS) when an entity applies the treasury stock method. An entity that applies such method under current guidance estimates the excess tax benefits and tax deficiencies to be recognized in APIC in determining the assumed proceeds available to repurchase shares. However, under the ASU, excess tax benefits and tax deficiencies are excluded from the calculation of assumed proceeds since such amounts are recognized in the income statement. In addition, the new guidance affects the accounting for tax benefits of dividends on share-based payment awards, which will now be reflected as income tax expense or benefit in the income statement rather than as an increase to APIC.

Further, the ASU eliminates the requirement to defer recognition of an excess tax benefit until the benefit is realized through a reduction to taxes payable.

In addition to addressing the recognition of excess tax benefits and tax deficiencies, the ASU provides guidance on the related cash flow presentation. Under existing guidance, excess tax benefits are viewed as a financing transaction and are presented as financing activities in the statement of cash flows. However, there is no cash receipt but only a reduction in taxes payable. Therefore, a reclassification is made in the statement of cash flows to reflect a hypothetical inflow in the financing section and a hypothetical outflow from the operating section.

Under the ASU, excess tax benefits no longer represent financing activities since they are recognized in the income statement; therefore, excess tax benefits are not separate cash flows and should be classified as operating activities in the same manner as other cash flows related to income taxes. Accordingly, the ASU eliminates the requirement to reclassify excess tax benefits from operating activities to financing activities.

Accounting for Forfeitures

The ASU allows an entity to elect as an accounting policy either to continue to estimate the total number of awards for which the requisite service period will not be rendered (as currently required) or to account for forfeitures when they occur. This entity-wide accounting policy election only applies to service conditions; for performance conditions, the entity continues to assess the probability that such conditions will be achieved. An entity must also disclose its policy election for forfeitures.

Thinking It Through

An entity that adopts a policy to account for forfeitures as they occur must still estimate forfeitures when an award is (1) modified (the estimate applies to the original award in the measurement of the effects of the modification) and (2) exchanged in a business combination (the estimate applies to the amount attributed to precombination service). However, the accounting policy for forfeitures will apply to the subsequent accounting for awards that are modified or exchanged in a business combination.

Statutory Tax Withholding Requirements

The ASU modifies the current exception to liability classification of an award when an employer uses a net-settlement feature to withhold shares to meet the employer's minimum statutory tax withholding requirement. Currently, the exception only applies when no more than the number of shares necessary for the minimum statutory tax withholding requirement to be met is repurchased or withheld. The new guidance stipulates that the net settlement of an award for statutory tax withholding purposes would not result, by itself, in liability classification of the award provided that the amount withheld for taxes does not exceed the maximum statutory tax rate in the employees' relevant tax jurisdictions.

Further, to eliminate diversity in practice, the ASU requires that cash payments to tax authorities in connection with shares withheld to meet statutory tax withholding requirements be presented as a financing activity in the statement of cash flows because such payments represent an entity's cash outflow to reacquire the entity's shares.

Thinking It Through

Under current guidance, an entity is required to track the minimum statutory tax withholding requirement applicable to each specific award grantee in each applicable jurisdiction if shares are repurchased or withheld. Under the new guidance, the maximum rate is determined on a jurisdiction-by-jurisdiction basis even if that rate exceeds the highest rate applicable to a specific award grantee. However, the classification exception would not apply to entities that do not have a statutory tax withholding obligation; for such entities, any net settlement for tax withholding would result in a liability-classified award.

In addition, an entity may change the terms of its awards related to net settlement for withholding taxes from the minimum statutory tax rate to a higher rate up to the maximum statutory tax rate. While this change may be made to existing awards, the entity would not be required to account for such a change as a modification. However, this accounting treatment applies only in these narrow circumstances (i.e., solely to change the net-settlement provisions from the minimum statutory tax rate to a higher rate up to the maximum statutory tax rate for statutory tax withholding purposes) and should not be analogized to other situations.

Practical Expedients for Nonpublic Entities

Expected-Term Practical Expedient

The ASU allows nonpublic entities to use the simplified method to estimate the expected term for awards (including liability-classified awards measured at fair value) with service or performance conditions that meet certain requirements. Such entities would apply this practical expedient as follows:

- For awards with only a service condition, nonpublic entities can estimate the expected term as the midpoint between the requisite service period and the contractual term of the award.
- For awards with a performance condition, the estimate of the expected term would depend on whether it is probable that the performance condition will be achieved:
  - If it is probable that the performance condition will be achieved, nonpublic entities can estimate the expected term as the midpoint between the requisite service period and the contractual term.
  - If it is not probable that the performance condition will be achieved, nonpublic entities can estimate the expected term as (1) the contractual term if the award does not contain an explicit service period or (2) the midpoint between the requisite service period and the contractual term if the award does contain an explicit service period.

Intrinsic Value Practical Expedient

The ASU allows nonpublic entities to make a one-time election to switch from fair value measurement to intrinsic value measurement, without demonstrating preferability, for share-based payment awards classified as liabilities.

Nonpublic entities are not allowed to make this election on an ongoing basis after the effective date of the new guidance.

Transition and Related Disclosures

The following table outlines the transition methods for an entity's adoption of ASU 2016-09:

Type	Transition Method
Recognition of excess tax benefits and tax deficiencies (accounting for income taxes)	Prospective
Unrecognized excess tax benefits (accounting for income taxes)	Modified retrospective
Classification of excess tax benefits in the statement of cash flows	Retrospective or prospective
Accounting for forfeitures	Modified retrospective
Classification and statutory tax withholding requirements	Modified retrospective
Classification of employee taxes paid in the statement of cash flows when an employer withholds shares for tax withholding purposes	Retrospective
Nonpublic entity practical expedient for expected term	Prospective
Nonpublic entity practical expedient for intrinsic value	Modified retrospective

Thinking It Through

An entity's prior-year APIC pool is not affected because prior-year excess tax benefits and tax deficiencies have already been recognized in the financial statements, and the recognition of excess tax benefits and tax deficiencies in the income statement is prospective only in the fiscal year of adoption. As a result, there is no reclassification between APIC and retained earnings in the fiscal years before adoption. The modified retrospective transition guidance for taxes only applies to previously unrecognized excess tax benefits outstanding upon adoption of ASU 2016-09 with a cumulative-effect adjustment to retained earnings.

In the period of adoption, entities are required to disclose (1) the nature of and reason for the changes in accounting principle and (2) any cumulative effects of the changes on retained earnings or other components of equity as of the date of adoption.

In addition, because the change in presentation in the statement of cash flows related to excess tax benefits can be applied either prospectively or retrospectively, entities are required to disclose (1) "that prior periods have not been adjusted" if the change is applied prospectively or (2) the "effect of the change on prior periods retrospectively adjusted" if the change is applied retrospectively. For the change in presentation in the statement of cash flows related to statutory tax withholding requirements, entities are required to disclose the "effect of the change on prior periods retrospectively adjusted."

Effective Date

For public business entities, the ASU is effective for annual reporting periods beginning after December 15, 2016, including interim periods within those annual reporting periods. For all other entities, the ASU is effective for annual reporting periods beginning after December 15, 2017, and interim periods within annual reporting periods beginning after December 15, 2018.

Early adoption will be permitted in any interim or annual period for which financial statements have not yet been issued or have not been made available for issuance. If early adoption is elected, all amendments in the ASU that apply must be adopted in the same period. In addition, if early adoption is elected in an interim period, any adjustments should be reflected as of the beginning of the annual period that includes that interim period.

Example

Entity A, an SEC registrant, adopts ASU 2016-09 in its third fiscal quarter. Entity A had $50 of excess tax benefits in each quarter in its current fiscal year to date and is not affected by adopting any of the other provisions of ASU 2016-09. In its previously issued financial statements in Form 10-Q, A recognized a total of $100 ($50 in each quarter) of excess tax benefits in APIC. In its third fiscal quarter, the period in which the ASU is adopted, A recognizes $50 of excess tax benefits in its income statement. That is, the quarter-to-date income tax provision will only include the third fiscal quarter excess tax benefits ($50). In addition, the year-to-date income tax provision will include excess tax benefits of $150 to reflect the reversal of the excess tax benefits recognized in APIC for the first two fiscal quarters ($100) and the recognition of those benefits in the income statement in those prior quarters (the $100 in excess tax benefits related to the first and second fiscal quarters are not recognized in the third quarter but are reflected on a recasted basis in the applicable prior quarters). In the quarterly information footnote of its subsequent Form 10-K filing, A will present a schedule reflecting the first and second fiscal quarters' excess tax benefits ($50 each quarter) in the income statement even though these amounts were reported in APIC in previously issued financial statements in Form 10-Q. Finally, A's financial statements in Form 10-Q issued in the year after A's adoption of the ASU will reflect the prior-year quarterly excess tax benefits (i.e., first and second fiscal quarters of the prior year) on a recasted basis in the income statement rather than in APIC.

Classification of Deferred Taxes

Background and Key Provisions

In November 2015, the FASB issued ASU 2015-17, which will require entities to present DTAs and deferred tax liabilities (DTLs) as noncurrent in a classified balance sheet. The ASU simplifies the current guidance, which requires entities to separately present DTAs and DTLs as current and noncurrent in a classified balance sheet.

The project on simplifying the balance sheet presentation of deferred taxes is part of the FASB's simplification initiative. Launched in June 2014, the simplification initiative is intended to improve U.S. GAAP by reducing costs and complexity while maintaining or enhancing the usefulness of the related financial information.

Under current guidance (ASC 740-10-45-4), entities "shall separate deferred tax liabilities and assets into a current amount and a noncurrent amount. Deferred tax liabilities and assets shall be classified as current or noncurrent based on the classification of the related asset or liability for financial reporting." Stakeholder feedback indicated that the separate presentation of deferred taxes as current or noncurrent provided little useful information to financial statement users and resulted in additional costs to preparers. Therefore, the FASB issued the ASU to simplify the presentation of deferred taxes in a classified balance sheet. Netting of DTAs and DTLs by tax jurisdiction will still be required under the new guidance.

Noncurrent balance sheet presentation of all deferred taxes eliminates the requirement to allocate a valuation allowance on a pro rata basis between gross current and noncurrent DTAs, which constituents had also identified as an issue contributing to complexity in accounting for income taxes.

Thinking It Through

The ASU will align with the current guidance in IAS 12, which requires entities to present DTAs and DTLs as noncurrent in a classified balance sheet.

The example below compares the classification of DTAs and DTLs under current U.S. GAAP with their classification under the new guidance.

Example

Company ABC has a net DTA of $100 million as of December 31, 20X1, as shown in the table below (amounts in millions):

Balance Sheet as of 12/31/X1	
	DTA/(DTL)
Inventory	$ 50
Net operating loss (NOL) carryforward	350
Fixed assets	(300)
Total DTA/(DTL)	$ 100

Company ABC expects that $100 million of the NOL carryforward will be used in the following year. Below are the current and noncurrent classifications of the DTA/(DTL) as of December 31, 20X1 (amounts in millions):

Description	Current U.S. GAAP		ASU 2015-17	
	Current	Noncurrent	Current	Noncurrent
Inventory	$ 50			$ 50
NOL carryforward	100	$ 250		350
Fixed assets		(300)		(300)
Total DTA/(DTL)	$ 150	$ (50)	$ 0	$ 100

Effective Date and Transition

The ASU requires the following:

- For public business entities, the ASU will be effective for annual periods beginning after December 15, 2016, and interim periods within those years.
- For entities other than public business entities, the ASU will be effective for annual reporting periods beginning after December 15, 2017, and interim reporting periods within annual reporting periods beginning after December 15, 2018.

The Board decided to allow all entities to early adopt the ASU for any interim or annual financial statements that have not been issued. In addition, entities are permitted to apply the amendments either prospectively or retrospectively.

In the period the ASU is adopted, an entity will need to disclose "the nature of and reason for the change in accounting principle." If the new guidance is applied prospectively, the entity should disclose that prior balance sheets were not retrospectively adjusted. However, if the new presentation is applied retrospectively, the entity will need to disclose the quantitative effects of the change on the prior balance sheets presented.

Alternatives for Private Companies

Background

The following guidance (developed in 2014 by the Private Company Council (PCC)) is effective in 2016:

- *Goodwill* — In January 2014, the FASB issued ASU 2014-02, which allows private companies to use a simplified approach to account for goodwill after an acquisition. Under such approach, an entity would (1) amortize goodwill on a straight-line basis, generally over 10 years; (2) test goodwill for impairment only when a triggering event occurs; and (3) make an accounting policy election to test for impairment at either the entity level or the reporting-unit level. The ASU also eliminates "step 2" of the goodwill impairment test; as a result, an entity would measure goodwill impairment as the excess of the entity's (or reporting unit's) carrying amount over its fair value. An entity that elects the simplified approach should adopt the ASU's guidance prospectively and apply it to all existing goodwill (and any goodwill arising from future acquisitions) existing as of the beginning of the period of adoption.

The ASU is effective for annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015. See Deloitte's January 27, 2014, *Heads Up* for more information.

- *Hedge accounting* — In January 2014, the FASB issued ASU 2014-03, which gives private companies a simplified method of accounting for certain receive-variable, pay-fixed interest rate swaps used to hedge variable-rate debt. An entity that elects to apply the simplified hedge accounting to a qualifying hedging relationship would continue to account for the interest rate swap and the variable-rate debt separately on the face of the balance sheet. However, the entity would be able to assume no ineffectiveness in the hedging relationship, thereby essentially achieving the same income statement profile as with a fixed-rate borrowing expense. In addition, the entity is allowed more time to complete its initial hedge documentation. An entity that applies the simplified approach also may elect to measure the related swap at its settlement value rather than at fair value. Financial institutions (including banks, savings and loan associations, savings banks, credit unions, finance companies, and insurance entities) are specifically ineligible to elect this accounting alternative. The ASU is effective for annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015. Entities that elect the simplified approach should adopt the ASU under either a full retrospective or a modified retrospective method. See Deloitte's January 27, 2014, *Heads Up* for more information.
- *Identified intangible assets* — In December 2014, the FASB issued ASU 2014-18, which gives private companies an exemption from having to recognize certain intangible assets for (1) assets acquired in a business combination or (2) investments accounted for under the equity method or upon the adoption of fresh-start accounting. Specifically, an entity would not be required to separately recognize intangible assets for noncompete agreements and certain customer-related intangible assets that arise within the scope of the ASU. Because the amounts associated with these items would be subsumed into goodwill, an entity that elects this accounting alternative would also be required to adopt ASU 2014-02 (see discussion above), resulting in the amortization of goodwill. Entities that elect the alternative should adopt the ASU prospectively to the first eligible transaction within the scope of the ASU that occurs in the annual period beginning after December 15, 2015 (with early adoption permitted), and all transactions thereafter. See Deloitte's December 30, 2014, *Heads Up* for more information.

Changes to Effective Date and Transition Guidance in Certain Private-Company ASUs

In March 2016, the FASB issued ASU 2016-03, which gives private companies a one-time unconditional option to forgo a preferability assessment the first time they elect a PCC accounting alternative within the ASU's scope. However, private companies would still be required to perform a preferability assessment in accordance with ASC 250 for any subsequent change to their accounting policy election in a manner consistent with all accounting policy changes under ASC 250.

The ASU also eliminates the effective dates of PCC accounting alternatives that are within the ASU's scope and extends the transition guidance for such alternatives indefinitely. The new guidance is effective immediately and affects all private companies within the scope of ASU 2014-02 (goodwill), ASU 2014-03 (derivatives and hedging), ASU 2014-07 (common-control leasing arrangements), and ASU 2014-18 (identifiable intangible assets). While the new standard extends the transition guidance in ASU 2014-07 (VIEs) and ASU 2014-18, it does not change the manner in which such guidance is applied. See Deloitte's March 16, 2016, *Heads Up* for more information.

Other Private-Company Matters

Throughout 2016, the PCC has discussed aspects of financial reporting that are complex and costly for private companies, including the application of VIE guidance to common-control arrangements, balance-sheet classification of debt, and liabilities and equity short-term improvements. During its April 2016 meeting, the PCC voted to recommend that the FASB add to its agenda PCC Issue 15-02, "Applying Variable Interest Entity Guidance to Entities Under Common Control."

Statement of Cash Flows: Classification of Certain Cash Receipts and Cash Payments

Background

In August 2016, the FASB issued ASU 2016-15, which amends ASC 230 to add or clarify guidance on the classification of certain cash receipts and payments in the statement of cash flows. ASC 230 lacks consistent principles for evaluating the classification of cash payments and receipts in the statement of cash flows. This has led to diversity in practice and, in certain circumstances, financial statement restatements. Therefore, the FASB issued the ASU with the intent of reducing diversity in practice with respect to eight types of cash flows.

Key Provisions of the ASU

The ASU is a result of consensuses reached by the EITF on issues related to the eight types of cash flows. Key provisions of the amendments are summarized below.

Cash Flow Issues	Amendments
Debt prepayment or debt extinguishment costs	Cash payments for debt prepayment or extinguishment costs (including third-party costs, premiums paid, and other fees paid to lenders) must "be classified as cash outflows for financing activities."
Settlement of zero-coupon bonds	The cash outflows for the settlement of a zero-coupon bond must be bifurcated into operating and financing activities. The portion of the cash payment related to accreted interest should be classified in operating activities, while the portion of the cash payment related to the original proceeds (i.e., the principal) should be classified in financing activities.
Contingent consideration payments made after a business combination	Contingent consideration payments that were not made soon after a business combination (on the basis of the consummation date) must be separated and classified in operating and financing activities. Cash payments up to the amount of the contingent consideration liability recognized as of the acquisition date, including any measurement-period adjustments, should be classified in financing activities, while any excess cash payments should be classified in operating activities.
Proceeds from the settlement of insurance claims	Cash proceeds from the settlement of insurance claims should be classified on the basis of the nature of the loss. For insurance proceeds received in a lump-sum settlement, an entity should determine the classification on the basis of the nature of each loss included in the settlement.
Proceeds from the settlement of corporate-owned life insurance (COLI) policies and bank-owned life insurance (BOLI) policies	Cash proceeds from the settlement of COLI and BOLI polices must be classified in investing activities. However, an entity is permitted, but not required, to align the classification of premium payments on COLI and BOLI policies with the classification of COLI and BOLI proceeds (i.e., payments for premiums may be classified as investing, operating, or a combination thereof).

(Table continued)

<table>
<tr><th>Cash Flow Issues</th><th>Amendments</th></tr>
<tr><td>Distributions received from equity method investees</td><td>An entity is required to make an accounting policy election to classify distributions received from equity method investees under either of the following methods:
Cumulative-earnings approach — Under this approach, distributions are presumed to be returns on investment and classified as operating cash inflows. However, if the cumulative distributions received, less distributions received in prior periods that were determined to be returns of investment, exceed the entity's cumulative equity in earnings, such excess is a return of capital and should be classified as cash inflows from investing activities.
Nature of the distribution approach — Under this approach, each distribution is evaluated on the basis of the source of the payment and classified as either operating cash inflows or investing cash inflows.
If an entity whose chosen policy is the nature of the distribution approach cannot apply the approach because it does not have enough information to determine the appropriate classification (i.e., the source of the distribution), the entity must apply the cumulative-earnings approach and report a change in accounting principle on a retrospective basis. The entity is required to disclose that a change in accounting principle has occurred as a result of the lack of available information as well as the information required under ASC 250-10-50-2, as applicable.

The amendments do not address equity method investments measured under the fair value option.</td></tr>
<tr><td>Beneficial interests in securitization transactions</td><td>A transferor's beneficial interests received as proceeds from the securitization of an entity's financial assets must be disclosed as a noncash activity. Subsequent cash receipts of beneficial interests from the securitization of an entity's trade receivables must be classified as cash inflows from investing activities.</td></tr>
<tr><td>Separately identifiable cash flows and application of the predominance principle</td><td>The guidance provides a three-step approach for classifying cash receipts and payments that have aspects of more than one class of cash flows:
An entity should first apply specific guidance in U.S. GAAP, if applicable.
If there is no specific guidance related to the cash receipt or payment, an entity should bifurcate the cash payment or receipt into "each separately identifiable source or use [of cash] on the basis of the nature of the underlying cash flows." Each separately identifiable source or use of cash will be classified as operating, investing, or financing activities by applying the guidance in ASC 230.
If the cash payment or receipt cannot be bifurcated, the entire payment or receipt should be classified as operating, investing, or financing activities on the basis of the activity that is likely to be the predominant source or use of cash.</td></tr>
</table>

Thinking It Through

The FASB's objective in the ASU is to eliminate the diversity in practice related to the classification of certain cash receipts and payments. As a result, there could be significant changes for some entities under the revised guidance, particularly with respect to the issues discussed below.

Settlement of Zero-Coupon Bonds

The lack of guidance on the classification of payments to settle zero-coupon bonds in the statement of cash flows has led to diversity in the classification of the cash payment made by a bond issuer at the settlement of a zero-coupon bond. Some entities bifurcate the settlement payment between the principal (the amount initially received by the entity) and accreted interest. In those situations, the portion of the repayment related to principal is classified in financing activities, and the portion related to accreted interest is classified in operating activities. However, other entities do not bifurcate the settlement payment between principal and accreted interest and present the entire repayment in financing activities.

Under the ASU, entities are required to bifurcate the repayment of zero-coupon bonds into principal and accreted interest, with the principal portion classified in financing activities and the accreted interest portion classified in operating activities. As a result, entities that currently classify the entire repayment of zero-coupon bonds in financing activities will need to identify the portion of such payments that are related to accreted interest and apply the provisions of the ASU accordingly.

Distributions Received From Equity Method Investees

While ASC 230 distinguishes between returns of investment (which should be classified as inflows from investing activities) and returns on investment (which should be classified as inflows from operating activities), it does not prescribe a method for differentiating between the two. With respect to distributions from equity method investees, entities make this determination by applying a cumulative-earnings approach or a nature of the distribution approach. The ASU formalizes each of these methods and allows an entity to choose either one as an accounting policy election.

However, the ASU requires entities that choose the nature of the distribution approach to report a change in accounting principle if the information required under this approach is unavailable with respect to a particular investee. Therefore, while the ASU will not eliminate diversity in practice, entities that are currently applying the nature of the distribution approach should be mindful of the additional information and disclosure requirements under the ASU in electing a method as their accounting policy.

Beneficial Interests in Securitization Transactions

There is no specific guidance in ASC 230 on how to classify cash receipts associated with beneficial interests in securitization transactions. As a result, entities have classified the subsequent cash receipts from payments on beneficial interests obtained by the transferor in a securitization of the transferor's trade receivables as either operating activities or investing activities in the statement of cash flows. Although there is diversity in practice, we believe that entities have predominantly presented cash receipts from payments on a transferor's beneficial interests in securitized trade receivables as a cash inflow from operating activities. Accordingly, the requirement to present such cash receipts as a cash inflow from investing activities could change practice significantly.

Separately Identifiable Cash Flows and Application of the Predominance Principle

ASC 230 acknowledges that certain cash inflows and outflows may have characteristics of more than one cash flow class (e.g., financing, investing, or operating) and states that the "appropriate classification shall depend on the activity that is likely to be the predominant source of cash flows for the item." Although ASC 230 gives examples illustrating the application of the predominance principle, entities often have difficulty applying the guidance.

As a result, when cash flows have aspects of more than one cash flow class, the ASU requires that entities first determine the classification of those cash receipts and payments by applying the specific guidance in ASC 230 and other applicable ASC topics. Further, the ASU notes that "[i]n the absence of specific guidance, a reporting entity shall determine each separately identifiable source or each separately identifiable use within the cash receipts and cash payments on the basis of the nature of the underlying cash flows." The ASU goes on to observe that "[i]n situations in which cash receipts and payments have aspects of more than one class of cash flows and cannot be separated by source or use . . . the appropriate classification shall depend on the activity that is likely to be the predominant source or use of cash flows for the item." However, because the ASU does not define the term "separately identifiable" in this context, we believe that challenges may be presented related to identifying separately identifiable cash receipts and payments as well as applying the term "predominant."

Effective Date and Transition

For public business entities, the guidance is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. For all other entities, it is effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early adoption will be permitted for all entities.

Entities must apply the guidance retrospectively to all periods presented but may apply it prospectively if retrospective application would be impracticable.

Restricted Cash

Background

In November 2016, the FASB issued ASU 2016-18, which amends ASC 230 to clarify guidance on the classification and presentation of restricted cash. The ASU is the result of the following consensuses reached by the EITF:

- An entity should include in its cash and cash-equivalent balances in the statement of cash flows those amounts that are deemed to be restricted cash and restricted cash equivalents. The Task Force decided not to define the terms "restricted cash" and "restricted cash equivalents" but observed that an entity should continue to provide appropriate disclosures about its accounting policies pertaining to restricted cash in accordance with other GAAP. The Task Force also observed that any change in accounting policy will need to be assessed under ASC 250.
- A reconciliation between the statement of financial position and the statement of cash flows must be disclosed when the statement of financial position includes more than one line item for cash, cash equivalents, restricted cash, and restricted cash equivalents.

- Changes in restricted cash and restricted cash equivalents that result from transfers between cash, cash equivalents, and restricted cash and restricted cash equivalents should not be presented as cash flow activities in the statement of cash flows.
- An entity with a material balance of amounts generally described as restricted cash and restricted cash equivalents must disclose information about the nature of the restrictions.

Effective Date and Transition

For public business entities, the guidance is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. For all other entities, it is effective for annual periods beginning after December 15, 2018, and interim periods beginning after December 15, 2019. Early adoption of the guidance in the ASU is permitted. A reporting entity will apply the guidance retrospectively.

On the Horizon

Financial Instruments

Hedging

In September 2016, the FASB issued a proposed ASU that would amend the hedge accounting recognition and presentation requirements of ASC 815 to (1) reduce their complexity and simplify their application by preparers and (2) improve the transparency and understandability of information conveyed to financial statement users about an entity's risk management activities by better aligning those activities with the entity's financial reporting for hedging relationships.

Although the changes proposed by the FASB are significant, constituents also should take note of those aspects of existing hedge accounting that the Board decided to retain. The proposal still would require all hedging relationships to be highly effective. Moreover, an entity would retain the ability to voluntarily dedesignate a hedging relationship, designate certain component risks of the hedged item as the hedged risk, and apply the critical-terms-match method or the shortcut method.

The FASB will determine the effective date of the proposed amendments after it considers constituent feedback; however, it has tentatively determined that earlier application of the proposed amendments will be permitted at the beginning of any fiscal year before the effective date. Comments on the proposal (see Deloitte's comments) were due by November 22, 2016.

The sections below summarize the proposed ASU's key provisions. For additional information about the proposed ASU, see Deloitte's September 14, 2016, *Heads Up*.

Key Proposed Changes to the Hedge Accounting Model

Hedge Documentation and Qualitative Assessments of Hedge Effectiveness

Under the proposed model, an entity would be required to perform an initial prospective quantitative assessment of hedge effectiveness at hedge inception (unless the hedging relationship qualifies for application of one of the expedients that permit an assumption of perfect hedge effectiveness, such as the shortcut method or critical-terms-match method); however, the entity generally would have until its first quarterly hedge effectiveness assessment date (i.e., up to three months) to complete this quantitative assessment. All other hedge documentation still would need to be in place at hedge inception. The entity could elect to perform subsequent prospective and retrospective hedge effectiveness assessments qualitatively if certain criteria are satisfied; however, the entity could be forced to revert to quantitative assessments if, because facts and circumstances have changed, the entity may no longer assert qualitatively that the hedging relationship was and continues to be highly effective. Once an entity is forced to perform a quantitative assessment, it would be prohibited from performing qualitative assessments in future periods.

Cash Flow Hedges of Forecasted Purchases or Sales of Nonfinancial Items

For a forecasted purchase or sale of a nonfinancial item, the proposed model would permit an entity to designate the variability in cash flows attributable to changes in a contractually specified component as the hedged risk if certain criteria are satisfied. An entity could also hedge exposures arising from a contractually specified component of an agreement to purchase or sell a nonfinancial item for a period that extends beyond the contractual term or when a contract does not yet exist if the qualifying criteria will be met in a future contract and all the other cash flow hedging requirements are met.

Recognition and Presentation of the Effects of Hedging Instruments

The proposed amendments would eliminate the concept of separately recognizing periodic hedge ineffectiveness (although under the mechanics of fair value hedging, economic ineffectiveness would still be reflected in current earnings for those hedges).

For highly effective fair value hedging relationships, all changes in the fair value of the hedging instrument, including any amounts excluded from the assessment of hedge effectiveness, would be recorded in current earnings in the same income statement line as the earnings effect of the hedged item.

For highly effective cash flow hedging relationships, the change in the fair value of the hedging instrument used to assess hedge effectiveness would initially be recorded in OCI and would be reclassified out of AOCI into earnings and presented in the same income statement line as the earnings effect of the hedged item when the hedged item affects earnings. Any amounts excluded from the assessment of hedge effectiveness would be recognized immediately in earnings in the same income statement line as the earnings effect of the hedged item. Furthermore, an entity would immediately reclassify out of AOCI amounts associated with any hedged forecasted transaction whose occurrence is not probable. Such amounts would be presented in current earnings in the same income statement line in which the earnings effect of the hedged item would have been recorded had the hedged forecasted transaction occurred.

For highly effective net investment hedges, the change in the fair value of the hedging instrument used to assess hedge effectiveness would initially be recorded in the cumulative translation adjustment in OCI. When the hedged net investment affects earnings (i.e., upon a sale or liquidation), amounts would be reclassified out of the cumulative translation adjustment and be presented in the same income statement line in which the earnings effect of the net investment is presented. The portion (if any) of the hedging instrument’s change in fair value that is excluded from the hedge effectiveness assessment would be recognized immediately in income (although the income statement presentation would not be prescribed).

Financial Hedging Relationships

For hedges of financial items, the proposed model (1) allows the contractually specified index rate in a variable-rate hedged item to be the designated interest rate risk, (2) retains the existing benchmark interest rate definition for fixed-rate hedged items with minor modifications to eliminate inconsistencies, and (3) designates the SIFMA Municipal Swap index as a permitted benchmark interest rate.

Fair Value Hedges of Interest Rate Risk

Under the proposal, for a fair value hedge of interest rate risk, an entity would be allowed to:

- Designate the change in only the benchmark component of total coupon cash flows attributable to changes in the benchmark interest rate as the hedged risk in a hedge of a fixed-rate financial asset or liability. However, if the current market yield of the hedged item is less than the benchmark interest rate at hedge inception (i.e., a "sub-benchmark" hedge), the entity would be required to use the total contractual coupon cash flows for its calculation.
- Consider, for prepayable financial instruments, only how changes in the benchmark interest rate affect a decision to settle a debt instrument before its scheduled maturity in calculating the change in the fair value of the hedged item attributable to interest rate risk.
- Designate as the hedged risk only a portion of the hedged item's term and measure the change in the fair value of the hedged item attributable to changes in the benchmark interest rate by "using an assumed term that begins with the first hedged cash flow and ends with the last hedged cash flow." The hedged item's assumed maturity would be the date on which the last hedged cash flow is due and payable.

Shortcut Method and Critical-Terms-Match Method

The proposal would retain both the shortcut and critical-terms-match methods and provide additional relief for entities applying those methods. It would amend the shortcut accounting requirements to allow an entity to specify, at the inception of the hedging relationship, the quantitative (long-haul) method it will use to assess hedge effectiveness and measure hedge results if it later determines that application of the shortcut method was not or no longer is appropriate. In addition, the proposal would amend certain shortcut-method criteria to allow partial-term fair value hedges to qualify for the shortcut method.

Further, the proposal would expedite an entity's ability to apply the critical-terms-match method to cash flow hedges of groups of forecasted transactions. If all other critical-terms-match criteria were satisfied, such hedges would qualify for the critical-terms-match method if all the forecasted transactions occurred within 31 days of the hedging derivative's maturity.

Disclosure Requirements

The proposed ASU would add new disclosure requirements and amend existing ones. Also, to align the disclosure requirements with the proposed changes to the hedge accounting model, the proposal would remove the requirement for entities to disclose amounts of hedge ineffectiveness. In addition, an entity would be required to provide:

- Tabular disclosure of (1) the total amounts reported in the statement of financial performance for each income and expense line item that is affected by hedging and (2) the effects of hedging on those line items.
- Disclosures about the carrying amounts and cumulative basis adjustments of items designated and qualifying as hedged items in fair value hedges.
- Qualitative disclosures describing (1) quantitative hedging goals, if any, established in developing its hedging objectives and strategies and (2) whether those goals were met.

These disclosures would be required for every annual and interim reporting period for which a statement of financial position and statement of financial performance are presented.

Adoption and Transition

Entities would adopt the proposal's provisions by applying a modified retrospective approach to existing hedging relationships as of the adoption date. After adoption, in all interim and annual periods, entities would begin to apply the new accounting and presentation model and provide the new and amended disclosures.

In each annual and interim reporting period in the fiscal year of adoption, entities would also be required to furnish certain disclosures required by ASC 250 about (1) the nature and reason for the change in accounting principle and (2) the cumulative effect of the change on the components of equity or net assets as of the date of adoption.

The proposal also describes (1) specific transition considerations related to the accounting for fair value hedges of interest rate risk, (2) one-time transition elections that allow entities to amend the documentation for existing hedging relationships and to take advantage of the guidance on qualitative assessments and the shortcut method of accounting, and (3) a one-time transition election that allows entities, for certain existing cash flow hedging relationships, to take advantage of the amendments that permit designation of a contractually specified interest rate (for variable-rate instruments) or a contractually specified component (for forecasted purchases or sales of nonfinancial items).

Liabilities and Equity — Targeted Improvements

Background

The FASB added a project to its technical agenda in 2014 to consider making targeted improvements to its guidance on the classification of financial instruments as either liabilities or equity. The objective of the project was to simplify the guidance in existing U.S. GAAP on distinguishing liabilities from equity, which involves the application of numerous complex rules and is one of the most common sources of errors and restatements.

However, the FASB tentatively decided in February 2016 to largely abandon the project after concluding that targeted improvements would not adequately address the pervasive problems related to this topic. Instead, the Board decided to seek feedback on whether it should recommence a comprehensive project on distinguishing liabilities from equity to holistically examine the associated issues. Nevertheless, the FASB issued an Invitation to Comment in August 2016 to determine whether it should undertake such a project. As a result, the Board has tentatively decided to proceed with making targeted improvements related to two narrow issues and is expected to issue a proposed ASU during the first quarter of 2017.

The tentative changes would affect the guidance in U.S. GAAP on:

- The accounting for instruments with "down-round" provisions.
- The indefinite deferral of certain pending content in ASC 480-10.

Down-Round Provisions

Background

A down-round provision is a term in an equity-linked financial instrument (e.g., a freestanding warrant contract or an equity conversion feature embedded within a host debt or equity contract) that triggers a downward adjustment to the instrument's strike price (or conversion price) if the entity issues equity shares at a lower price (or equity-linked financial instruments with a lower strike price) than the instrument's then-current strike price. The purpose of the feature is to protect the instrument's counterparty from future issuances of equity shares at a more favorable price.

Under current U.S. GAAP, a contract (or embedded equity conversion feature) that contains a down-round provision does not qualify as equity because such arrangement precludes a conclusion that the contract is indexed to the entity's own stock under ASC 815-40-15 (as illustrated in ASC 815-40-55-33 and 55-34). As a result, contracts and features that include down-round provisions do not currently qualify for the scope exception from derivative accounting in ASC 815-10 for contracts that are indexed to, and classified in, stockholders' equity. Therefore, freestanding contracts on an entity's own equity that contain a down-round feature and meet the definition of a derivative (including net settlement) are accounted for at fair value with changes in fair value recognized in earnings. Similarly, features embedded in an entity's own equity that contain down-round provisions must be separated and accounted for as derivative instruments at fair value if they meet the bifurcation criteria in ASC 815-15.

Tentative Changes

The tentative changes would apply to issuers of financial instruments (e.g., a warrant or a convertible instrument) with down-round features. Specifically excluded from the scope would be (1) freestanding financial instruments and embedded conversion options that are accounted for at fair value with changes in fair value recognized in earnings (e.g., freestanding and bifurcated embedded derivative instruments within the scope of ASC 815 and debt for which the issuer has elected the fair value option in ASC 825-10) and (2) convertible debt instruments that are separated into liability and equity components (e.g., convertible debt with beneficial conversion features or cash conversion features pursuant to ASC 470-20).

Under the tentative proposed approach, a down-round provision would not preclude an entity from concluding that the instrument or feature that includes the provision is indexed to the entity's own stock. For example, when an entity evaluates whether it is required to classify a freestanding warrant that gives the counterparty the right to acquire the entity's common stock as a liability or equity under ASC 815-40, the existence of the down-round feature would not affect the analysis. If the warrant otherwise meets the condition for equity classification, it would be classified as equity. Similarly, in the analysis of whether an embedded conversion feature in a debt host contract must be bifurcated as an embedded derivative under ASC 815-15, the existence of a down-round provision would not prevent the contract from qualifying for the scope exception in ASC 815-10-15-74 for contracts indexed to an entity's own stock and classified in stockholders' equity.

While instruments that contain down-round features would no longer be expressly precluded from equity classification, such instruments may still not qualify for equity classification for other reasons (e.g., if the issuer could be forced to net cash settle the contract). The classification of instruments as liabilities or equity would not, under the proposal, be dictated by the down-round feature. Instead, the down-round feature would affect the accounting only if it were "triggered" (i.e., the entity issued shares at a price below the strike price). Once the feature was triggered, entities would determine the value that was transferred to the holder when the price adjustment occurred.

Thinking It Through

Under current U.S. GAAP, down-round protection often results in instruments being accounted for as liabilities, with changes in fair value recorded through earnings. Under the proposed changes, fewer instruments are expected to require such classification and resulting fair value treatment. However, many instruments or embedded features are precluded from equity classification because of the existence of other terms (e.g., warrants on contingently redeemable preferred stock) and would therefore be unaffected by this proposed change.

Further, entities that present fair value financial statements (e.g., in accordance with ASC 946) would be largely unaffected by this change.

Removal of the Indefinite Deferral Under ASC 480

The transition guidance in ASC 480-10 indefinitely defers the application of some of its requirements for certain instruments and entities (i.e., certain mandatorily redeemable financial instruments of nonpublic entities that are not SEC registrants and certain mandatorily redeemable noncontrolling interests). Accordingly, such instruments may qualify as equity under U.S. GAAP even though ASC 480-10-25 suggests that they should be classified as liabilities.

ASC 480-10 requires issuers to classify mandatorily redeemable financial instruments as liabilities. Because of the indefinite deferral noted above, these requirements are labeled “pending content” in the Codification, but the transition guidance in ASC 480-10-65 provides no effective date for them. Therefore, the transition requirements under the tentative guidance would effectively provide scope exceptions for parts of the guidance in ASC 480-10 for affected entities and instruments.

Simplifying the Balance Sheet Classification of Debt

Background

The FASB recently directed its staff to draft a proposed ASU that would simplify the classification of debt as either current or noncurrent on the balance sheet. The guidance currently in ASC 470-10 consists of an assortment of fact-specific rules and exceptions, the application of which varies according to the terms and conditions of the debt arrangement, management’s expectations of when debt may be settled or refinanced, and certain post-balance-sheet events. The objective of the project is to reduce the cost and complexity of applying this guidance while maintaining or improving the usefulness of the information provided to financial statement users.

Principles-Based Approach

The FASB’s tentative approach would replace the current, fact-specific guidance with a unified principle for determining the classification of a debt arrangement in a classified balance sheet as either current or noncurrent. Specifically, an entity would classify a debt arrangement as noncurrent if *either* of the following criteria is met as of the financial reporting date:[1]

- “The liability is contractually due to be settled more than 12 months (or operating cycle, if longer) after the balance sheet date.”
- “The entity has a contractual right to defer settlement of the liability for at least 12 months (or operating cycle, if longer) after the balance sheet date.”

[1] Quoted text is from the FASB’s summary of tentative Board decisions reached at its January 28, 2015, meeting.

As an exception to this classification principle, debt that is due to be settled within 12 months as a result of a covenant violation as of the balance sheet date would be classified as noncurrent if the debtor receives a waiver that meets certain conditions after the balance sheet date (see Covenant Violations below).

Scope

The FASB has tentatively decided to clarify that the balance sheet classification guidance in ASC 470-10 applies not only to nonconvertible debt arrangements but also to convertible debt and to mandatorily redeemable financial instruments that are classified as liabilities under ASC 480-10.

Short-Term Obligations Expected to Be Refinanced on a Long-Term Basis

Under current guidance, entities that have the intent and ability to refinance a short-term obligation on a long-term basis *after* the financial reporting date — as evidenced by the post-balance-sheet-date issuance of a long-term obligation, equity securities, or a qualifying refinancing agreement — are required to present the obligation as a noncurrent liability as of the financial reporting date. The tentative approach, however, would require such short-term obligations to be classified within current liabilities because the refinancing of debt after the financial reporting date would be viewed as a new transaction that should not be retroactively reflected in the balance sheet as of that date.

Subjective Acceleration Clauses and Debt Covenants

Under existing GAAP, the classification of long-term obligations depends in part on whether they are governed by subjective acceleration clauses (SACs) for which exercise is probable (e.g., because of recurring losses or liquidity problems). Under the Board's tentative approach, however, SACs and covenants within long-term obligations would affect the classification of long-term obligations only when triggered or violated, in which case disclosure of the SAC or covenant would be required.

Thinking It Through

Under the Board's tentative approach, some liabilities that are now classified as noncurrent would be classified as current, and vice versa. For example, as a result of the proposed change to the treatment of the refinancing of short-term obligations, an entity would not be allowed to consider refinancing events after the financial reporting date but before the financial statements were issued. Thus, such debt obligations would be classified as current liabilities as of the financial reporting date. Entities should consider the timing of refinancing plans and the potential effect on the classification of short-term obligations.

Covenant Violations

Under current guidance, if the creditor can demand the repayment of a long-term obligation as of the financial reporting date because of the debtor's violation of a debt covenant, the corresponding debt obligation is classified as noncurrent if the debtor obtains a covenant waiver *before* the date the financial statements are issued and certain other conditions are met. While the Board's tentative approach would retain similar guidance, it would classify such debt as current if the waiver results in the debt's being accounted for as having been extinguished. Because debt extinguishment accounting treats the debt as a newly issued instrument, the original debt obligation, as of the balance sheet date, should be classified within current liabilities since the debtor could demand repayment as of that date.

At its October 19, 2016, meeting, the Board decided to clarify the application of the probability assessment that is associated with the waiver exception. Entities would be required to assess whether a violation of any other covenant not covered by the waiver is probable within 12 months from the reporting date. If so, the related debt would be required to be classified as current.

Presentation and Disclosure

Under the Board's tentative approach, debt that is classified as noncurrent in accordance with the exception for debt covenant waivers would be presented separately in the balance sheet. Further, as previously noted, the tentative approach would require entities to disclose information about debt covenants and SACs upon violation or trigger.

Effective Date and Transition

The Board will determine an effective date for the guidance after it considers feedback on the proposed ASU. Once finalized, the proposed approach will be applicable on a prospective basis to debt that exists as of the effective date. Early adoption will be permitted.

Next Steps

The proposed ASU is expected to be released in December 2016 or early January 2017. The comment period is expected to end no earlier than May 5, 2017.

Goodwill and Business Combinations

Subsequent Accounting for Goodwill for Public Business Entities and Not-for-Profit Entities, Including Goodwill Impairment

Background

In November 2013, the FASB endorsed (and later issued guidance on[2]) a decision by the PCC to give nonpublic business entities an accounting alternative under which they can elect to amortize goodwill and perform a simplified impairment test. The Board received feedback on the PCC accounting alternative indicating that many public business entities and not-for-profit entities had similar concerns about the cost and complexity of the annual goodwill impairment test.

In response, the Board in 2014 added to its agenda a goodwill simplification project that would be completed in two phases. The Board later separated the undertaking into two individual projects: (1) accounting for goodwill impairment and (2) subsequent accounting for goodwill for public business entities and not-for-profit entities.

Current Status and Next Steps

Under ASC 350, impairment of goodwill "is the condition that exists when the carrying amount of goodwill exceeds its implied fair value." The implied fair value of goodwill is determined in the same manner as the amount of goodwill recognized in a business combination. The process of measuring the implied fair value of goodwill is currently referred to as step 2 of the goodwill impairment test. Step 2 requires an entity to "assign the fair value of a reporting unit to all of the assets and liabilities of that unit (including any unrecognized intangible assets) as if the reporting unit had been acquired in a business

[2] For more information, see Deloitte's January 27, 2014, *Heads Up*.

combination." Consequently, the performance of step 2 of the goodwill impairment test can result in significant cost and complexity.

As part of its goodwill impairment project, the FASB issued a proposed ASU in May 2016 that would remove step 2 from the goodwill impairment test. The proposed guidance, which is intended to simplify the accounting for goodwill impairment, would require an entity to "recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value. However, that amount should not exceed the carrying amount of goodwill allocated to that reporting unit."

The qualitative assessment of goodwill would be unchanged under the proposed ASU. However, all reporting units, even those with a zero or negative carrying amount, would apply the same impairment test. As noted in the proposal's Basis for Conclusions, goodwill of reporting units with a zero or negative carrying amount would not be impaired even when conditions underlying the reporting unit indicate that it was impaired. However, entities would be required to disclose any reporting units with a zero or negative carrying amount and the respective amounts of goodwill allocated to those reporting units.

Thinking It Through

The proposed guidance would significantly change the accounting for goodwill for reporting units with zero or negative carrying amounts. While current guidance addresses the assignment of liabilities to a reporting unit, practitioners have had questions about the assignment of debt. A reporting unit may have a negative carrying amount because of an entity's decision to assign debt to it, resulting in diversity in practice and different goodwill impairment outcomes.

Comments on the proposed ASU were due by July 11, 2016.[3] The FASB is redeliberating the proposed ASU and has not yet determined a proposed effective date for the final standard. A nonpublic business entity that has already elected the PCC's accounting alternative for goodwill and would like to apply the final guidance would need to perform an assessment of preferability in accordance with ASC 250.

As part of its project on the subsequent accounting for goodwill, the Board expects to consider whether to permit or require amortization of goodwill or make further changes to impairment testing methods.

Clarifying the Definition of a Business

Background

In November 2015, the FASB issued a proposed ASU related to the first phase of its project on the definition of a business. The proposal is in response to concerns that the current definition of a business has been interpreted too broadly and that many transactions are accounted for as business combinations when they are more akin to asset acquisitions. Comments on the proposed guidance were due by January 22, 2016, and were analyzed by the FASB staff at its meeting on August 24, 2016. The proposal's key provisions are discussed below. For more information, see Deloitte's December 4, 2015, *Heads Up*.

Under the proposal:

- To be a business, a set of assets and activities ("set") must include an input and a substantive process that together contribute to the ability to create outputs.
- If substantially all the fair value of the gross assets is concentrated in a single identifiable asset or group of similar identifiable assets, the set would not be a business.
- The definition of outputs is narrowed to be consistent with ASC 606.

[3] See Deloitte's comment letter on the proposed ASU.

Thinking It Through

The proposed guidance may significantly affect the real estate industry as a result of the different accounting for business combinations and asset acquisitions. For example, acquisition costs are expensed in a business combination and capitalized in an asset acquisition. Thus, a more narrow definition of a business will result in more asset acquisitions and, therefore, more capitalized costs.

Single or Similar Asset Concentration

Under the proposal, if substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets, the set would not be considered a business. Gross assets acquired would exclude cash and cash equivalents, DTAs, and the effects of DTLs. If the fair value of the gross assets cannot be concentrated, the entity would apply the proposed ASU's framework for evaluating whether an input and a substantive process are both present and together contribute to the ability to produce outputs.

In the determination of gross asset concentration, a tangible asset that is attached to and cannot be physically removed and used separately from another tangible asset without incurring significant cost or significant diminution in utility or fair value to either asset (e.g., land and building) would qualify as a single identifiable asset. The FASB also indicated that while tangible and intangible assets should generally not be combined, an in-place lease intangible asset, including any favorable and unfavorable intangible asset or liability, and the related real estate asset would qualify as a single identifiable asset.

Thinking It Through

The introduction of a gross asset concentration threshold is likely to have a significant effect on the real estate industry since many acquisitions of properties with in-place leases that are accounted for as business combinations under current guidance may qualify as asset acquisitions under the proposed guidance.

Input and Substantive Process Requirement

The proposal provides a framework for determining whether a set has an input and a substantive process that collectively contribute to the ability to create outputs. When a set does not yet have outputs, the set would have a substantive process only if it has an organized workforce (or an acquired contract that provides access to an organized workforce) that has the necessary skills, knowledge, or experience to perform an acquired process (or group of processes) that, when applied to an acquired input or inputs, is critical to the ability to continue producing outputs. For a set with outputs, the FASB proposed less stringent criteria for determining that the set has a substantive process. An organized workforce may represent a substantive process. However, a set may have a substantive process even without an organized workforce if an acquired process or processes contribute to the ability to continue producing outputs and cannot be replaced without significant cost, effort, or delay or are considered unique or scarce.

Definition of Outputs

Under current guidance (ASC 805-10-55-4), outputs are defined as "[t]he result of inputs and processes applied to those inputs that provide or have the ability to provide a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants." The proposal would change this definition to the "result of inputs and processes applied to those inputs that provide goods or services to customers, other revenues, or investment income, such as dividends or interest." The revised definition of outputs aligns the definition with the new revenue guidance in ASC 606.

Transition and Effective Date

The amendments in the proposal would be applied prospectively to any transaction that occurs on or after the effective date of the final standard. No disclosures would be required at transition. The FASB will determine the effective date and whether the proposed amendments may be applied before the effective date after it redeliberates its proposal on clarifying the scope of asset derecognition guidance and accounting for partial sales of nonfinancial assets.

Accounting for Identifiable Intangible Assets in a Business Combination

Background

In November 2014, the FASB agreed to add to its agenda a project to explore potential changes to the guidance on accounting for identifiable intangible assets in a business combination for public business entities and not-for-profit entities. The Board will evaluate whether certain intangible assets should be subsumed into goodwill.

Current Status and Next Steps

The project is in the initial deliberations phase. At the FASB's October 28, 2015, meeting, the Board decided to conduct further research in conjunction with the IASB. The boards discussed the status of their respective projects on this topic at their June 20, 2016, meeting; however, no decisions were made.

Accounting for Derecognition and Partial Sales of Nonfinancial Assets

Background

In June 2016, the FASB issued a proposed ASU that would clarify the scope of the Board's recently established guidance on nonfinancial asset derecognition (ASC 610-20) as well as the accounting for partial sales of nonfinancial assets. The proposed guidance is in response to stakeholder feedback indicating that (1) the meaning of the term "in-substance nonfinancial asset" is unclear because the Board's new revenue standard does not define it and (2) the scope of the guidance on nonfinancial assets is complex and does not specify how a partial sales transaction should be accounted for or which model entities should apply. The proposed ASU would conform the derecognition guidance on nonfinancial assets with the model for revenue transactions in ASC 606. Comments on the proposed guidance (see Deloitte's comments) were due by August 5, 2016, and the FASB is analyzing the comment letters received.

Key provisions of the proposed ASU are discussed below. For more information, see Deloitte's June 14, 2016, *Heads Up*.

Scope of the Guidance on Nonfinancial Asset Derecognition and Unit of Account

The proposed ASU would clarify the scope of ASC 610-20 and require entities to apply that guidance to the derecognition of all nonfinancial assets and in-substance nonfinancial assets. While the concept of in-substance assets resided in ASC 360-20, this guidance would not have applied to transactions outside of real estate. The FASB is therefore proposing to add to the ASC master glossary the following definition of an in-substance nonfinancial asset:

> An asset of a reporting entity that is included in either of the following:
>
> a. A contract in which substantially all the fair value of the assets (recognized and unrecognized) promised to a counterparty is concentrated in nonfinancial assets
>
> b. A consolidated subsidiary in which substantially all the fair value of the assets (recognized and unrecognized) in the subsidiary is concentrated in nonfinancial assets.
>
> An in substance nonfinancial asset does not include:
>
> a. A group of assets or a subsidiary that is a business or nonprofit activity
>
> b. An investment of a reporting entity that is being accounted for within the scope of Topic 320 on investments — debt securities, Topic 321 on investments — equity securities, Topic 323 on investments — equity method and joint ventures, or Topic 325 on other investments regardless of whether the assets underlying the investment would be considered in substance nonfinancial assets.

Thinking It Through

The proposed ASU's guidance would significantly affect the real estate industry. Under the current guidance, all transfers of real estate (including in-substance real estate and transactions that are considered a business) are accounted for under ASC 360-20. Under the proposed guidance, since business or nonprofit activities are not in-substance nonfinancial assets, they would be excluded from the scope of ASC 610-20 and accounted for under the consolidation guidance in ASC 810-10. Further, all investments would be accounted for under the guidance in ASC 860 on transfers and servicing transactions, regardless of whether the investments were businesses or nonprofit activities or in-substance nonfinancial assets.

Partial Sales

"Partial sales" are sales or transfers of a nonfinancial asset to another entity in exchange for a noncontrolling ownership interest in that entity. Entities account for partial sales before adoption of the new revenue standard principally under the transaction-specific guidance in ASC 360-20 on real estate sales and partly under ASC 845-10-30. Since ASC 606 and ASC 610-20 supersede that guidance, the proposed ASU would clarify that any transfer of a nonfinancial asset in exchange for the noncontrolling ownership interest in another entity (including a noncontrolling ownership interest in a joint venture or other equity method investment) would be accounted for in accordance with ASC 610-20.

In addition, if the reporting entity no longer retained a controlling financial interest in the nonfinancial asset, it would derecognize the asset when it transferred control of that asset in a manner consistent with the principles in ASC 606. Further, any retained noncontrolling ownership interest (and resulting gain or loss to be recognized) would be measured at fair value in a manner consistent with the guidance on noncash consideration in ASC 606-20-32-21 through 32-24.

Thinking It Through

Partial sales are common in the real estate industry (e.g., a seller transfers an asset to a buyer but retains either an interest in the asset or has an interest in the buyer). Under the current real estate guidance in ASC 360-20, entities are required to recognize a partial gain and measure the retained ownership interest in a partial sale of real estate at carryover basis. The proposed ASU would eliminate the differences in the accounting between transactions with assets and businesses and would require an entity that sells real estate assets to recognize full gain when it loses its controlling financial interest and any retained interest in such real estate would be measured at fair value.

Effective Date and Transition

The effective date of the new guidance and the transition methods would be aligned with the requirements in the new revenue standard as amended by ASU 2015-14,[4] which delays the effective date of the new revenue standard by one year and permits early adoption on a limited basis. However, an entity would be permitted to use a transition approach to adopt ASC 610-20 that is different from the one it uses to adopt ASC 606 (e.g., the entity may use the modified retrospective approach to adopt ASC 610-20 and the full retrospective approach to adopt ASC 606). If different methods are used, an entity would need to provide the transition-method disclosures required by ASC 606 and indicate the method it used to adopt ASC 610-20.

Modification Accounting for Share-Based Payment Arrangements

Background

In November 2016, the FASB issued a proposed ASU that would amend the scope of modification accounting for share-based payment arrangements. The proposed ASU provides guidance on the types of changes to the terms or conditions of share-based payment awards to which an entity would be required to apply modification accounting under ASC 718. Specifically, an entity would not apply modification accounting if the fair value, vesting conditions, and classification of the awards are the same immediately before and after the modification.

When ASU 2016-09 was issued in March 2016 under the Board's simplification initiative, it made a change to ASC 718 regarding the exception to liability classification of an award related to an employer's use of a net-settlement feature to withhold shares to meet the employer's statutory tax withholding requirement. Under ASU 2016-09, the net settlement of an award for statutory tax withholding purposes does not result, by itself, in liability classification of the award as long as the amount withheld for taxes does not exceed the *maximum* statutory tax rate in the employee's relevant tax jurisdiction(s). Before an entity adopts ASU 2016-09, the exception applies only when no more than the number of shares necessary for the *minimum* statutory tax withholding requirement to be met is repurchased or withheld.

[4] For public business entities, the standard is effective for annual reporting periods (including interim reporting periods within those periods) beginning after December 15, 2017. For nonpublic entities, the standard is effective for annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019.

Upon adopting ASU 2016-09, some entities may change the net-settlement terms of their share-based payment arrangements from the minimum statutory tax rate to a higher rate up to the maximum statutory tax rate. Some constituents questioned whether this change, if made to existing awards, would require the application of modification accounting under ASC 718-20-35-3. When an entity applies modification accounting to equity-classified awards and the original awards are expected to vest (because of any service or performance conditions) on the modification date, a modification may result in incremental compensation cost.

The proposed ASU's key provisions are discussed below. For more information, see Deloitte's November 18, 2016, *Heads Up*.

Key Provisions of the Proposed ASU

Scope of Modification Accounting

The proposed ASU would amend ASC 718 to limit the instances in which modification accounting is applied. Entities "would account for the effects of a modification unless all the following are the same immediately before and after the modification":

- "The fair value (or calculated value or intrinsic value, if such an alternative measurement method is used) of the award."
- "The vesting conditions of the award."
- "The classification of the award as an equity instrument or a liability instrument."

In addition, as a consequential amendment, the proposal would remove the phrase "any of" from the definition of "modification." Under the proposed ASU, a modification would be defined as a "change in the terms or conditions of a share-based payment award."

The proposal's Basis for Conclusions provides additional clarity on the application of proposed ASC 718-20-35-2A(a), which requires that the fair value be the same immediately before and after the modification for modification accounting not to be applied. In paragraph BC11, the Board clarified that the evaluation should be based on whether the fair value has changed, not on whether the compensation cost recognized has changed. In addition, BC14 clarifies that a computation of the fair value before and after the modification is not expected in all cases. Rather, if the entity determines that the modification does not affect any of the inputs used in its fair value calculation, the entity most likely could conclude that the fair value would be the same immediately before and after the modification.

The proposed ASU's Basis for Conclusions also provides examples (that "are educational in nature, are not all-inclusive, and should not be used to override the guidance in paragraph 718-20-35-2A") of changes to awards for which the Board believes that modification accounting would not be required as well as those for which the Board believes that it would be required. The following table summarizes those examples:

Examples of Changes for Which Modification Accounting Would Not Be Required	Examples of Changes for Which Modification Accounting Would Be Required
• Administrative changes, such as a change to the company name, company address, or plan name. • Changes in net-settlement provisions related to tax withholdings that do not affect the classification of the award.	• Repricing of options that results in a change in value. • Changes in a service condition. • Changes in a performance condition or a market condition. • Changes in an award that results in a reclassification of the award (equity to liability or vice versa). • The addition of a change-in-control provision under which awards are immediately vested upon occurrence of the event.

Disclosures

ASC 718 currently requires entities to disclose a description of significant modifications, including the terms of the modifications, the number of employees affected, and the total incremental compensation cost resulting from the modifications. Under the proposed ASU, additional disclosures would not be required.

Thinking It Through

Entities would still be required to disclose any significant changes to the terms or conditions of share-based payment awards that meet the definition of a modification under ASC 718-20-20, even if modification accounting is not applied under the proposed ASU. For example, under the proposed ASU, if an entity changes the settlement terms of its share-based payment awards but such a change does not result in a change in fair value, vesting condition, or classification, modification accounting would not be applied. However, the entity may still be required to disclose the change in settlement terms if the modification is significant.

Effective Date and Transition

The FASB plans to determine an effective date for the final guidance after considering stakeholder feedback on the proposed ASU. Entities would apply the proposed amendments prospectively to modifications on or after the effective date, and transition disclosures would not be required.

Nonemployee Share-Based Payment Accounting Improvements

Background

In December 2015, the FASB decided to add to its agenda a project on improving the accounting for nonemployee share-based payment arrangements. When the Board previously deliberated its initial share-based payment simplification project, it decided that potential improvements to the nonemployee model could involve broader changes and take longer to complete than other simplification projects. As a result, the Board concluded that reconsideration of the accounting for nonemployee share-based payments should be moved to a separate project.

Tentative Decisions

In May 2016, the FASB tentatively decided to expand the scope of ASC 718 to include all share-based payment arrangements related to acquiring both goods and services from nonemployees. The Board's tentative decision would require an entity to apply most of the guidance in ASC 718 to nonemployee share-based payments. In addition, a nonpublic entity would be permitted to use certain practical expedients, including the use of (1) calculated value to measure certain nonemployee awards and (2) intrinsic value to measure liability-classified nonemployee awards. Further, nonemployee share-based payments initially within the scope of ASC 718 would remain within the scope of that guidance for classification and measurement purposes (even after the nonemployee awards have vested) unless the awards are modified after performance is complete.

However, the FASB tentatively decided that attribution of any cost associated with nonemployee share-based payments would continue to be accounted for under other applicable accounting literature as though the issuer had paid cash for the goods or services.

Thinking It Through

Nonemployee share-based payments issued for goods and services are accounted for under ASC 505-50. The guidance in ASC 505-50 differs significantly from ASC 718, including the (1) determination of the measurement date, (2) accounting for performance conditions, (3) ability to use nonpublic entity practical expedients, and (4) classification of awards after vesting. The tentative decisions of this project would align such guidance.

Transition

The Board tentatively decided that a modified retrospective transition approach, with a cumulative-effect adjustment to retained earnings, would generally be required for outstanding nonemployee awards at the time of adoption. However, in allowing nonpublic companies to use calculated values to measure certain nonemployee awards, the Board tentatively decided that a prospective approach should be used for all nonemployee awards that are measured at fair value after the date of adoption.

Disclosures

With the exception of disclosures specifying the income statement effects of the change in principle in the year of adoption (or interim periods therein), the Board tentatively decided that an entity should apply the disclosure requirements in ASC 250 related to a change in accounting principle.

Finally, the Board tentatively decided that the disclosure requirements for nonemployee awards should be aligned with those in ASC 718 and that these requirements did not need to be modified.

Next Steps

At its November 30, 2016, board meeting, the FASB directed its staff to draft a proposed ASU with a 90-day comment period. The staff indicated that it expects to issue the proposal in the first quarter of 2017.

Disclosures by Business Entities About Government Assistance

Background and Key Provisions of the Proposed Guidance

In November 2015, the FASB issued for public comment a proposed ASU to increase transparency in financial reporting by requiring specific disclosures about government assistance received by businesses. Government assistance arrangements are legally enforceable agreements under which the government provides value to the entity (e.g., grants, loan guarantees, tax incentives). The objective of the proposed disclosure requirements is to enable financial statement users to better assess (1) the nature of the government assistance, (2) the accounting policies for the government assistance, (3) the impact of the government assistance on the financial statements, and (4) the significant terms and conditions of the government assistance arrangements.

There is no explicit guidance in current U.S. GAAP on the recognition, measurement, and disclosure of government assistance received by business entities. As a result, there is diversity in practice related to how business entities account for, and disclose information about, government assistance arrangements.

The proposed ASU would require business entities to disclose the following information about government assistance arrangements in their annual financial statements:

1. Information about the nature of the assistance, including a general description of the significant categories and the related accounting policies adopted or the method applied to account for government assistance
2. Which line items on the balance sheet and income statement are affected by government assistance and the amounts applicable to each line item
3. Significant terms and conditions of the agreement, including commitments and contingencies
4. Unless impracticable, the amount of government assistance received but not recognized directly in the financial statements. The amount of government assistance received but not recognized includes value that was received by an entity for which no amount has been recorded directly in any financial statement line item (for example, a benefit of a loan guarantee, a benefit of a below-market rate loan, or a benefit from tax or other expenses that have been abated).

Such disclosures would provide financial statement users with information about the effect of government assistance on an entity's financial results and prospects for future cash flows. In addition, the disclosures would help users better assess the nature of the assistance.

The proposed amendments would apply to entities (other than not-for-profit entities within the scope of ASC 958, employee benefit plans, and entities that have entered into government assistance agreements within the scope of ASC 740) that have entered into a "legally enforceable agreement with a government to receive value." However, such provisions would not apply to transactions in which the government is (1) "legally required to provide a nondiscretionary level of assistance to an entity simply because the entity meets applicable eligibility requirements that are broadly available without specific agreement between the entity and the government" or (2) "solely a customer" of the entity.

Effective Date and Transition

The FASB plans to determine an effective date for the final guidance after considering stakeholder feedback on the proposed ASU. To apply the guidance, entities would use a prospective approach; however, retrospective application would be allowed.

Redeliberations and Next Steps

Since the conclusion of the comment letter period on February 10, 2016, the FASB has held redeliberation sessions to discuss comments received from constituents. The tentative decisions reached as a result of the Board's redeliberations at its meeting on June 8, 2016, are reflected above.

The Board will continue to conduct additional redeliberations at future meetings before issuing a final ASU.

Disclosure Framework

Background

In July 2012, the FASB issued a discussion paper as part of its project to develop a framework to make financial statement disclosures "more effective, coordinated, and less redundant." The paper identifies aspects of the notes to the financial statements that need improvement and explores possible ways to improve them. The FASB subsequently decided to distinguish between the "FASB's decision process" and the "entity's decision process" for evaluating disclosure requirements.

FASB's Decision Process

Overview

In March 2014, the FASB released for public comment a proposed concepts statement that would add a new chapter to the Board's conceptual framework for financial reporting. The proposal outlines a decision process to be used by the Board and its staff for determining what disclosures should be required in notes to financial statements. The FABS's objective in issuing the proposal is to improve the effectiveness of such disclosures by ensuring that reporting entities clearly communicate the information that is most important to users of financial statements. See Deloitte's March 6, 2014, *Heads Up* for additional information.

In February 2015, the Board tentatively decided that the disclosure section of each Codification subtopic (1) would state that an entity should apply materiality as described in the proposed amendments to ASC 235 in complying with the disclosure requirements and (2) would not contain language that precludes an entity from exercising discretion in determining what disclosures are necessary (e.g., "shall at a minimum provide").

In September 2015, in response to feedback from outreach activities and to maintain consistency with both current practice and the FASB's proposed ASU on the omission of immaterial disclosures (see Entity's Decision Process below for discussion of the proposed ASU), the Board issued a proposal to modify the definition of materiality in Concepts Statement 8. The proposal would replace the original discussion of materiality in Concepts Statement 8 with the U.S. Supreme Court's definition. See Deloitte's September 28, 2015, *Heads Up* for additional information.

Comments on the proposed changes to Concepts Statement 8 have been provided to the FASB.

Entity's Decision Process

In September 2015, to reduce entities' reluctance to omit immaterial disclosures, the FASB issued a proposed ASU that would amend the Codification to indicate that the omission of disclosures about immaterial information is not an accounting error. The proposal, which is part of the FASB's disclosure effectiveness initiative, notes that materiality is a legal concept applied to assess quantitative and qualitative disclosures individually and in the aggregate in the context of the financial statements taken as a whole. See Deloitte's September 28, 2015, *Heads Up* for additional information.

Comments on the proposed ASU have been provided to the FASB.

Next Steps

The FASB will continue deliberating concerns raised in comment letters and will review feedback received as a result of its outreach activities, which include testing the Board's and entity's decision processes against various Codification topics. A final concepts statement is expected to be issued after the outreach process is complete.

Topic-Specific Disclosure Reviews

In addition to proposing amendments to guidance, the FASB is analyzing ways to "further promote [entities'] appropriate use of discretion"[5] in determining proper financial statement disclosures. The Board is applying the concepts in both the entity's and the Board's decision process in considering topic-specific modifications. The FASB reached tentative decisions about disclosure requirements in the following Codification topics:

- ASC 820 (fair value measurement).
- ASC 740 (income taxes).
- ASC 715-20 (defined benefit plans).

Proposed changes to the disclosure requirements are discussed below.

[5] Quoted from "What You Need to Know About Disclosure Framework" on the FASB's Web site.

Fair Value Measurement

Objective for Disclosures

In December 2015, the FASB issued for public comment a proposed ASU that would amend the requirements in ASC 820 for disclosing fair value measurements. The proposed ASU would add the following objective to ASC 820 to encourage preparers to use discretion in complying with the disclosure requirements:

> The objective of the disclosure requirements in this Subtopic is to provide users of financial statements with information about all of the following:
>
> a. The valuation techniques and inputs that a reporting entity uses to arrive at its measures of fair value, including judgments and assumptions that the entity makes
>
> b. The effects of changes in fair value on the amounts reported in financial statements
>
> c. The uncertainty in the fair value measurement of Level 3 assets and liabilities as of the reporting date
>
> d. How fair value measurements change from period to period.

In addition, the proposed ASU would make changes (eliminations, modifications, and additions) to the fair value disclosure requirements in ASC 820, as discussed below.

Eliminated and Modified Disclosure Requirements

Policy on Timing of Transfers Between Levels and Transfers Between Levels 1 and 2

The proposed ASU would remove the requirement in ASC 820-10-50-2C for an entity to disclose its policy on the timing of transfers between levels of the fair value hierarchy. An entity would still be required to have a consistent policy on timing of such transfers. The requirement to separately disclose the amounts transferred between Level 1 and Level 2 and the corresponding reason for doing so would also be removed.

Level 3 Fair Value Measurements

The disclosure requirements for Level 3 fair value measurements would be amended as follows:

- *Valuation process* — The proposed ASU would remove requirements in ASC 820-10-50-2(f) (and related implementation guidance in ASC 820-10-55-105) for an entity to disclose its valuation processes for Level 3 fair value measurements.

Thinking It Through

Removing the disclosure requirement in ASC 820-10-50-2(f) will result in divergence between U.S. GAAP and IFRSs. The requirement was added to the FASB's and IASB's jointly issued standard on the basis of a recommendation by the IASB's expert panel. The panel explained that the disclosure would help users understand the quality of the entity's fair value estimates and give investors more confidence in management's estimate. The FASB has proposed to remove the requirement because it would conflict with the Board's proposed concepts statement. The Board indicated that disclosure of internal control procedures is outside the purpose of the notes to the financial statements and is not required under other topics in U.S. GAAP.

Removing this requirement does not change management's responsibility for internal controls over the valuation process and related auditor testing. Further, it should not affect investor confidence in the quality of the fair value estimate given the regulatory environment in the United States (e.g., SEC and PCAOB) as well as the intense scrutiny in this area. The Board also noted that investors are typically familiar with the overall valuation process.

- *Measurement uncertainty* — The proposed ASU would retain the requirement in ASC 820-10-50-2(g) to provide a narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs. However, it would clarify that this disclosure is intended to communicate information about the uncertainty in measurement as of the reporting date and not to provide information about sensitivity to future changes in fair value.
- *Quantitative information about unobservable inputs* — The proposed ASU would require disclosure of the range and weighted average of the unobservable inputs to comply with the requirement in ASC 820-10-50-2(bbb) (as shown by example in the implementation guidance in ASC 820-10-55-103). Disclosing the period used to develop significant unobservable inputs based on historical data would also be required. A private company would be exempt from such a disclosure requirement.
- *Level 3 rollforward* — The proposed ASU would retain the Level 3 rollforward requirement for entities that are not private companies. For entities that are private companies, the proposed ASU would modify the Level 3 rollforward requirement and remove the requirement to disclose the change in unrealized appreciation or deprecation related to investments held as of the balance sheet date under ASC 820-10-50-2(d). Instead, disclosures would be required about transfers into and out of Level 3 and purchases (and issues) of Level 3 investments. The Board indicated that entities are already required to disclose the ending balance in the fair value hierarchy table, and they could disclose transfers into (and out of) and purchases (or issues) of Level 3 investments in a sentence rather than in a full rollforward as required today. A defined benefit plan sponsor that is a private company would also remove the reconciliation of beginning and ending balances for plan investments categorized as Level 3 within the fair value hierarchy (i.e., the Level 3 rollforward) and would be required to disclose transfers into and out of Level 3 and purchases (or issues) of Level 3 assets only in its defined benefit plan footnote (for more information about the FASB's project on reviewing defined benefit plan disclosures, see discussion below).

Thinking It Through

In its outreach on the Level 3 rollforward, the Board noted that some financial statement users believe that the rollforward is useful because it helps them understand management's decisions, especially for different economic cycles. The full rollforward was generally deemed less useful for users of private-company financial statements. Transfers into and out of Level 3 were generally considered to be the most useful aspect of the rollforward.

Net Asset Value Disclosures of Estimates of Timing of Future Events

The following disclosures currently required under ASC 820-10-50-6A(b) and ASC 820-10-50-6A(e) would apply only when they have been communicated to the reporting entity by the investee or are otherwise made publicly available (even if not specifically communicated to the investor):

- "For each class of investment that includes investments that can never be redeemed with the investees, but the reporting entity receives distributions through the liquidation of the underlying assets of the investees, the reporting entity's estimate of the period of time over which the underlying assets are expected to be liquidated by the investees."
- "[W]hen the restriction from redemption might lapse."

If the timing is unknown, the entity would be required to disclose that fact.

Thinking It Through

The objective of this change is to prevent an investor from having to make its own estimate when it does not have knowledge of the timing from the investee or other public source. In addition, ASU 2015-07 removed the requirement for entities to categorize within the levels of the fair value hierarchy all investments they have measured under the net asset value practical expedient.

New Disclosure Requirements — Unrealized Gains and Losses

Entities that are not private companies would disclose fair value changes for assets and liabilities held as of the balance sheet date disaggregated by fair value hierarchy level (i.e., Levels 1, 2, and 3) for (1) net income before taxes and (2) comprehensive income. This is currently required only for the Level 3 amounts within net income under ASC 820-10-50-2(c) and (d). This requirement would not apply to private companies in accordance with the private-company decision-making framework.

Transition and Next Steps

The proposed ASU requires that the modifications to disclosures about changes in unrealized gains and losses and the changes in the quantitative information about unobservable inputs (see discussion above) would be applied prospectively beginning in the period of adoption. Entities would apply all other changes in disclosures retrospectively to all periods presented.

The FASB did not propose an effective date. Rather, the Board indicated that it plans to determine such date after considering stakeholders' feedback on the proposed guidance.

Comments on the proposed ASU were due by February 29, 2016, and were discussed at the FASB's meeting on June 1, 2016, at which it was decided that additional outreach would be conducted with investors and other financial statement users. It is not currently expected that a final ASU will be issued in 2016.

Income Taxes

Background

In July 2016, the FASB issued a proposed ASU that would modify or eliminate certain disclosure requirements related to income taxes as well as establish new requirements. The proposed ASU is the result of the application of the Board's March 2014 proposed concepts statement to disclosures about income taxes. Comments on the proposed ASU were due by September 30, 2016.

Key Provisions of the Proposed ASU

Scope

Although many of the amendments would apply to all entities that are subject to income taxes, certain amendments would apply only to public business entities.

As part of the proposal, the FASB decided that it would also replace the term "public entity," as defined in the glossary in ASC 740-10, with "public business entity," as defined in the ASC master glossary. The definition of a public business entity includes certain types of entities that the definition of a public entity under ASC 740 does not include. Thus, the disclosure requirements in ASC 740 that currently apply only to public entities would apply to other entities as well.

Indefinitely Reinvested Foreign Earnings

The proposed ASU would require all entities to explain any change to an indefinite reinvestment assertion made during the year, including the circumstances that caused such change in assertion. All entities would also be required to disclose the amount of earnings for which there was a change in assertion made during the year. In addition, all entities would be required to disclose the aggregate of cash, cash equivalents, and marketable securities held by their foreign subsidiaries.

Such information is intended to give financial statement users information that will help them predict the likelihood of future repatriations and the associated income tax consequences related to foreign indefinitely reinvested earnings.

Unrecognized Tax Benefits

The proposed ASU would modify the disclosure requirements for a public business entity related to unrecognized tax benefits. It would also add a requirement for entities to disclose, in the tabular reconciliation of the total amount of unrecognized tax benefits required by ASC 740-10-50-15A(a), settlements disaggregated by those that have been (or will be) settled in cash and those that have been (or will be) settled by using existing DTAs (e.g., settlement by using existing net operating loss or tax credit carryforwards).

A public business entity would also be required to provide a breakdown (i.e., a mapping) of the amount of total unrecognized tax benefits shown in the tabular reconciliation by the respective balance-sheet lines on which such unrecognized tax benefits are recorded. If an unrecognized tax benefit is not included in a balance-sheet line, such amount would be disclosed separately. In addition, a public business entity would be required to disclose the total amount of unrecognized tax benefits that are offset against existing DTAs for net operating loss and tax credit carryforwards.

Under the guidance currently in ASC 740-10-50-15(d), all entities must disclose details of tax positions for which it is reasonably possible that the total amount of unrecognized tax benefits will significantly increase or decrease in the next 12 months. The proposed ASU would eliminate this disclosure requirement.

Further, the proposed ASU would amend the example in ASC 740-10-55-217 to illustrate the applicability of the proposed disclosure requirements related to unrecognized tax benefits.

Operating Loss and Tax Credit Carryforwards

Currently, entities are required to disclose the amount and expiration dates of operating losses and tax credit carryforwards for tax purposes. Historically, there has been diversity in practice related to this disclosure requirement. The proposed ASU would reduce this diversity by requiring a public business entity to disclose the total amount of:

- Federal, state, and foreign gross net operating loss and tax credit carryforwards (i.e., not tax effected) by period of expiration for each of the first five years after the reporting date and a total for any remaining years.
- Federal, state, and foreign DTAs related to net operating loss and tax credit carryforwards (i.e., tax effected) before any valuation allowance.

Thinking It Through

Generally, an entity should measure a DTA in accordance with the recognition and measurement criteria in ASC 740. While the proposed ASU uses the term "deferred tax asset," it is unclear whether that term as used in the proposal refers to a DTA measured under the ASC 740 criteria or simply the tax-effected amount of the net operating loss and tax credit carryforwards as reflected on the income tax returns as filed.

As discussed previously, a public business entity would also be required to disclose the total amount of unrecognized tax benefits that are offset against existing DTAs for net operating loss and tax credit carryforwards.

In addition, the proposed ASU would modify the disclosure requirement related to net operating loss and tax credit carryforwards for entities other than public business entities. An entity other than a public business entity would be required to disclose the total gross amounts of federal, state, and foreign net operating loss and tax credit carryforwards (i.e., not tax effected) along with their expiration dates. The example in ASC 740-10-55-218 through 55-222 (as amended) would illustrate the applicability of these disclosure requirements.

Rate Reconciliation

ASC 740-10-50-12 currently requires a public business entity to disclose a reconciliation of the reported amount of income tax expense (or benefit) from continuing operations to the amount of income tax expense (or benefit) that would result from multiplying the pretax income (or loss) from continuing operations by the domestic federal statutory tax rate. The proposed ASU would amend the requirement for a public business entity to disclose the income tax rate reconciliation in a manner consistent with SEC Regulation S-X, Rule 4-08(h).

As amended, ASC 740-10-50-12 would continue to require a public business entity to disclose a reconciliation of the reported amount of income tax expense (or benefit) from continuing operations to the amount of income tax expense (or benefit) that would result from multiplying the pretax income (or loss) from continuing operations by the domestic federal statutory tax rate. However, the amendment would modify the requirement to disaggregate and separately present components in the rate reconciliation that are greater than or equal to 5 percent of the tax at the statutory rate in a manner consistent with the requirement in Rule 4-08(h).

Government Assistance

As a result of deliberations on its November 2015 proposed ASU on government assistance, the FASB decided to require an entity to disclose certain information related to assistance received from a governmental unit that reduces the entity's income taxes. Accordingly, the proposed ASU on income tax disclosures would require all entities that receive income tax-related government assistance to disclose a "description of a legally enforceable agreement with a government, including the duration of the agreement and the commitments made with the government under that agreement and the amount of benefit that reduces, or may reduce, its income tax burden." This disclosure requirement would apply only when the government determined whether, under such agreement, the entity would receive assistance and, if so, how much it would receive even if it met the applicable eligibility requirements. In the absence of a specific agreement between the entity and the government, the entity would not be required to disclose this information if the entity obtained the government assistance because it met eligibility requirements that apply to all taxpayers.

Other Income Tax Disclosure Requirements

The proposed ASU would require all entities to disclose the following:

- The amount of pretax income (or loss) from continuing operations disaggregated by foreign and domestic amounts.
- The amount of income tax expense (or benefit) from continuing operations disaggregated by foreign and domestic amounts.
- The amount of income taxes paid disaggregated by foreign and domestic amounts. A further disaggregation would be required for any country that is significant to the total amount of income taxes paid.
- An enacted tax law change if it is probable that such change would have an effect on the entity in the future.

In the determination of pretax income (or loss), foreign income tax expense (or benefit), or foreign income taxes paid, "foreign" refers to any country outside the reporting entity's home country.

In addition, the proposal would require public business entities to explain any valuation allowance recognized or released during the year along with the corresponding amount.

The proposed ASU is also aligned with the guidance in the proposed ASU on assessing the materiality of disclosures, which allows an entity to consider materiality when assessing income tax disclosure requirements.

Transition Guidance and Effective Date

The proposed ASU's amendments would be applied prospectively. The FASB will determine an effective date for the final guidance after it has considered feedback from stakeholders.

Defined Benefit Plans

In January 2016, the FASB issued a proposed ASU that would modify the disclosure requirements for employers that sponsor defined benefit pension or other postretirement plans. The proposed ASU contains an overall objective for the disclosures and guidance on how an entity would consider materiality in determining the extent of its defined benefit plan disclosures. The proposed ASU would add to or remove from ASC 715 a number of disclosure requirements related to an entity's defined benefit pension and other postretirement plans. The Board believes that additional costs incurred by entities as a result of implementing the proposed new disclosure requirements would be offset by cost reductions associated with the elimination of other disclosure requirements as well as the omission of immaterial disclosures.

The amendments in the proposed ASU would be applied retrospectively to all periods presented, except for those related to disclosures about plan assets that entities measure by using the net asset value practical expedient. Such changes would be applied beginning with the initial period of adoption.

The FASB received more than 30 comment letters (which were due by April 25, 2016) on the proposal from various respondents, including preparers, professional and trade organizations, and accounting firms. At its meeting on July 13, 2016, the FASB discussed a summary of the comments received and directed its staff to perform research on particular aspects of the proposed ASU. For additional information about the proposed ASU, see Deloitte's January 28, 2016, *Heads Up*.

Other Topics

SEC and AICPA Updates

Background

The SEC continues to focus on rulemaking, particularly in connection with its efforts to complete mandated actions under the Dodd-Frank Act and to implement provisions under the FAST Act. Key SEC rulemaking activities and other developments that have occurred since the last edition of this publication are discussed below.

Non-GAAP Measures

Press coverage and SEC scrutiny of non-GAAP measures have resulted from the SEC's concerns about (1) the increased use and prominence of such measures, (2) their potential to be misleading, and (3) the progressively larger difference between the amounts reported for them and for GAAP measures. In a speech on June 27, 2016, SEC Chair Mary Jo White reiterated the SEC's concerns about practices that can result in misleading non-GAAP disclosures. She exhorted companies "to carefully consider [SEC guidance on this topic] and revisit their approach to non-GAAP disclosures." She also urged "that appropriate controls be considered and that audit committees carefully oversee their company's use of non-GAAP measures and disclosures."

In May 2016, the SEC staff issued new and updated Compliance and Disclosure Interpretations (C&DIs) that clarify the SEC's guidance on non-GAAP measures. The updated guidance was intended to change certain practices about which the SEC has expressed concern. In remarks after the issuance of the C&DIs, the SEC staff strongly encouraged registrants to "self-correct" before the staff considers any further rulemaking or enforcement action related to non-GAAP measures.

For more information, see Deloitte's *A Roadmap to Non-GAAP Financial Measures*.

Thinking It Through

For the 12 months ended July 31, 2016, non-GAAP measures ranked second in the top-ten list of topics frequently commented on by the SEC's Division of Corporation Finance (the "Division") as part of its filing review process, moving up from fourth place for the comparable prior year. Over the next year, we expect the number of SEC comments to continue to remain high and even increase until the guidance in the updated C&DIs has been fully incorporated into practice. The SEC staff's most recent comment letters have particularly focused on the use and prominence of non-GAAP measures in press releases. Comments on press releases and filed documents have also centered on disclosures, including reconciliation requirements and the purpose and use of such measures. In addition, we expect to see more comments about the use of misleading measures, including measures that use individually tailored accounting principles, and the tax effect of non-GAAP adjustments. For more information about SEC comment letter trends, see Deloitte's *SEC Comment Letters — Including Industry Insights: What "Edgar" Told Us* and the 2016 supplement, *SEC Comment Letters — Statistics According to "Edgar."*

SEC Adopts Rules to Modernize Information Reported by Funds, Require Liquidity Risk Management Programs, and Permit Swing Pricing

In October 2016, the SEC voted to adopt changes to modernize and enhance the reporting and disclosure of information by registered investment companies and to enhance liquidity risk management by open-end funds, including mutual funds and exchange traded funds. The new rules will enhance the quality of information available to investors and will allow the SEC to more effectively collect and use data reported by funds. The rules will also promote effective liquidity risk management across the open-end-fund industry and will enhance disclosure regarding fund liquidity and redemption practices. The new rules permit the use of "swing pricing" by certain open-end management investment companies.

The changes are part of the Commission's initiative to enhance its monitoring and regulation of the asset management industry.

For more information, see the press release on the SEC's Web site.

SEC Issues Rules for Securities Clearing Agencies

In September 2016, the SEC issued a final rule and a proposed rule related to covered clearing agencies.

The final rule establishes "enhanced standards for the operation and governance" of covered clearing agencies. The final rule's scope includes "SEC-registered securities clearing agencies that have been designated as systemically important by the Financial Stability Oversight Council . . . or that are involved in more complex transactions." Such clearing agencies "will be subject to new requirements regarding, among other things, their financial risk management, governance, recovery planning, operations, and disclosures to market participants and the public."

Under the proposed rule, a covered clearing agency would be defined as "any registered clearing agency that provides the services of a central counterparty, central securities depository, or a securities settlement system." The proposal would also define various terms related to covered clearing agencies.

For more information, see the press release on the SEC's Web site.

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

In recent speeches, the SEC staff has reminded registrants about best practices to follow in the periods leading up to the adoption of ASU 2014-09 (on revenue), ASU 2016-02 (on leases), and ASU 2016-13 (on credit losses). The staff's comments, which reiterated themes the Commission has addressed over the past year, focused on internal control over financial reporting (ICFR), auditor independence, and disclosures related to implementation activities.

For more information, see Deloitte's September 22, 2016, *Financial Reporting Alert*.

SEC Proposes to Shorten Standard Settlement Cycle for Broker-Dealer Securities Transactions

In September 2016, the SEC issued a proposed rule that would "shorten the standard settlement cycle for most broker-dealer transactions from three business days after the trade date ('T+3') to two business days after the trade date ('T+2')." The purpose of the proposed amendments is "to reduce a number of risks, including credit risk, market risk, and liquidity risk and, as a result, reduce systemic risk for U.S. market participants."

For more information, see the press release on the SEC's Web site.

SEC Publishes Final Rule on Cross-Border Security-Based Swaps

In February 2016, the SEC issued a final rule related to cross-border security-based swaps (SBSs). Under the final rule, which is being issued in response to a mandate of the Dodd-Frank Act, "a non-U.S. company that uses personnel located in a U.S. branch or office to arrange, negotiate, or execute a security-based swap transaction in connection with its dealing activity [must] include that transaction in determining whether it is required to register as a security-based swap dealer."

For more information, see the press release on the SEC's Web site.

SEC Publishes Final Rules on SBSs

In April 2016, the SEC issued final rules on SBSs that "implement provisions of Title VII relating to business conduct standards and the designation of a chief compliance officer for [SBS] dealers and major [SBS] participants." In addition, the rules address "the cross-border application of the rules and the availability of substituted compliance." The final rules, which became effective on July 12, 2016, include:

- *Rule 15Fh-1* — Defines the scope of the rules.
- *Rule 15Fh-2* — Defines terms used throughout the rules.
- *Rule 15Fh-3* — Addresses the business conduct requirements applicable to SBS entities.
- *Rule 15Fh-4* — Outlines unlawful activities for SBS entities and contains requirements for SBS dealers that advise special entities.
- *Rule 15Fh-5* — Provides requirements for SBS entities that act as counterparties to special entities.
- *Rule 15Fh-6* — Imposes pay-to-play restrictions on SBS dealers.
- *Rule 15k-1* — Outlines requirements for chief compliance officers.

For more information, see the speech by SEC Chair Mary Jo White on the SEC's Web site.

SEC Issues Final Rule to Establish Trade Acknowledgment and Verification Requirements for SBS Transactions

In June 2016, the SEC issued a final rule to establish trade acknowledgment and verification requirements for SBS transactions. Under the final rule, which is being issued in response to a mandate of the Dodd-Frank Act, an SBS entity that enters into an SBS transaction is required to do the following:

- "Provide a trade acknowledgment electronically to its transaction counterparty promptly, and no later than the end of the first business day following the day of execution."
- "Promptly verify or dispute with its counterparty the terms of a trade acknowledgment it receives."
- "Have written policies and procedures in place that are reasonably designed to obtain verification of the terms outlined in any trade acknowledgment that it provides."

In addition, certain broker-dealers that are SBS entities will be exempt from the requirements in Exchange Act Rule 10b-10 if they meet the requirements of the final rule. The final rule became effective on August 16, 2016.

For more information, the press release on the SEC's Web site.

SEC Issues Final Rule on Regulation SBSR

In July 2016, the SEC issued a final rule that amends Regulation SBSR on the reporting and dissemination of SBS information. The purpose of the final rule, which implements requirements in Title VII of the Dodd-Frank Act, is to "increase transparency in the security-based swap market." The final rule became effective on October 11, 2016.

For more information, see the press release on the SEC's Web site.

SEC Issues Final Rule Granting Regulatory Access to Data Held by SBS Data Repositories

In August 2016, the SEC issued a final rule that amends Rule 13n-4 of the Exchange Act to give certain regulators and other authorities access to SBS data repositories. Specifically, the final rule:

- Requires "either a memorandum of understanding or other arrangement between the Commission and the recipient of the data to address the confidentiality of the security-based swap data provided to the recipient."
- Identifies "the five prudential regulators named in the statute, as well as the Federal Reserve banks and the Office of Financial Research, as being eligible to access data."
- Addresses "factors that the Commission may consider in determining whether to permit other entities to access data."

For more information, see the press release on the SEC's Web site.

SEC Issues Proposed and Final Rules Related to Investment Advisers

In June 2016, the SEC issued a proposed rule that would require "SEC-registered investment advisers to adopt and implement written business continuity and transition plans reasonably designed to address operational and other risks related to a significant disruption in the investment adviser's operations." Further, such advisers would need to "make and keep all business continuity and transition plans that are currently in effect or at any time within the past five years were in effect."

In August 2016, the SEC issued a final rule (effective October 31, 2016) to improve the reporting and disclosure requirements for investment advisers. Specifically, the final rule amends:

- Form ADV to (1) require investment advisers to disclose additional information (e.g., about their "separately managed account business"), (2) include an approach under which "private fund adviser entities operating a single advisory business" can use a single Form ADV to register, and (3) make certain technical corrections to "Form ADV items and instructions."
- Investment Advisers Act rules to (1) require advisers to maintain additional records of performance-related calculations and communications and (2) "remove transition provisions that are no longer necessary."

Advisers will need to begin complying with the amendments on October 1, 2017.

For more information on the proposed rule, see the press release on the SEC's Web site.

For more information on the final rule, see the press release on the SEC's Web site.

SEC Requests Comments on Regulation S-K

In April 2016, the SEC issued a concept release that seeks feedback from constituents on modernizing certain business and financial disclosure requirements of Regulation S-K. The main requirements of Regulation S-K, which is the central repository for nonfinancial statement disclosure requirements for public companies, were established more than 30 years ago, and the modernization and optimization of these requirements may be called for as a result of evolving business models, new technology, and changing investor interests.

The release is part of the SEC's ongoing disclosure effectiveness initiative, which is a broad-based review of the Commission's disclosure, presentation, and delivery requirements for public companies. It follows the SEC's issuance last fall of a request for comment that sought feedback on the effectiveness of financial disclosure requirements in Regulation S-X that apply to certain entities other than the registrant.

For more information, see Deloitte's April 18, 2016, *Heads Up*.

SEC Requests Comments on Certain Regulation S-K Disclosure Requirements

In August 2016, the SEC published a request for comment (with an October 31, 2016, comment deadline) as part of its disclosure effectiveness initiative. The request for comment seeks feedback on certain disclosure requirements in Subpart 400 of Regulation S-K related to management, certain security holders, and corporate governance matters. The Commission plans to take the comments received into account when it develops its study on Regulation S-K, which is required by the FAST Act.

For more information, see the press release on the SEC's Web site.

SEC Proposes to Eliminate Outdated and Duplicative Disclosure Requirements

In July 2016, the SEC issued a proposed rule that would amend certain of the Commission's disclosure requirements that may be redundant, duplicative, or outdated, or may overlap with other SEC, U.S. GAAP, or IFRS disclosure requirements. The proposal also seeks comment on whether certain of the SEC's disclosure requirements that overlap with requirements under U.S. GAAP should be retained, modified, eliminated, or referred to the FASB for potential incorporation into U.S. GAAP.

The proposed amendments are the next step in the SEC's ongoing disclosure effectiveness initiative. As part of the initiative, the SEC in April 2016 also issued a concept release that sought feedback on modernizing certain business and financial disclosure requirements of Regulation S-K.

Thinking It Through

The implications of the proposal are likely to vary depending on the category of change (e.g., duplicate, overlapping, superseded). The effect of some changes may not be significant if their purpose is only to eliminate a duplicated or superseded requirement. Changes to address overlapping requirements could have a more significant effect since they can result in what the SEC describes as (1) disclosure location considerations and (2) bright-line threshold considerations.

For more information, see Deloitte's July 18, 2016, *Heads Up* and the press release on the SEC's Web site.

SEC Staff Updates C&DIs Related to Regulation S-K, the Securities Act, and Other Topics

In October 2016, the Division updated C&DIs related to Regulation S-K, Item 402(u), and added the following new questions:

- *Question 128C.01* — Clarifies what type of consistently applied compensation measure (CACM) a registrant should select to identify the median employee when a registrant does not use annual total compensation calculated in accordance with Regulation S-K, Item 402(c)(2)(x).
- *Question 128C.02* — Clarifies whether a registrant may use hourly or annual rates of pay in determining its CACM.
- *Question 128C.03* — Clarifies the time period a registrant may use when it uses a CACM to identify the median employee.

- *Question 128C.04* — Clarifies the treatment of furloughed employees by registrants in the identification of the median employee.
- *Question 128C.05* — Clarifies the circumstances under which a worker is considered an independent contractor or a leased worker.

In September 2016, the Division issued the following C&DIs:

- *Question 139.33 and Question 126.41 related to Securities Act sections and forms* — Include guidance on self-directed "brokerage windows."
- *Question 301.03 related to Regulation AB* — Clarifies whether a funding-agreement-backed note with certain characteristics should be considered an "asset-backed security," as that term is defined in either Item 1101(c) of Regulation AB or Section 3(a)(79) of the Exchange Act.

In July 2016, the Division issued the following C&DIs:

- *Question 103.11 related to filing Schedules 13D and 13G (Rule 13d-1)* — Addresses whether a shareholder is exempt from filing Schedule 13G on the basis of the provisions in the Hart-Scott-Rodino Act.
- *Question 111.02 and Question 125.13 related to Securities Act sections and forms* — Contain questions related to an issuer's representation about the absence of a distribution of the securities received in an exchange.
- *Question 140.02 related to Regulation S-K* — Discusses how, in situations in which "a selling security holder is not a natural person," a registrant should "satisfy the obligation in Item 507 of Regulation S-K to disclose the nature of any position, office, or other material relationship that the selling security holder has had within the past three years with the registrant or any of its predecessors or affiliates."

In June 2016, the Division updated Section 271 of its C&DIs on rules related to the Securities Act. The updated guidance addresses questions about the completion of a merger transaction.

SEC Proposes Amendments to Broker-Dealers' Disclosures About Order Handling Information

In July 2016, the SEC issued a proposed rule that would enhance the requirements related to broker-dealers' disclosures about order handling information. Specifically, the proposal would require broker-dealers to "disclose the handling of institutional orders to customers" and to include additional information in their existing retail order disclosures.

For more information, see the press release on the SEC's Web site.

SEC Proposes Amendments to the Definition of Smaller Reporting Company

In June 2016, the SEC issued a proposed rule that "would expand the number of companies that qualify as smaller reporting companies, thus qualifying for certain existing scaled disclosures provided in Regulation S-K and Regulation S-X." Specifically, the proposal would increase the qualification threshold from less than $75 million of public float to less than $250 million. Further, companies with public float of zero "would be permitted to provide scaled disclosures if [their] annual revenues are less than $100 million, as compared to the current threshold of less than $50 million in annual revenues."

For more information, see Deloitte's June 29, 2016, journal entry and the press release on the SEC's Web site.

Thinking It Through

The proposal does not change the $75 million public float threshold in the SEC's definition of "accelerated filer." Therefore, a company could qualify as a smaller reporting company and be eligible for the scaled disclosures but may also be an accelerated filer and subject to those requirements, including the shorter deadlines for periodic filings and the requirement to include an auditor's attestation report on ICFR.

FAST Act Amends JOBS Act and SEC Disclosure Requirements

The FAST Act became law in December 2015. Among its many provisions, it amends the JOBS Act and certain SEC disclosure requirements as well as establishes a new statutory exemption for private resales of securities. Specific provisions of the FAST Act include those related to JOBS Act changes for IPOs of emerging growth companies (EGCs), Form 10-K and Regulation S-K disclosure changes, a new Section 4(a)(7) exemption for private resales, incorporation by reference for smaller reporting companies, and an amendment to registration thresholds applicable to savings and loan holding companies.

For more information, see Deloitte's December 8, 2015, journal entry as well as the announcement on the SEC's Web site.

Thinking It Through

The aim of this legislation is make it easier for EGCs to gain exposure to the capital markets to access funding by easing regulations related to when an EGC can begin its road show as well as the omission of certain historical financial information to the extent that such information is not expected to be required at the time of an IPO's effectiveness.

SEC Releases Guidance Related to FAST Act

In January 2016, the SEC issued interim final rules and form amendments to implement certain provisions of the FAST Act. Among other aspects, the rules revise Forms S-1 and F-1 to permit an EGC to omit financial information from registration statements filed before an IPO (or confidentially submitted to the SEC for review) for historical periods required by Regulation S-X if the EGC reasonably believes that it will not be required to include these historical periods at the time the contemplated offering becomes effective. The rules and amendments became effective on January 19, 2016.

In addition, in December 2015, the SEC issued a number of C&DIs related to the FAST Act. Topics addressed in the C&DIs include (1) whether, and in what circumstances, an EGC can omit interim financial statements or financial statements of other entities from its registration statement and (2) FAST Act requirements that affect savings and loan holding companies.

See Deloitte's December 8, 2015, journal entry for more information about the FAST Act's effects on securities laws and regulations. Also see Deloitte's January 15, 2016, journal entry for further details on the interim final rules and January 12, 2016, and December 18, 2015, journal entries for more information about the C&DIs.

SEC Adopts Rules to Implement FAST Act and JOBS Act Provisions

In May 2016, the SEC issued a final rule that (1) marks the completion of the Commission's rulemaking mandates under the JOBS Act and (2) implements provisions of the FAST Act. Specifically, the final rule:

- Amends "Exchange Act Rules 12g-1 through 12g-4 and 12h-3 which govern the procedures relating to registration and termination of registration under Section 12(g), and suspension of reporting obligations under Section 15(d), to reflect the new thresholds established by the JOBS Act and the FAST Act."
- Applies "the definition of 'accredited investor' in Securities Act Rule 501(a) to determinations as to which record holders are accredited investors for purposes of Exchange Act Section 12(g)(1)." The final rule also revises the definition of "held of record" and establishes a nonexclusive safe harbor under Exchange Act Section 12(g).

The final rule became effective on June 9, 2016. For more information, see the press release on the SEC's Web site.

In June 2016, the SEC issued an interim final rule that implements provisions mandated by the FAST Act. The interim final rule allows Form 10-K filers to provide a summary of business and financial information contained in the annual report. The rule indicates that "a registrant may, at its option, include a summary in its Form 10-K provided that each item in the summary includes a cross-reference by hyperlink to the material contained in the registrant's Form 10-K to which such item relates." In addition, the rule solicits comments on whether it should (1) include specific requirements or guidance related to the form and content of the summary and (2) be expanded to include other annual reporting forms. The interim final rule became effective on June 9, 2016.

For more information on the interim final rule, see Deloitte's June 2, 2016, journal entry and the press release on the SEC's Web site.

Thinking It Through

The SEC considered the interim final rule's effects on registrants and noted that the rule was not likely to significantly alter their current disclosure practices. SEC rules do not currently prohibit registrants from voluntarily including a summary in their Form 10-K; however, on the basis of the SEC staff's review of select Form 10-K filings, most do not include such a summary. Instead, the vast majority of registrants include a fully hyperlinked table of contents that allows users to easily navigate to corresponding disclosure items.

SEC and Other Organizations Propose Guidance on Incentive-Based Compensation Arrangements

In May 2016, the SEC and several other government agencies, including the Federal Reserve Board, OCC, FDIC, FHFA, and NCUA, jointly issued a proposed rule on incentive-based compensation arrangements to implement Section 956 of the Dodd-Frank Act. The proposed rule would:

- Prohibit "incentive-based payment arrangements that the Agencies determine encourage inappropriate risks by certain financial institutions by providing excessive compensation or that could lead to material financial loss."
- Require "financial institutions to disclose information concerning incentive-based compensation arrangements to the appropriate Federal regulator."

For more information, see the press release on the SEC's Web site.

SEC Updates *Financial Reporting Manual*

In March 2016, the Division updated its Financial Reporting Manual to clarify or add guidance on the following topics:

- *Paragraph 2410.8* — Significance testing related to equity method investments.
- *Topic 10* — Requirements as a result of the FAST Act.
- *Topic 11* — Implementation of the FASB's and IASB's new revenue standard.

In November 2016, the Division updated its Financial Reporting Manual to clarify or add guidance on the following topics:

- *Paragraphs 1140.3 and 10220.7* — The number of years of a target company's financial statements that an EGC should present.
- *Paragraph 1330.5* — Filings required after Form 10 is effective.
- *Paragraph 5120.1* — Effect of loss of smaller reporting company status on accelerated filer determination and filing due dates.
- *Paragraph 8110.2* — The May 2016 C&DI updates on non-GAAP financial measures.
- *Paragraph 10220.5* — EGC guidance on the financial statements of entities other than the registrant; pro forma information.
- *Paragraph 11120.4, Index* — Implementation of the FASB's and IASB's new revenue standard.
- *Section 11200, Index* — Implementation of the FASB's and IASB's new leases standard.
- *Section 11300, Index* — Implementation of the FASB's new standard on disclosures about short-duration insurance contracts.

For more information, see Deloitte's March 22, 2016, and November 9, 2016, journal entries.

SEC and FDIC Issue Proposed Rule on Covered Broker-Dealer Provisions

In February 2016, the SEC and FDIC issued a proposed rule that establishes certain "provisions applicable to the orderly liquidation of covered brokers and dealers." The proposal is being issued in response to a mandate of the Dodd-Frank Act.

SEC Publishes Examination Priorities for 2016

In January 2016, the SEC's Office of Compliance Inspections and Examinations published its examination priorities for 2016. New priorities include liquidity controls, public pension advisers, product promotion, exchange-traded funds, and variable annuities. Further, the priorities "reflect a continuing focus on protecting investors in ongoing risk areas such as cybersecurity, microcap fraud, fee selection, and reverse churning."

For more information, see the press release on the SEC's Web site.

2015 AICPA Conference on Current SEC and PCAOB Developments

At the 2015 AICPA Conference on Current SEC and PCAOB Developments, numerous speakers and discussion panels shared their insights into current accounting, reporting, and auditing practice issues. Key topics addressed at the event included the following:

- *Disclosure effectiveness* — Speakers focused on improving disclosure requirements, with the goal of enhancing the information provided to investors and promoting efficiency, competition, and capital formation. The SEC reiterated its continued focus on disclosure effectiveness, including its outreach to the investor community and its ongoing collaboration with the FASB.
- *ICFR* — This topic continues to be a key focus for regulators, preparers, and auditors. SEC Chief Accountant James Schnurr stated that "[m]anagement's ability to fulfill its financial reporting responsibilities depends, in large part, on the design and effectiveness of internal control over financial reporting." Several speakers commented that the frequency of ICFR-related findings in PCAOB inspections highlights the need for management, auditors, and audit committees to work together to address potential underlying issues with controls and assessments.
- *IFRSs* — The SEC's consideration of the potential incorporation of IFRSs into the U.S. financial reporting system has long been a topic at the conference, and this year was no exception. At the 2014 conference, Mr. Schnurr introduced a potential fourth alternative regarding the use of IFRSs in the United States that would allow U.S.-based filers to voluntarily provide supplemental IFRS-based information without reconciliation to U.S. GAAP. In his remarks at the 2015 conference, Mr. Schnurr indicated that the OCA is likely to recommend that the SEC consider and commence rulemaking that is consistent with this fourth alternative.
- *Audit committees* — Speakers observed that the roles and responsibilities now frequently imposed on audit committees in addition to their core SEC-required duties may interfere with their primary responsibility of overseeing the company's financial reporting. Mr. Schnurr recapped the SEC staff's efforts over the past year to address "whether investors are interested in hearing from audit committees on *how* (not just *if*) they have fulfilled their responsibilities; and . . . whether the Commission's rules support such reporting." As part of these efforts, the SEC issued a concept release in July 2015 to seek feedback on the proposed changes to the reporting requirements as well as on additional disclosures investors may want.

For more information, see Deloitte's December 15, 2015, *Heads Up*.

SEC Proposes Rule on Use of Derivatives

In December 2015, the SEC issued a proposed rule on use of derivatives by registered investment companies and business development companies. The proposal would "place restrictions on funds, such as mutual funds and exchange-traded funds . . . that would limit their use of derivatives and require funds to put in place risk management measures resulting in better protection for investors."

For more information, see the press release on the SEC's Web site.

SEC Proposes Enhancements to Disclosure Requirements for Alternative Trading Systems

In November 2015, the SEC issued a proposed rule that would amend the requirements for alternative trading systems under the Exchange Act. Specifically, the proposal would require alternative trading systems that "trade stocks listed on a national securities exchange (NMS stocks), including 'dark pools,' to publicly disclose detailed information about the operations and activities of a broker-dealer operator and its affiliates."

For more information, see the press release on the SEC's Web site.

Summary of Accounting Pronouncements Effective in 2016

The table below lists ASUs that became effective for calendar year 2016. (Note that it is assumed that the ASUs were not early adopted before 2016 if early adoption was permitted.)

ASU (Issuance Month)	Affects	Effective Date for Public Business Entities	Effective Date for All Other Entities
ASU 2016-03, *Intangibles — Goodwill and Other (Topic 350), Business Combinations (Topic 805), Consolidation (Topic 810), Derivatives and Hedging (Topic 815): Effective Date and Transition Guidance* — a consensus of the Private Company Council (March 2016)	Private entities.	Not applicable.	Upon issuance.
ASU 2015-16, *Simplifying the Accounting for Measurement-Period Adjustments* (September 2015)	Entities that have reported provisional amounts for items in a business combination for which the accounting is incomplete by the end of the reporting period in which the business combination occurs and during the measurement period have an adjustment to provisional amounts recognized.	Fiscal years (and interim periods therein) beginning after December 15, 2015.	Fiscal years beginning after December 15, 2016, and interim periods within fiscal years beginning after December 15, 2017.

(Table continued)

ASU (Issuance Month)	Affects	Effective Date for Public Business Entities	Effective Date for All Other Entities
ASU 2015-12, *(Part I) Fully Benefit-Responsive Investment Contracts, (Part II) Plan Investment Disclosures, (Part III) Measurement Date Practical Expedient* — consensuses of the FASB Emerging Issues Task Force (July 2015)	Reporting entities within the scope of ASC 960, ASC 962, or ASC 965. Effective for fiscal years beginning after December 15, 2015.		
ASU 2015-10, *Technical Corrections and Improvements* (June 2015)	All entities.	Transition guidance varies on the basis of the amendments in the ASU. The amendments that require transition guidance are effective for all entities for fiscal years and interim periods within those fiscal years beginning after December 15, 2015.	
ASU 2015-09, *Disclosures About Short-Duration Contracts* (May 2015)	All insurance entities that issue short-duration contracts as defined in ASC 944. The amendments do not apply to the holder (i.e., policyholder) of short-duration contracts.	Fiscal years beginning after December 15, 2015, and interim periods within annual periods beginning after December 15, 2016.	Fiscal years beginning after December 15, 2016, and interim periods within annual periods beginning after December 15, 2017.
ASU 2015-07, *Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)* — a consensus of the FASB Emerging Issues Task Force (May 2015)	All entities.	Fiscal years (and interim periods therein) beginning after December 15, 2015.	Fiscal years (and interim periods therein) beginning after December 15, 2016.
ASU 2015-06, *Effects on Historical Earnings per Unit of Master Limited Partnership Dropdown Transactions* — a consensus of the FASB Emerging Issues Task Force (April 2015)	All entities.	Fiscal years (and interim periods therein) beginning after December 15, 2015.	
ASU 2015-05, *Customer's Accounting for Fees Paid in a Cloud Computing Arrangement* (April 2015)	All entities.	Annual periods (and interim periods therein) beginning after December 15, 2015.	Annual periods beginning after December 15, 2015, and interim periods within annual periods beginning after December 15, 2016.

(Table continued)

ASU (Issuance Month)	Affects	Effective Date for Public Business Entities	Effective Date for All Other Entities
ASU 2015-04, *Practical Expedient for the Measurement Date of an Employer's Defined Benefit Obligation and Plan Assets* (April 2015)	All entities.	Fiscal years (and interim periods therein) beginning after December 15, 2015.	Fiscal years beginning after December 15, 2016, and interim periods within fiscal years beginning after December 15, 2017.
ASU 2015-03, *Simplifying the Presentation of Debt Issuance Costs* (April 2015)	All entities.	Fiscal years (and interim periods therein) beginning after December 15, 2015.	Fiscal years beginning after December 15, 2015, and interim periods within fiscal years beginning after December 15, 2016.
ASU 2015-02, *Amendments to the Consolidation Analysis* (February 2015)	Entities that are required to evaluate whether they should consolidate certain legal entities.	Fiscal years (and interim periods therein) beginning after December 15, 2015.	Fiscal years beginning after December 15, 2016, and for interim periods within fiscal years beginning after December 15, 2017.
ASU 2015-01, *Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items* (January 2015)	All entities.	Fiscal years (and interim periods therein) beginning after December 15, 2015.	
ASU 2014-18, *Accounting for Identifiable Intangible Assets in a Business Combination* — a consensus of the Private Company Council (December 2014)	All entities **except** public business entities and not-for-profit entities, as those terms are defined in the ASC master glossary.	Not applicable.	If the first in-scope transaction occurs in the first fiscal year beginning after December 15, 2015, the elective adoption will be effective for that fiscal year's annual financial reporting and all interim and annual periods thereafter. If the first transaction occurs in fiscal years beginning after December 15, 2016, the elective adoption will be effective in the interim period that includes the date of the transaction and subsequent interim and annual periods thereafter.

(Table continued)

ASU (Issuance Month)	Affects	Effective Date for Public Business Entities	Effective Date for All Other Entities
ASU 2014-16, *Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share Is More Akin to Debt or to Equity* — a consensus of the FASB Emerging Issues Task Force (November 2014)	Entities that are issuers of, or investors in, hybrid financial instruments that are issued in the form of a share.	Fiscal years (and interim periods therein) beginning after December 15, 2015.	Fiscal years beginning after December 15, 2015, and interim periods within fiscal years beginning after December 15, 2016.
ASU 2014-13, *Measuring the Financial Assets and the Financial Liabilities of a Consolidated Collateralized Financing Entity* — a consensus of the FASB Emerging Issues Task Force (August 2014)	A reporting entity that is required to consolidate a collateralized financing entity under the variable interest entities subsections of ASC 810-10 and that measures assets and liabilities of the collateralized financing entity by using fair value.	Fiscal years (and interim periods therein) beginning after December 15, 2015.	Fiscal years ending after December 15, 2016, and interim periods beginning after December 15, 2016.
ASU 2014-12, *Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved After the Requisite Service Period* — a consensus of the FASB Emerging Issues Task Force (June 2014)	Reporting entities that grant their employees share-based payments in which the terms of the award stipulate that a performance target that affects vesting could be achieved after the requisite service period.	Fiscal years (and interim periods therein) beginning after December 15, 2015.	

Appendixes

Appendix A — Glossary of Standards and Other Literature

The following are the titles of standards and other literature mentioned in this publication:

AICPA

Working Draft: Engineering & Construction Contractors Revenue Recognition Implementation Issues; Issue #4-1: Identifying the Unit of Account

FASB ASUs

ASU 2016-18, *Statement of Cash Flows (Topic 230): Restricted Cash* — a consensus of the FASB Emerging Issues Task Force

ASU 2016-17, *Consolidation (Topic 810): Interests Held Through Related Parties That Are Under Common Control*

ASU 2016-15, *Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments* — a consensus of the Emerging Issues Task Force

ASU 2016-13, *Financial Instruments — Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*

ASU 2016-12, *Revenue From Contracts With Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients*

ASU 2016-11, *Revenue Recognition (Topic 605) and Derivatives and Hedging (Topic 815): Rescission of SEC Guidance Because of Accounting Standards Updates 2014-09 and 2014-16 Pursuant to Staff Announcements at the March 3, 2016 EITF Meeting (SEC Update)*

ASU 2016-10, *Revenue From Contracts With Customers (Topic 606): Identifying Performance Obligations and Licensing*

ASU 2016-09, *Compensation — Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting*

ASU 2016-08, *Revenue From Contracts With Customers (Topic 606): Principal Versus Agent Considerations (Reporting Revenue Gross Versus Net)*

ASU 2016-07, *Investments — Equity Method and Joint Ventures (Topic 323): Simplifying the Transition to the Equity Method of Accounting*

ASU 2016-03, *Intangibles — Goodwill and Other (Topic 350), Business Combinations (Topic 805), Consolidation (Topic 810), Derivatives and Hedging (Topic 815): Effective Date and Transition Guidance* — a consensus of the Private Company Council

ASU 2016-02, *Leases (Topic 842)*

ASU 2016-01, *Financial Instruments — Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*

ASU 2015-17, *Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes*

ASU 2015-16, *Business Combinations (Topic 805): Simplifying the Accounting for Measurement-Period Adjustments*

ASU 2015-14, *Revenue From Contracts With Customers (Topic 606): Deferral of the Effective Date*

ASU 2015-12, *Plan Accounting: Defined Benefit Pension Plans (Topic 960), Defined Contribution Pension Plans (Topic 962), Health and Welfare Benefit Plans (Topic 965): (Part I) Fully Benefit-Responsive Investment Contracts, (Part II) Plan Investment Disclosures, (Part III) Measurement Date Practical Expedient* — consensuses of the FASB Emerging Issues Task Force

ASU 2015-10, *Technical Corrections and Improvements*

ASU 2015-09, *Financial Services — Insurance (Topic 944): Disclosures About Short-Duration Contracts*

ASU 2015-07, *Fair Value Measurement (Topic 820): Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)* — a consensus of the FASB Emerging Issues Task Force

ASU 2015-06, *Earnings per Share (Topic 260): Effects on Historical Earnings per Unit of Master Limited Partnership Dropdown Transactions* — a consensus of the FASB Emerging Issues Task Force

ASU 2015-05, *Intangibles — Goodwill and Other — Internal-Use Software (Subtopic 350-40): Customer's Accounting for Fees Paid in a Cloud Computing Arrangement*

ASU 2015-04, *Compensation — Retirement Benefits (Topic 715): Practical Expedient for the Measurement Date of an Employer's Defined Benefit Obligation and Plan Assets*

ASU 2015-03, *Interest — Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs*

ASU 2015-02, *Consolidation (Topic 810): Amendments to the Consolidation Analysis*

ASU 2015-01, *Income Statement — Extraordinary and Unusual Items (Subtopic 225-20): Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items*

ASU 2014-18, *Business Combinations (Topic 805): Accounting for Identifiable Intangible Assets in a Business Combination* — a consensus of the Private Company Council

ASU 2014-16, *Derivatives and Hedging (Topic 815): Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share Is More Akin to Debt or to Equity* — a consensus of the FASB Emerging Issues Task Force

ASU 2014-13, *Consolidation (Topic 810): Measuring the Financial Assets and the Financial Liabilities of a Consolidated Collateralized Financing Entity* — a consensus of the FASB Emerging Issues Task Force

ASU 2014-12, *Compensation — Stock Compensation (Topic 718): Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period* — a consensus of the FASB Emerging Issues Task Force

ASU 2014-09, *Revenue From Contracts With Customers (Topic 606)*

ASU 2014-07, *Consolidation (Topic 810): Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements* — a consensus of the Private Company Council

ASU 2014-03, *Derivatives and Hedging (Topic 815): Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps — Simplified Hedge Accounting Approach* — a consensus of the Private Company Council

ASU 2014-02, *Intangibles — Goodwill and Other (Topic 350): Accounting for Goodwill* — a consensus of the Private Company Council

ASU 2014-01, *Investments — Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects* — a consensus of the FASB Emerging Issues Task Force

ASU 2010-20, *Receivables (Topic 310): Disclosures About the Credit Quality of Financing Receivables and the Allowance for Credit Losses*

ASU 2010-10, *Consolidation (Topic 810): Amendments for Certain Investment Funds*

ASU 2009-17, *Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved With Variable Interest Entities*

FASB ASC Topics and Subtopics

ASC 230, *Statement of Cash Flows*

ASC 235, *Notes to Financial Statements*

ASC 250, *Accounting Changes and Error Corrections*

ASC 250-10, *Accounting Changes and Error Corrections: Overall*

ASC 320, *Investments — Debt and Equity Securities*

ASC 321-10, *Investments — Equity Securities: Overall*

ASC 325-40, *Investments — Other: Beneficial Interests in Securitized Financial Assets*

ASC 326-30, *Financial Instruments — Credit Losses: Available-for-Sale Debt Securities*

ASC 350, *Intangibles — Goodwill and Other*

ASC 360-20, *Property, Plant, and Equipment: Real Estate Sales*

ASC 460, *Guarantees*

ASC 470-10, *Debt: Overall*

ASC 470-20, *Debt: Debt With Conversion and Other Options*

ASC 480, *Distinguishing Liabilities From Equity*

ASC 480-10, *Distinguishing Liabilities From Equity: Overall*

ASC 505-50, *Equity: Equity-Based Payments to Non-Employees*

ASC 605, *Revenue Recognition*

ASC 605-20, *Revenue Recognition: Services*

ASC 605-45, *Revenue Recognition: Principal Agent Considerations*

ASC 605-50, *Revenue Recognition: Customer Payments and Incentives*

ASC 606, *Revenue From Contracts With Customers*

ASC 606-10, *Revenue From Contracts With Customers: Overall*

ASC 610-20, *Other Income: Gains and Losses From the Derecognition of Nonfinancial Assets*

ASC 715, *Compensation — Retirement Benefits*

ASC 715-20, *Compensation — Retirement Benefits: Defined Benefit Plans — General*

ASC 718, *Compensation — Stock Compensation*

ASC 718-20, *Compensation — Stock Compensation: Awards Classified as Equity*

ASC 740, *Income Taxes*

ASC 740-10, *Income Taxes: Overall*

ASC 805, *Business Combinations*

ASC 805-10, *Business Combinations: Overall*

ASC 810, *Consolidation*

ASC 810-10, *Consolidation: Overall*

ASC 815, *Derivatives and Hedging*

ASC 815-10, *Derivatives and Hedging: Overall*

ASC 815-15, *Derivatives and Hedging: Embedded Derivatives*

ASC 815-40: *Derivatives and Hedging: Contracts in Entity's Own Equity*

ASC 820, *Fair Value Measurement*

ASC 820-10, *Fair Value Measurement: Overall*

ASC 825, *Financial Instruments*

ASC 825-10, *Financial Instruments: Overall*

ASC 840, *Leases*

ASC 845-10, *Nonmonetary Transactions: Overall*

ASC 860, *Transfers and Servicing*

ASC 932-10, *Extractive Activities — Oil and Gas: Overall*

ASC 944, *Financial Services — Insurance*

ASC 946, *Financial Services — Investment Companies*

ASC 958, *Not-for-Profit Entities*

ASC 960, *Plan Accounting — Defined Benefit Pension Plans*

ASC 962, *Plan Accounting — Defined Contribution Pension Plans*

ASC 965, *Plan Accounting — Health and Welfare Benefit Plans*

ASC 970, *Real Estate — General*

ASC 970-605, *Real Estate — General: Revenue Recognition*

FASB Proposed ASUs

Proposed ASU 2016-360, *Compensation — Stock Compensation (Topic 718) — Scope of Modification Accounting*

Proposed ASU 2016-320, *Technical Corrections and Improvements to Update No. 2014-09, Revenue From Contracts With Customers (Topic 606) — Additional Corrections*

Proposed ASU 2016-310, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*

Proposed ASU 2016-270, *Income Taxes (Topic 740): Disclosure Framework — Changes to the Disclosure Requirements for Income Taxes*

Proposed ASU 2016-250, *Other Income — Gains and Losses From the Derecognition of Nonfinancial Assets (Subtopic 610-20): Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets*

Proposed ASU 2016-240, *Technical Corrections and Improvements to Update 2014-09, Revenue From Contracts With Customers (Topic 606)*

Proposed ASU 2016-230, *Intangibles — Goodwill and Other (Topic 350): Simplifying the Accounting for Goodwill Impairment*

Proposed ASU 2016-210, *Compensation — Retirement Benefits — Defined Benefit Plans —General (Subtopic 715-20): Changes to the Disclosure Requirements for Defined Benefit Plans*

Proposed ASU 2015-350, *Fair Value Measurement (Topic 820): Disclosure Framework — Changes to the Disclosure Requirements for Fair Value Measurement*

Proposed ASU 2015-330, *Business Combinations (Topic 805): Clarifying the Definition of a Business*

Proposed ASU 2015-340, *Government Assistance (Topic 832): Disclosures by Business Entities About Government Assistance*

Proposed ASU 2015-300, *Conceptual Framework for Financial Reporting — Chapter 3: Qualitative Characteristics of Useful Financial Information*

Proposed ASU 2015-310, *Notes to Financial Statements (Topic 235): Assessing Whether Disclosures Are Material*

Proposed ASU 2015-280, *Investments — Equity Method and Joint Ventures (Topic 323): Simplifying the Equity Method of Accounting*

Other FASB Proposals

Invitation to Comment 2016-290, *Agenda Consultation*

Proposed Concepts Statement 2015-300, *Conceptual Framework for Financial Reporting: Chapter 3: Qualitative Characteristics of Useful Financial Information*

Proposed Concepts Statement 2014-200, *Conceptual Framework for Financial Reporting: Chapter 8: Notes to Financial Statements*

Invitation to Comment 2012-220, *Disclosure Framework*

FASB Concepts Statement

CON 8, *Conceptual Framework for Financial Reporting*

EITF Issue

15-F, "Statement of Cash Flows: Classification of Certain Cash Receipts and Cash Payments"

Private Company Council Literature

PCC Issue No. 15-02, "Applying Variable Interest Entity Guidance to Entities Under Common Control"

SEC Division of Corporation Finance *Financial Reporting Manual*

Topic 2, "Other Financial Statements Required"; Section 2400, "Equity Method Investments, Including Fair Value Option"

Topic 10, "Emerging Growth Companies"

Topic 11, "Reporting Issued Related to Adoption of New Revenue Recognition Standard"

Topic 13, "Effects of Subsequent Events on Financial Statements Required in Filings"

SEC Regulation AB (Asset-Backed Securities)

Item 1101(c), "Definitions; Asset-Backed Security"

SEC Regulation S-X

Rule 4-08(h), "General Notes to Financial Statements: Income Tax Expense"

SEC Regulation S-K

Item 402(c), "Executive Compensation; Summary Compensation Table"

Item 402(u), "Executive Compensation; Pay Ratio Disclosure"

Item 507, "Selling Security Holders"

SEC Final Rules

34-78961, *Standards for Covered Clearing Agencies*

34-78716, *Access to Data Obtained by Security-Based Swap Data Repositories*

IA-4509, *Form ADV and Investment Advisers Act Rules*

34-78321, *Regulation SBSR — Reporting and Dissemination of Security-Based Swap Information*

34-78011, *Trade Acknowledgment and Verification of Security-Based Swap Transactions*

33-10075, *Changes to Exchange Act Registration Requirements to Implement Title V and Title VI of the JOBS Act*

34-77617, *Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants*

SIPA-175, *Securities Investor Protection Corporation*

34-77104, *Security-Based Swap Transactions Connected With a Non-U.S. Person's Dealing Activity That Are Arranged, Negotiated, or Executed by Personnel Located in a U.S. Branch or Office or in a U.S. Branch or Office of an Agent; Security-Based Swap Dealer* De Minimis *Exception*

SEC Interim Final Rules

34-77969, Request for Comment, *Form 10-K Summary*

33-10003, Request for Comment, *Simplification of Disclosure Requirements for Emerging Growth Companies and Forward Incorporation by Reference on Form S-1 for Smaller Reporting Companies*

SEC Proposed Rules and Concept Releases

34-78963, *Definition of "Covered Clearing Agency"*

34-78962, *Amendment to Securities Transaction Settlement Cycle*

34-78309, *Disclosure of Order Handling Information*

33-10110, *Disclosure Update and Simplification*

IA-4439, *Adviser Business Continuity and Transition Plans*

33-10107, *Amendments to Smaller Reporting Company Definition*

33-10064, *Business and Financial Disclosure Required by Regulation S-K*

34-77776, *Incentive-Based Compensation Arrangements*

34-77157, *Covered Broker-Dealer Provisions Under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act*

IC-31933, *Use of Derivatives by Registered Investment Companies and Business Development Companies*

34-76474, *Regulation of NMS Stock Alternative Trading Systems*

33-9862, *Possible Revisions to Audit Committee Disclosures*

Other SEC Proposal

33-10198, *Request for Comment on Subpart 400 of Regulation S-K Disclosure Requirements Relating to Management, Certain Security Holders and Corporate Governance Matters*

SEC Staff Accounting Bulletin

SAB Topic 13, "Revenue Recognition"

SEC Office of Compliance Inspections and Examinations

Examination Priorities for 2016

SEC C&DI Topics

Exchange Act Sections 13(d) and 13(g) and Regulation 13D-G Beneficial Ownership Reporting

Non-GAAP Financial Measures

Regulation AB and Related Rules

Regulation S-K

Securities Act Forms

Securities Act Rules

Securities Act Sections

Securities Act of 1933 Rule

Rule 501(a), "Definitions and Terms Used in Regulation D; Accredited Investor"

Securities Exchange Act of 1934 Rules

Rule 10b-10 "Manipulative and Deceptive Devices and Contrivances; Confirmation of Transactions"

Rule 12g "Extensions and Temporary Exemptions":

- Rule 12g-1, "Definitions; Exemption From Section 12(g)"
- Rule 12g-2, "Securities Deemed to Be Registered Pursuant to Section 12(g)(1) Upon Termination of Exemption Pursuant to Section 12(g)(2) (A) or (B)"
- Rule 12g-3, "Registration of Securities of Successor Issuers Under Section 12(b) or 12(g)"
- Rule 12g-4, "Certifications of Termination of Registration Under Section 12(g)"

Rule 12h-3, "Suspension of Duty to File Reports Under Section 15(d)"

Rule 13n-4, "Regulation SBSR; Duties and Core Principles of Security-Based Swap Data Repository"

International Standards

IFRS 16, *Leases*

IAS 17, *Leases*

IAS 12, *Income Taxes*

Appendix B — Abbreviations

Abbreviation	Description
AFS	available for sale
AICPA	American Institute of Certified Public Accountants
AOCI	accumulated other comprehensive income
APIC	additional paid-in capital
ASC	FASB Accounting Standards Codification
ASU	FASB Accounting Standards Update
AUP	agreed-upon procedures
BOLI	bank-owned life insurance
C&DI	SEC compliance and disclosure interpretation
CACM	consistently applied compensation measure
CECL	current expected credit loss
COLI	corporate-owned life insurance
DTA	deferred tax asset
DTL	deferred tax liability
EGC	emerging growth company
EITF	Emerging Issues Task Force
EPS	earnings per share
FASB	Financial Accounting Standards Board
FDIC	Federal Deposit Insurance Corporation
FHFA	Federal Housing Finance Agency
FINRA	Financial Industry Regulatory Authority
GAAP	generally accepted accounting principles

Abbreviation	Description
GP	general partner
HTM	held to maturity
IAS	International Accounting Standard
IASB	International Accounting Standards Board
ICFR	internal control over financial reporting
IFRS	International Financial Reporting Standard
IPO	initial public offering
LP	limited partner
NCUA	National Credit Union Administration
NMS	National Market System
NOL	net operating loss
OCA	SEC's Office of the Chief Accountant
OCC	Office of the Comptroller of the Currency (U.S. Department of the Treasury)
OCI	other comprehensive income
PCAOB	Public Company Accounting Oversight Board
PCC	Private Company Council
PCD asset	purchased financial assets with credit deterioration
ROU	right of use
SAB	SEC Staff Accounting Bulletin
SAC	subjective acceleration clause
SBS	security-based swap
SEC	Securities and Exchange Commission

Abbreviation	Description
SIFMA	Securities Industry and Financial Markets Association
SIPC	Securities Investor Protection Corporation
TRG	transition resource group
VIE	variable interest entity

The following is a list of short references for the Acts mentioned in this publication:

Abbreviation	Act
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act
Exchange Act	Securities Exchange Act of 1934
FAST Act	Fixing America's Surface Transportation Act
Hart-Scott-Rodino Act	Hart-Scott-Rodino Antitrust Improvements Act
Investment Advisers Act	Investment Advisers Act of 1940
JOBS Act	Jumpstart Our Business Startups Act
Securities Act	Securities Act of 1933

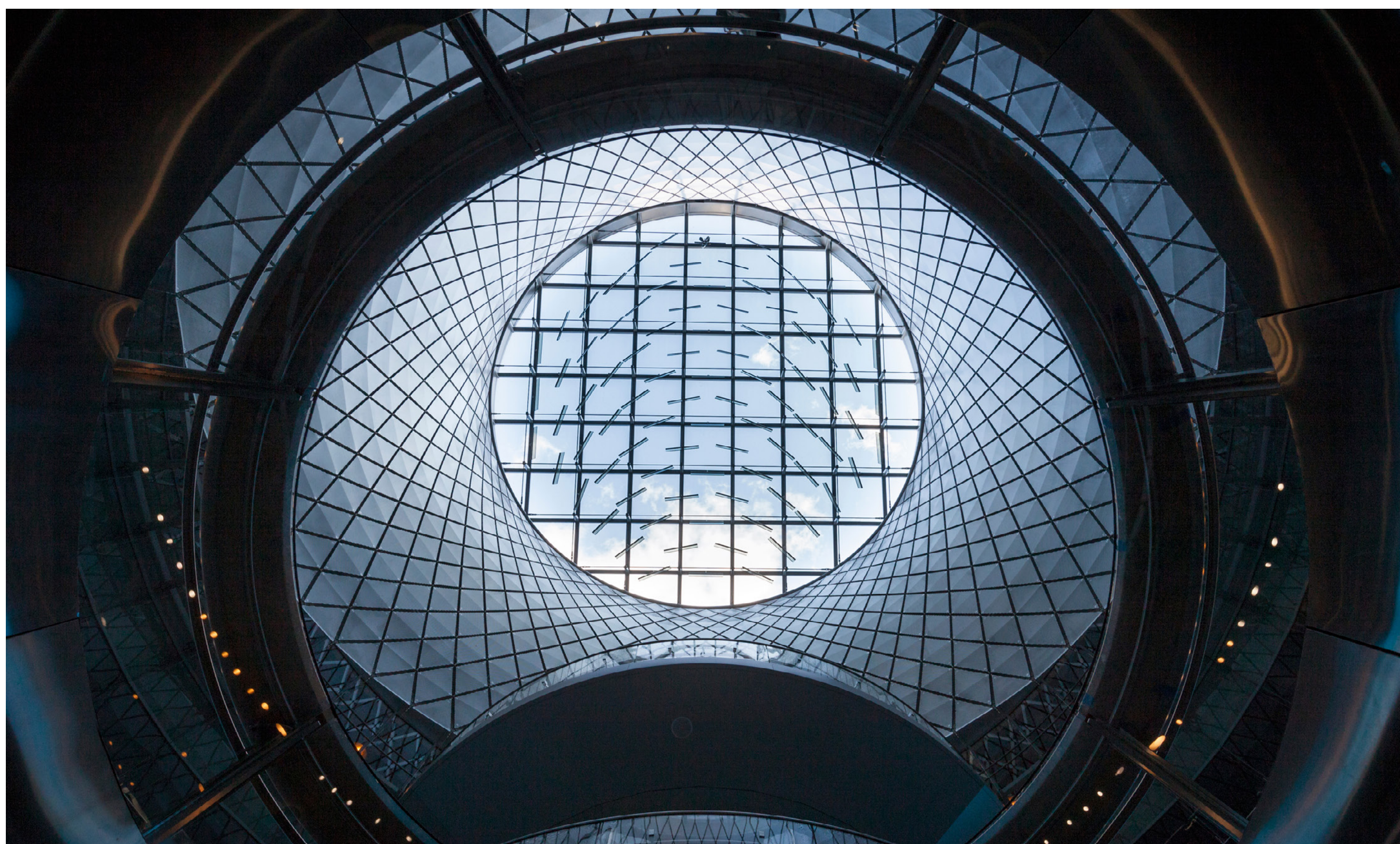
This publication contains general information only and Deloitte is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor.

Deloitte shall not be responsible for any loss sustained by any person who relies on this publication.

Copyright © 2016 Deloitte Development LLC. All rights reserved.

Deloitte.

Heads Up — June 17, 2016
Volume 23, Issue 18



In This Issue

- The CECL Model
- AFS Debt Securities
- PCD Assets
- Certain Beneficial Interests Within the Scope of ASC 325-40
- Loan Commitments
- Disclosures
- Effective Date and Transition
- Appendix A — Application of the CECL Model to PCD Assets
- Appendix B — Application of the CECL Model to Trade Receivables

Great Expectations

FASB Issues Final Standard on Accounting for Credit Losses

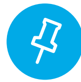
by Stephen McKinney and Jon Howard, Deloitte & Touche LLP

Yesterday, the FASB issued ASU 2016-13,[1] which amends the Board's guidance on the impairment of financial instruments. The ASU adds to U.S. GAAP an impairment model (known as the current expected credit loss (CECL) model)[2] that is based on expected losses rather than incurred losses. Under the new guidance, an entity recognizes as an allowance its estimate of expected credit losses, which the FASB believes will result in more timely recognition of such losses. The ASU is also intended to reduce the complexity of U.S. GAAP by decreasing the number of credit impairment models that entities use to account for debt instruments.

[1] FASB Accounting Standards Update No. 2016-13, *Measurement of Credit Losses on Financial Instruments*.

[2] Although the impairment project began as a joint FASB and IASB effort, constituent feedback on the boards' "dual-measurement" approach led the FASB to develop its own impairment model. The IASB, however, continued to develop the dual-measurement approach and issued final impairment guidance based on that model as part of its July 2014 amendments to IFRS 9. For more information about the IASB's impairment model, see Deloitte's August 8, 2014, *Heads Up*.

Once effective (see the Effective Date discussion below), the new guidance will significantly change the accounting for credit impairment. Banks and certain asset portfolios (e.g., loans, leases, debt securities) will need to modify their current processes for establishing an allowance for loan and lease losses and other-than-temporary impairments to ensure that they comply with the ASU's new requirements. To do so, they will need to make changes to their operations and systems associated with credit modeling, regulatory compliance, and technology.



Editor's Note

In late 2015, the FASB established a transition resource group (TRG) for credit losses. Like the TRG for the new revenue recognition standard, the credit losses TRG does not issue guidance but provides feedback to the FASB on potential implementation issues. By analyzing and discussing such issues, the TRG helps the Board determine whether it needs to take further action (e.g., by clarifying or issuing additional guidance). The credit losses TRG's first public meeting was April 1, 2016. For more information about that meeting and the credit losses TRG, see Deloitte's April 2016 *TRG Snapshot*.

This *Heads Up* discusses the ASU's changes to the guidance on credit impairment under current U.S. GAAP. The examples in Appendix A and Appendix B illustrate how an entity might apply the CECL model to purchased financial assets with credit deterioration ("PCD assets") and to trade receivables, respectively.

The CECL Model

Scope

The CECL model applies to most[3] debt instruments (other than those measured at fair value), trade receivables, lease receivables, reinsurance receivables that result from insurance transactions, financial guarantee contracts,[4] and loan commitments. However, available-for-sale (AFS) debt securities are excluded from the model's scope and will continue to be assessed for impairment under the guidance in ASC 320[5] (the FASB moved the impairment model for AFS debt securities from ASC 320 to ASC 326-30 and has made limited amendments to the impairment model for AFS debt securities, as discussed below).

***Dbriefs* Webcast Coming Soon!**

Join us on July 25 at 2 p.m. for a *Dbriefs* webcast on the new standard.

We'll discuss the new standard's requirements and scope, changes to the AFS debt security model, expected loss measurement methods, and much more!

Register for the webcast today!

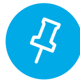
Recognition of Expected Credit Losses

Unlike the incurred loss models in existing U.S. GAAP, the CECL model does not specify a threshold for the recognition of an impairment allowance. Rather, an entity will recognize its estimate of expected credit losses for financial assets as of the end of the reporting period. Credit impairment will be recognized as an allowance — or contra-asset — rather than as a direct write-down of the amortized cost basis of a financial asset. However, the carrying amount of a financial asset that is deemed uncollectible will be written off in a manner consistent with existing U.S. GAAP.

[3] The following debt instruments would not be accounted for under the CECL model:
- Loans made to participants by defined contribution employee benefit plans.
- Policy loan receivables of an insurance entity.
- Pledge receivables (promises to give) of a not-for-profit entity.
- Loans and receivables between entities under common control.

[4] The CECL model does not apply to financial guarantee contracts that are accounted for as insurance or measured at fair value through net income.

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



Editor’s Note

Because the CECL model does not have a minimum threshold for recognition of impairment losses, entities will need to measure expected credit losses on assets that have a low risk of loss (e.g., investment-grade held-to-maturity (HTM) debt securities). However, the ASU states that “an entity is not required to measure expected credit losses on a financial asset . . . in which historical credit loss information adjusted for current conditions and reasonable and supportable forecasts results in an expectation that nonpayment of the [financial asset’s] amortized cost basis is zero.” U.S. Treasury securities and certain highly rated debt securities may be assets the FASB contemplated when it decided to allow an entity to recognize zero credit losses on an asset, but the ASU does not so indicate. Regardless, there are likely to be challenges associated with measuring expected credit losses on financial assets whose risk of loss is low.

Measurement of Expected Credit Losses

The ASU describes the impairment allowance as a “valuation account that is deducted from the amortized cost basis of the financial asset(s) to present the net carrying value at the amount expected to be collected on the financial asset.” An entity can use a number of measurement approaches to determine the impairment allowance. Some approaches project future principal and interest cash flows (i.e., a discounted cash flow method) while others project only future principal losses. Regardless of the measurement method used, an entity’s estimate of expected credit losses should reflect those losses occurring over the contractual life of the financial asset.

When determining the contractual life of a financial asset, an entity is required to consider expected prepayments either as a separate input in the determination or as an amount embedded in the credit loss experience that it uses to estimate expected credit losses. The entity is not allowed to consider expected extensions of the contractual life unless it reasonably expects to execute a troubled debt restructuring with the borrower by the reporting date.

An entity must consider all available relevant information when estimating expected credit losses, including details about past events, current conditions, and reasonable and supportable forecasts and their implications for expected credit losses. That is, while the entity is able to use historical charge-off rates as a starting point for determining expected credit losses, it has to evaluate how conditions that existed during the historical charge-off period may differ from its current expectations and accordingly revise its estimate of expected credit losses. However, the entity is not required to forecast conditions over the contractual life of the asset. Rather, for the period beyond the period for which the entity can make reasonable and supportable forecasts, the entity reverts to historical credit loss experience.

Editor’s Note

It will most likely be challenging for entities, particularly financial institutions, to measure expected credit losses. Further, one-time or recurring costs may be associated with the measurement, some of which may be related to system changes and data collection. While such costs will vary by institution, nearly all entities will incur some costs when using forward-looking information to estimate expected credit losses over the contractual life of an asset.

Unit of Account

The CECL model does not prescribe a unit of account (e.g., an individual asset or a group of financial assets) in the measurement of expected credit losses. However, an entity is required to evaluate financial assets within the scope of the model on a collective (i.e., pool) basis when assets share similar risk characteristics. If a financial asset's risk characteristics are not similar to the risk characteristics of any of the entity's other financial assets, the entity would evaluate the financial asset individually. If the financial asset is individually evaluated for expected credit losses, the entity would not be allowed to ignore available external information such as credit ratings and other credit loss statistics.

Editor's Note

The ASU requires an entity to collectively measure expected credit losses on financial assets that share similar risk characteristics (including HTM securities). While certain loans are pooled or evaluated collectively under current U.S. GAAP, entities may need to refine their data-capturing processes to comply with the new requirements.

Practical Expedients for Measuring Expected Credit Losses

The ASU permits entities to use practical expedients to measure expected credit losses for the following two types of financial assets:

- *Collateral-dependent financial assets*[6] — Consistently with its practice under existing U.S. GAAP, an entity is permitted to measure its estimate of expected credit losses for collateral-dependent financial assets as the difference between the financial asset's amortized cost and the collateral's fair value (adjusted for selling costs, when applicable).
- *Financial assets for which the borrower must continually adjust the amount of securing collateral (e.g., certain repurchase agreements and securities lending arrangements)* — An entity is permitted to measure its estimate of expected credit losses on these financial assets as the difference between the amortized cost basis of the asset and the collateral's fair value.

Write-Offs

Like current guidance, the ASU requires an entity to write off the carrying amount of a financial asset when the asset is deemed uncollectible. However, unlike current requirements, the ASU's write-off guidance also applies to AFS debt securities.

AFS Debt Securities

The CECL model does not apply to AFS debt securities. Instead, the FASB decided to make targeted improvements to the existing other-than-temporary impairment model in ASC 320 for certain AFS debt securities to eliminate the concept of "other than temporary" from that model.[7] Accordingly, the ASU states that an entity:

- Must use an allowance approach (vs. permanently writing down the security's cost basis).
- Must limit the allowance to the amount at which the security's fair value is less than its amortized cost basis.

[6] The ASU defines a "collateral-dependent financial asset" as a "financial asset for which the repayment is expected to be provided substantially through the operation or sale of the collateral when the borrower is experiencing financial difficulty based on the entity's assessment as of the reporting date." Under the definition in current U.S. GAAP, an entity is not required to assess the borrower's financial wherewithal when determining whether the financial asset is collateral-dependent.

[7] The amendments do not apply to an AFS debt security that an entity intends to sell or will more likely than not be required to sell before the recovery of its amortized cost basis. If an entity intends to sell or will more likely than not be required to sell a security before recovery of its amortized costs basis, the entity would write down the debt security's amortized cost to the debt security's fair value as required under existing U.S. GAAP.

- May not consider the length of time fair value has been less than amortized cost.
- May not consider recoveries in fair value after the balance sheet date when assessing whether a credit loss exists.

Editor's Note

The Board did not revise (1) step 1 of the existing other-than-temporary impairment model (i.e., an "investment is impaired if the fair value of the investment is less than its cost") or (2) the requirement under ASC 320 for an entity to recognize in net income the impairment amount only related to credit and to recognize in other comprehensive income (OCI) the noncredit impairment amount. However, the ASU does require an entity to use an allowance approach for certain AFS debt securities when recognizing credit losses (as opposed to a permanent write-down of the AFS security's cost basis). As a result, the entity would reverse credit losses through current-period earnings on an AFS debt security in both of the following circumstances:

- If the fair value of the debt security exceeds its amortized cost in a period after a credit loss had been recognized through earnings (because fair value was less than amortized cost), the entity would reverse the *entire* credit loss previously recognized and recognize a corresponding adjustment to its allowance for credit losses.
- If the fair value of the debt security does not exceed its amortized cost in a period after a credit loss had been recognized through earnings (because fair value was less than amortized cost) but the credit quality of the debt security improves in the current period, the entity would reverse the credit loss previously recognized only in an amount that would reflect the improved credit quality of the debt security.

PCD Assets

For PCD assets,[8] the ASU requires an entity's method for measuring expected credit losses to be consistent with its method for measuring expected credit losses for originated and purchased non-credit-deteriorated assets. Upon acquiring a PCD asset, the entity would recognize its allowance for expected credit losses as an adjustment that increases the cost basis of the asset (the "gross-up" approach). After initial recognition of the PCD asset and its related allowance, the entity would continue to apply the CECL model to the asset — that is, any changes in the entity's estimate of cash flows that it expects to collect (favorable or unfavorable) would be recognized immediately in the income statement. Interest income recognition would be based on the purchase price plus the initial allowance accreting to the contractual cash flows. See Appendix A for an example of how to apply the ASU's guidance to PCD assets.

[8] The ASU defines PCD assets as "[a]cquired individual financial assets (or acquired groups of financial assets with similar risk characteristics) that, as of the date of acquisition, have experienced a more-than-insignificant deterioration in credit quality since origination, as determined by an acquirer's assessment."

Editor's Note

Under current U.S. GAAP, an acquired asset is considered credit-impaired when it is probable that the investor would be unable to collect all contractual cash flows as a result of deterioration in the asset's credit quality since origination. Under the ASU, a PCD asset is an acquired asset that has experienced a more-than-insignificant deterioration in credit quality since origination. Consequently, entities will most likely need to use more judgment than they do under current guidance to determine whether an acquired asset has experienced significant credit deterioration.

Also, under the current accounting for purchased credit-impaired assets, an entity recognizes unfavorable changes in expected cash flows as an immediate credit impairment but treats favorable changes in expected cash flows that are in excess of the allowance as prospective yield adjustments. The CECL model's approach to PCD assets eliminates this asymmetrical treatment in cash flow changes. However, in a manner consistent with current practice, the CECL model precludes an entity from recognizing as interest income the discount embedded in the purchase price that is attributable to expected credit losses as of the date of acquisition.

Certain Beneficial Interests Within the Scope of ASC 325-40

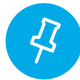
Under the ASU, entities should measure an impairment allowance for purchased or retained beneficial interests in the same manner as PCD assets if the beneficial interest meets the definition of a PCD asset or there is a significant difference between the contractual cash flows and expected cash flows of the beneficial interest. At initial recognition, a beneficial interest holder would therefore present an impairment allowance equal to the estimate of expected credit losses. In addition, the ASU requires entities to accrete changes in expected cash flows attributable to factors other than credit into interest income over the life of the asset.

Editor's Note

Under the CECL model, an entity would be required to determine the contractual cash flows of beneficial interests in securitized transactions. However, the beneficial interests in certain structures may not have contractual cash flows (e.g., when a beneficial interest holder receives only residual cash flows of a securitization structure). In these situations, the entity may need to use a proxy for the contractual cash flows of the beneficial interest (e.g., the gross contractual cash flows of the underlying debt instrument).

Loan Commitments

Off-balance-sheet arrangements such as commitments to extend credit, guarantees, and standby letters of credit that are not considered derivatives under ASC 815 are subject to credit risk and are therefore within the scope of the CECL model. Accordingly, the ASU requires an entity's method for determining the estimate of expected credit losses on the *funded* portion of a loan commitment to be similar to its method for determining the estimate for other loans. For an *unfunded* portion of a loan commitment, an entity must estimate expected credit losses over the full contractual period over which the entity is exposed to credit risk under an unconditional present legal obligation to extend credit. Such an estimate takes into account both the likelihood that funding will occur and the expected credit losses on commitments to be funded.



Editor's Note

An entity's estimate of expected credit losses on unfunded loan commitments (e.g., credit card receivables) will depend on (1) whether the entity has the unconditional ability to cancel the commitment to extend credit and, if so, (2) the time it takes for the cancellation to become effective. It is our understanding that if an entity has the unconditional ability to cancel the unfunded portion of a loan commitment, the entity would not be required to estimate expected credit losses on that portion, even if the entity has historically never exercised its cancellation right.

Disclosures

Many of the disclosures required under the ASU are similar to those already required under U.S. GAAP.[9] Accordingly, entities must disclose information about:

- Credit quality.[10]
- Allowances for expected credit losses.
- Their policies for determining write-offs.
- Past-due status.
- Nonaccrual status.
- PCD assets.
- Collateral-dependent financial assets.

In addition, other disclosures are required as follows:

- Public business entities that meet the U.S. GAAP definition of an SEC filer[11] must disclose credit quality indicators disaggregated by year of origination for a five-year period.
- Public business entities that do not meet the U.S. GAAP definition of an SEC filer must disclose credit quality indicators disaggregated by year of origination. However, upon adoption of the ASU, they would only be required disclose such information for the previous three years, and would add another year of information until they have provided disclosures for the previous five years.
- Other entities are not required to disclose credit quality indicators disaggregated by year of origination.

Effective Date and Transition

Effective Date

For public business entities that meet the U.S. GAAP definition of an SEC filer, the ASU is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years.

For public business entities that do not meet the U.S. GAAP definition of an SEC filer, the ASU is effective for fiscal years beginning after December 15, 2020, including interim periods within those fiscal years.

[9] See the disclosure requirements as a result of FASB Accounting Standards Update No. 2010-20, *Disclosures About the Credit Quality of Financing Receivables and the Allowance for Credit Losses*.

[10] Short-term trade receivables resulting from revenue transactions within the scope of ASC 605 and ASC 606 are excluded from these disclosure requirements.

[11] Under U.S. GAAP, an SEC filer is defined as follows:

> An entity that is required to file or furnish its financial statements with either of the following:
>
> a. The Securities and Exchange Commission (SEC)
>
> b. With respect to an entity subject to Section 12(i) of the Securities Exchange Act of 1934, as amended, the appropriate agency under that Section.
>
> Financial statements for other entities that are not otherwise SEC filers whose financial statements are included in a submission by another SEC filer are not included within this definition.

For all other entities, the ASU is effective for fiscal years beginning after December 15, 2020, and interim periods within those fiscal years beginning after December 15, 2021.

In addition, entities are permitted to early adopt the new guidance for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

Transition Approach

For most debt instruments, entities must record a cumulative-effect adjustment to the statement of financial position as of the beginning of the first reporting period in which the guidance is effective (modified retrospective approach). However, the ASU provides the following instrument-specific transition guidance:

- *Other-than-temporarily impaired debt securities* — An entity is required to apply (1) the CECL model prospectively to HTM debt securities and (2) the changes to the impairment model for AFS debt securities prospectively. As a result, previous write-downs of a debt security's amortized cost basis would not be reversed; rather, only changes in the estimate of expected cash flows of the debt security occurring on or after the ASU's effective date would be reflected as an allowance for credit losses. Upon adoption of the new guidance, any impairment previously recognized in OCI would be accounted for as a prospective adjustment to the accretable yield of the debt instrument.
- *PCD assets* — An entity is required to apply the changes to PCD assets prospectively. That is, the change in the definition of a PCD asset applies only to assets acquired on or after the ASU's effective date. For debt instruments accounted for under ASC 310-30, an entity would apply the gross-up approach as of the transition date (i.e., establish an allowance for expected credit losses with a corresponding adjustment to the debt instrument's cost basis).

  In addition, an entity would immediately recognize any postadoption changes to its estimate of cash flows that it expects to collect (favorable or unfavorable) in the income statement as impairment expense (or reduction of expense). Accordingly, the yield on a PCD asset as of the date of adoption would be "locked" and would not be affected by subsequent changes in the entity's estimate of expected credit losses.
- *Certain beneficial interests within the scope of ASC 325-40* — Entities holding such interests need to comply with the same transition requirements as those that apply to PCD assets.

Transition Disclosures

An entity must disclose the following upon its adoption of the new guidance:

- "The nature of the change in accounting principle, including an explanation of the newly adopted accounting principle."
- "The method of applying the change."
- "The effect of the adoption on any line item in the statement of financial position, if material, as of the beginning of the first period for which the pending content that links to this paragraph is effective. Presentation of the effect on financial statement subtotals is not required."
- "The cumulative effect of the change on retained earnings or other components of equity in the statement of financial position as of the beginning of the first period for which the pending content that links to this paragraph is effective."

In addition, "an entity that issues interim financial statements shall provide the [above disclosures] in each interim financial statement of the year of change and the annual financial statement of the period of the change."

Appendix A — Application of the CECL Model to PCD Assets

The example below, which is reproduced from ASC 326-20-55-63 through 55-65 (Example 12), illustrates the application of the ASU's guidance to PCD assets.[12]

> Bank O records purchased financial assets with credit deterioration in its existing systems by recognizing the amortized cost basis of the asset, at acquisition, as equal to the sum of the purchase price and the associated allowance for credit loss at the date of acquisition. The difference between amortized cost basis and the par amount of the debt is recognized as a noncredit discount or premium. By doing so, the credit-related discount is not accreted to interest income after the acquisition date.
>
> Assume that Bank O pays $750,000 for a financial asset with a par amount of $1 million. The instrument is measured at amortized cost basis. At the time of purchase, the allowance for credit losses on the unpaid principal balance is estimated to be $175,000. At the purchase date, the statement of financial position would reflect an amortized cost basis for the financial asset of $925,000 (that is, the amount paid plus the allowance for credit loss) and an associated allowance for credit losses of $175,000. The difference between par of $1 million and the amortized cost of $925,000 is a non-credit related discount. The acquisition-date journal entry is as follows:

Loan — par amount	$ 1,000,000	
Loan — noncredit discount		$ 75,000
Allowance for credit losses		175,000
Cash		750,000

> Subsequently, the $75,000 noncredit discount would be accreted into interest income over the life of the financial asset . . . . The $175,000 allowance for credit losses should be updated in subsequent periods . . . , with changes in the allowance for credit losses on the unpaid principal balance reported immediately in the statement of financial performance as a credit loss expense.

[12] ASC paragraph numbers have been omitted.

Appendix B — Application of the CECL Model to Trade Receivables

The CECL model applies to trade receivables that result from revenue transactions within the scope of ASC 605 (or ASC 606, if adopted). The example below, which is reproduced from ASC 326-20-55-38 through 55-40 (Example 5), illustrates how an entity would apply the proposed guidance to trade receivables by using a provision matrix.[13]

Entity E manufactures and sells products to a broad range of customers, primarily retail stores. Customers typically are provided with payment terms of 90 days with a 2 percent discount if payments are received within 60 days. Entity E has tracked historical loss information for its trade receivables and compiled the following historical credit loss percentages:

a. 0.3 percent for receivables that are current

b. 8 percent for receivables that are 1–30 days past due

c. 26 percent for receivables that are 31–60 days past due

d. 58 percent for receivables that are 61–90 days past due

e. 82 percent for receivables that are more than 90 days past due.

Entity E believes that this historical loss information is a reasonable base on which to determine expected credit losses for trade receivables held at the reporting date because the composition of the trade receivables at the reporting date is consistent with that used in developing the historical credit-loss percentages (that is, the similar risk characteristics of its customers and its lending practices have not changed significantly over time). However, Entity E has determined that the current and reasonable and supportable forecasted economic conditions have improved as compared with the economic conditions included in the historical information. Specifically, Entity E has observed that unemployment has decreased as of the current reporting date, and Entity E expects there will be an additional decrease in unemployment over the next year. To adjust the historical loss rates to reflect the effects of those differences in current conditions and forecasted changes, Entity E estimates the loss rate to decrease by approximately 10 percent in each age bucket. Entity E developed this estimate based on its knowledge of past experience for which there were similar improvements in the economy.

At the reporting date, Entity E develops the following aging schedule to estimate expected credit losses.

Past-Due Status	Amortized Cost Basis	Credit Loss Rate	Expected Credit Loss Estimate
Current	$ 5,984,698	0.27%	$ 16,159
1–30 days past due	8,272	7.2%	596
31–60 days past due	2,882	23.4%	674
61–90 days past due	842	52.2%	440
More than 90 days past due	1,100	73.8%	812
	$ 5,997,794		$ 18,681

Editor’s Note

The ASU’s example highlights that an entity’s application of the CECL model to trade receivables through the use of a provision matrix may not differ significantly from the entity’s current methods for determining the allowance for doubtful accounts. However, the example illustrates that when an entity uses a provision matrix to estimate credit losses on trade receivables, it would be required to do the following when moving to an expected loss model:

- Under the CECL model, the entity would be required to consider whether expected credit losses should be recognized for trade receivables that are considered “current” (i.e., not past due). In the example above, a historical loss rate of 0.3 percent is applied to the trade receivables that are classified as current.
- When using historical loss rates in a provision matrix, the entity would be required to consider whether and, if so, how the historical loss rates differ from what is currently expected over the life of the trade receivables (on the basis of current conditions and reasonable and supportable forecasts about the future).

[13] ASC paragraph numbers have been omitted.

Subscriptions

If you wish to receive *Heads Up* and other accounting publications issued by Deloitte's Accounting Services Department, please register at www.deloitte.com/us/accounting/subscriptions.

Dbriefs for Financial Executives

We invite you to participate in *Dbriefs*, Deloitte's webcast series that delivers practical strategies you need to stay on top of important issues. Gain access to valuable ideas and critical information from webcasts in the "Financial Executives" series on the following topics:

- Business strategy and tax.
- Driving enterprise value.
- Financial reporting.
- Financial reporting for taxes.
- Governance, risk, and compliance.
- Technology.
- Transactions and business events.

Dbriefs also provides a convenient and flexible way to earn CPE credit — right at your desk. Subscribe to *Dbriefs* to receive notifications about future webcasts at www.deloitte.com/us/dbriefs.

Technical Library and US GAAP Plus

Deloitte makes available, on a subscription basis, access to its online library of accounting and financial disclosure literature. Called Technical Library: The Deloitte Accounting Research Tool, the library includes material from the FASB, EITF, AICPA, PCAOB, IASB, and SEC, in addition to Deloitte's own accounting and SEC manuals and other interpretive accounting and SEC guidance.

Updated every business day, Technical Library has an intuitive design and navigation system that, together with its powerful search features, enable users to quickly locate information anytime, from any computer. Technical Library subscribers also receive *Technically Speaking*, the weekly publication that highlights recent additions to the library. For more information, including subscription details and an online demonstration, visit www.deloitte.com/us/techlibrary.

In addition, be sure to visit US GAAP Plus, our free Web site that features accounting news, information, and publications with a U.S. GAAP focus. It contains articles on FASB activities and updates to the *FASB Accounting Standards Codification*™ as well as developments of other U.S. and international standard setters and regulators, such as the PCAOB, AICPA, SEC, IASB, and IFRS Interpretations Committee. Check it out today!

Heads Up is prepared by the National Office Accounting Services Department of Deloitte as developments warrant. This publication contains general information only and Deloitte is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor.

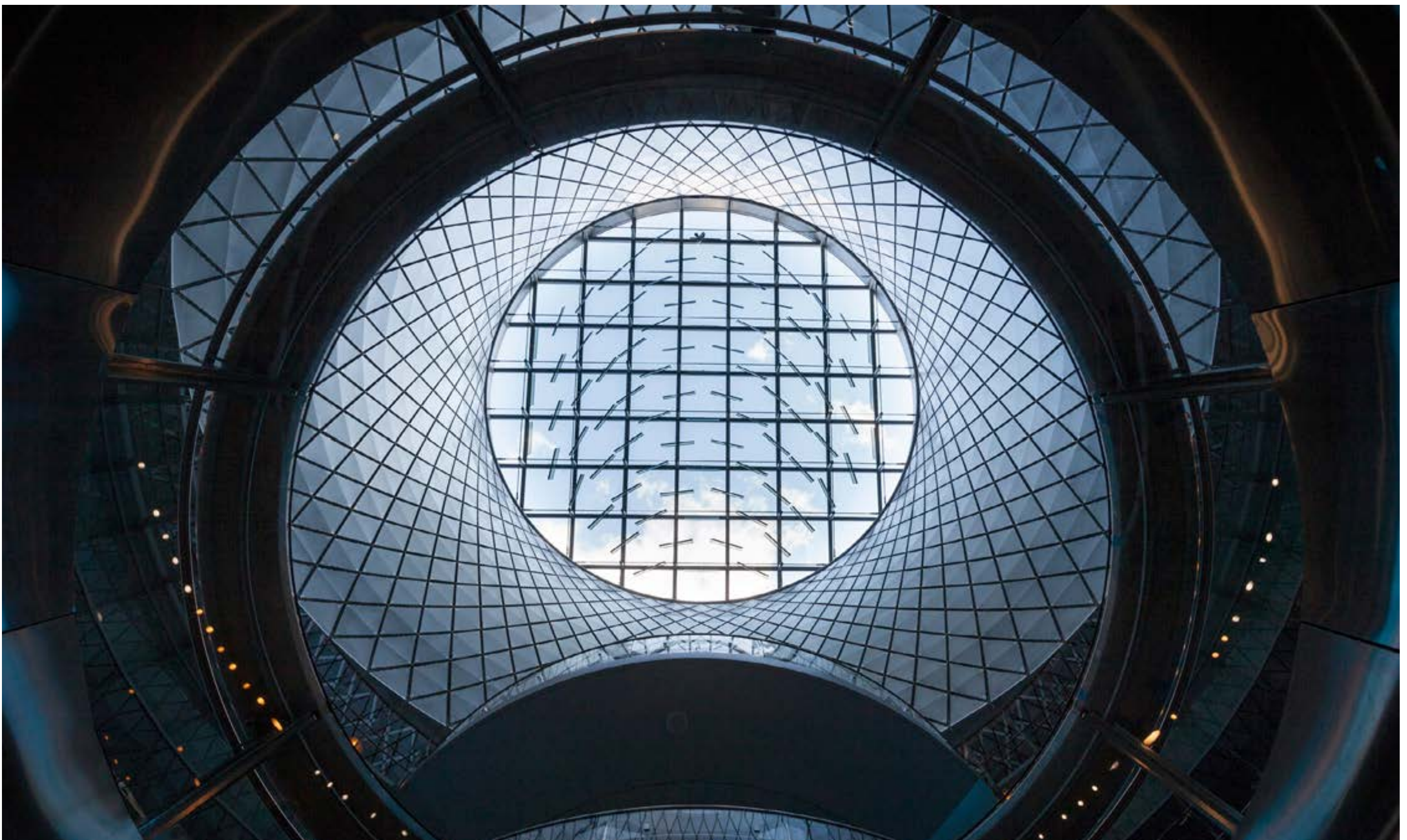
Deloitte shall not be responsible for any loss sustained by any person who relies on this publication.

As used in this document, "Deloitte" means Deloitte & Touche LLP, a subsidiary of Deloitte LLP. Please see www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries. Certain services may not be available to attest clients under the rules and regulations of public accounting.

Copyright © 2016 Deloitte Development LLC. All rights reserved.
Member of Deloitte Touche Tohmatsu Limited.

Deloitte.

Heads Up | September 14, 2016
Volume 23, Issue 25



In This Issue

- Introduction
- Key Proposed Changes to the Hedge Accounting Model
- Transition and Adoption
- Comparison With IFRSs
- Appendix A — Questions for Respondents
- Appendix B — Comparison of Hedge Accounting Models

FASB Proposes Targeted Improvements to Hedge Accounting

Relief Is Coming

by Mark Bolton and Ermir Berberi, Deloitte & Touche LLP

Introduction

On September 8, 2016, the FASB issued a proposed ASU[1] that would amend the hedge accounting recognition and presentation requirements of ASC 815[2] to (1) reduce their complexity and simplify their application by preparers and (2) improve the transparency and understandability of information conveyed to financial statement users about an entity's risk management activities by better aligning those activities with the entity's financial reporting for hedging relationships.

Although the changes proposed by the FASB are significant, constituents also should take note of those aspects of existing hedge accounting that the Board decided to retain. The proposal still would require all hedging relationships to be highly effective. Moreover, an entity

[1] FASB Proposed Accounting Standards Update, *Targeted Improvements to Accounting for Hedging Activities*.

[2] FASB Accounting Standards Codification Topic 815, *Derivatives and Hedging*.

would retain the ability to voluntarily dedesignate a hedging relationship, designate certain component risks of the hedged item as the hedged risk, and apply the critical-terms-match method or the shortcut method.

The FASB will determine the effective date of the proposed amendments after it considers constituent feedback; however, it has tentatively determined that earlier application of the proposed amendments will be permitted at the beginning of any fiscal year before the effective date.

Comments on the proposed ASU are due by November 22, 2016. The Board also will sponsor public roundtable meetings (tentatively scheduled for December 2, 2016) to discuss the proposed amendments. Participants in the roundtable sessions will need to submit their comments by November 4, 2016.

This *Heads Up* summarizes the proposed ASU's key provisions. The appendixes of this *Heads Up* contain (1) the proposal's questions for respondents, which have been reproduced for ease of reference, and (2) a high-level comparison of the proposed hedging model to existing U.S. GAAP and the IASB's standard on hedging, IFRS 9.[3]

Key Proposed Changes to the Hedge Accounting Model

Elimination of the Concept of Separately Recognizing Periodic Hedge Ineffectiveness

The proposed amendments would eliminate the concept of separately recognizing periodic hedge ineffectiveness (although under the mechanics of fair value hedging, economic ineffectiveness would still be reflected in current earnings for those hedges). The Board's rationale for this decision is that the entire change in the fair value of the hedging instrument represents a cost of hedging; accordingly, presenting that whole change in the same income statement line as the earnings effect of the hedged item provides "a more faithful representation of an entity's risk management activities." Under this rationale, even a portion of the change in a hedging instrument's fair value that is excluded from a hedging relationship's effectiveness assessment is considered a cost of hedging that should be recognized in the same income statement line as the earnings effect of the hedged item (other than amounts excluded from the assessment of effectiveness of net investment hedges). Furthermore, this rationale extends to "missed forecasts" as well. Thus, an entity that ultimately determines that it is probable that a hedged forecasted transaction will not occur would record the amounts reclassified out of accumulated other comprehensive income (AOCI) for that hedging relationship into earnings in the same income statement line that would have been affected by the forecasted transaction.

Editor's Note

The Board acknowledges that, unlike the existing hedge accounting model, its proposed model will defer the timing of recognition of any economic ineffectiveness arising from cash flow or net investment overhedges (and eliminate recognition of ineffectiveness arising from net investment underhedges); however, it believes that the new model will benefit constituents by (1) reducing the costs of administering a hedging program and (2) allowing users to more clearly identify how an entity's hedging program has affected its financial statements, thereby resulting in more decision-useful information.

[3] IFRS 9, *Financial Instruments*, also allows entities to elect to continue to follow the hedge accounting provisions of IAS 39, *Financial Instruments: Recognition and Measurement*.

Recognition and Presentation of Changes in the Fair Value of Hedging Instruments

The following table summarizes key aspects of the amended hedge accounting and presentation model described in the proposal:

Fair Value Hedges	Cash Flow Hedges	Net Investment Hedges
• The entire change in the fair value of the hedging instrument would be recorded in the same income statement line as the earnings effect of the hedged item.[4] • The entire change in fair value of the hedged item attributable to the hedged risk would be recorded in income/loss and as an adjustment to the carrying amount of the hedged item.	• The entire change in the fair value of the hedging instrument used to assess hedge effectiveness would be recorded in other comprehensive income (OCI). • When the hedged item affects earnings, amounts would be reclassified out of AOCI and presented in the same income statement line in which the earnings effect of the hedged item is presented.[5] • The portion (if any) of the hedging instrument's change in fair value that is excluded from the hedge effectiveness assessment would be recognized immediately in the same income statement line in which the earnings effect of the hedged item is presented.	• The entire change in the fair value of the hedging instrument used to assess hedge effectiveness would be recorded in the cumulative translation adjustment (CTA) in OCI. • When the hedged net investment affects earnings (i.e., upon a sale or liquidation), amounts would be reclassified out of CTA and be presented in the same income statement line in which the earnings effect of the net investment is presented.[6] • The portion (if any) of the hedging instrument's change in fair value that is excluded from the hedge effectiveness assessment would be recognized immediately in income (although the income statement presentation would not be prescribed).

Hedge Effectiveness Assessments and Documentation Requirements

Quantitative Versus Qualitative Assessments of Hedge Effectiveness

The proposal would require an entity to perform an initial prospective quantitative hedge effectiveness assessment (by using either a dollar-offset test or a statistical method such as regression) unless the hedging relationship qualifies for application of one of the expedients that permits an assumption of perfect hedge effectiveness (e.g., the shortcut or critical-terms-match methods).

An entity would be permitted to perform the initial prospective quantitative hedge effectiveness assessment after hedge designation by using information available at hedge inception; however, the entity would have to complete that assessment by the earlier of:

- "The first quarterly hedge effectiveness assessment date."
- "The date that financial statements that include the hedged transaction are available to be issued."
- "The date that [any required hedging criterion] no longer is met."
- "The date of expiration, sale, termination, or exercise of the hedging instrument."

[4] When a hedging relationship involves multiple hedged items or risks that affect more than one income statement line, the entity would be required to allocate the total change in the hedging instrument's fair value to the appropriate income statement lines.
[5] See footnote 4.
[6] See footnote 4.

- “The date of dedesignation of the hedging relationship.”
- “For a cash flow hedge of a forecasted transaction . . . the date that the forecasted transaction occurs.”

If (1) an entity’s initial prospective quantitative hedge effectiveness assessment of a hedging relationship demonstrates there is a highly effective offset, and (2) the entity can, at hedge inception, “reasonably support an expectation of high effectiveness on a qualitative basis in subsequent periods,” the entity may elect to perform subsequent retrospective and prospective effectiveness assessments qualitatively. To do so, in the hedge documentation it prepares at hedge inception, it must (1) specify how it will perform the qualitative assessments and (2) document the alternative quantitative assessment method that it would use if it later concludes, on the basis of a change in the hedging relationship’s facts and circumstances, that subsequent quantitative assessments will be necessary.

Editor’s Note

The proposal notes that an entity’s determination of whether it can reasonably support an expectation of high effectiveness will require the use of judgment and that the entity should consider (1) the results of the initial prospective quantitative hedge effectiveness assessment, (2) the extent to which the critical terms of the hedging instrument and the hedged item are aligned, and (3) the degree and consistency of correlation between changes in the underlyings of the hedging instrument and the hedged item.

The proposal also states that “[a]n entity must document that it will perform the same quantitative assessment method for both initial and subsequent prospective hedge effectiveness assessments.” Moreover, the proposal indicates that an entity that elects to perform subsequent qualitative effectiveness assessments should do so for all similar hedging relationships.

The proposal states that after an entity makes its initial election, “whenever financial statements or earnings are reported and at least every three months, [it must] verify and document that the facts and circumstances related to the hedging relationship have not changed to an extent that it no longer can assert qualitatively that the hedging relationship was and continues to be highly effective.” Indicators that may (individually or in the aggregate) allow an entity to continue to assert qualitatively that a hedging relationship continues to be highly effective include:

- “The factors that were assessed at the inception of the hedging relationship that enabled the entity to reasonably support an expectation of high effectiveness on a qualitative basis have not changed to an extent that the entity no longer can assert qualitatively that the hedging relationship was and continues to be highly effective.”
- “There have been no adverse developments regarding the risk of counterparty default.”
- “In a cash flow hedge of a variable-rate financial instrument with an interest rate cap or interest rate floor in which effectiveness is assessed in accordance with paragraph 815-20-25-100, the variable rate does not approach or move above or below the rate associated with the cap or floor.”
- “In a cash flow hedge of the variability in cash flows attributable to changes in a contractually specified component in a forecasted purchase or sale of a nonfinancial asset with a cap or floor in which effectiveness is assessed in accordance with

paragraph 815-20-25-100, the price associated with the contractually specified component does not approach or move above or below the price associated with the cap or floor."

Editor's Note

An entity that initially elects to perform subsequent qualitative effectiveness assessments but later determines that the hedging relationship's facts and circumstances have changed to the extent that qualitative assessments are no longer sufficient, would be required to quantitatively assess effectiveness at the time of the change and for the duration of the hedging relationship. The entity would not be able to revert to making qualitative effectiveness assessments at any time after such a change.

Amendments to Benchmark Interest Rates and the Definition of Interest Rate Risk

The proposed amendments would redefine the term "interest rate risk" as follows to describe hedgeable risks:

- "For recognized variable-rate financial instruments and forecasted issuances or purchases of variable rate financial instruments, interest rate risk is the risk of changes in the hedged item's cash flows attributable to changes in the contractually specified interest rate in the agreement."
- "For recognized fixed-rate financial instruments, interest rate risk is the risk of changes in the hedged item's fair value attributable to changes in the designated benchmark interest rate. For forecasted issuances or purchases of fixed-rate financial instruments, interest rate risk is the risk of changes in the hedged item's cash flows attributable to changes in the designated benchmark interest rate."

Thus, the benchmark interest rate concept would be eliminated for variable-rate financial instruments under the proposed amendments but retained for fixed-rate financial instruments.

As indicated in the definition of interest rate risk, in cash flow hedges of interest rate risk associated with forecasted issuances or purchases of debt, the nature of the hedgeable risk will depend on the characteristics of the forecasted transaction. An entity that knows it will issue or purchase fixed-rate debt would hedge the variability in cash flows associated with changes in the benchmark interest rate; for a forecasted issuance or purchase of variable-rate debt, the entity would hedge the variability in cash flows associated with changes in the contractually specified rate. If the entity is unsure about the nature of its forecasted transaction, it would designate as the hedged risk the variability in cash flows attributable to a change in a rate that would qualify both as a benchmark interest rate (if the forecasted transaction ultimately was fixed rate) and as a contractually specified rate (if the forecasted transaction ultimately was variable rate).

Under the proposal, the Securities Industry and Financial Markets Association Municipal Swap Index (SIFMA) swap rate would also be added to those benchmark interest rates already permitted in the United States under U.S. GAAP[7] to make it easier for entities to hedge interest rate risk for fixed-rate tax-exempt financial instruments.

[7] The other benchmark interest rates for the United States specified in ASC 815-20-25-6A are (1) interest rates on direct Treasury obligations of the U.S. government, (2) the London Interbank Offered Rate (LIBOR) swap rate, and (3) the Fed Funds Effective Swap Rate (also referred to as the Overnight Index Swap Rate).

Shortcut Method and Critical-Terms-Match Method

The proposal retains both the shortcut and critical-terms-match methods and provides additional relief for entities applying those methods. As a response to concerns about the number of restatements that have resulted from attempted application of the shortcut method, the proposal would amend the shortcut accounting requirements to allow an entity to specify, at the inception of the hedging relationship, the quantitative (long-haul) method it will use to assess hedge effectiveness and measure hedge results if it later determines that application of the shortcut method was not or no longer is appropriate. Before being able to use this alternative quantitative method (and avoid having to dedesignate the original hedging relationship), the entity would have to have demonstrated that:

> a. [It] documented at hedge inception . . . which quantitative method it would use to assess hedge effectiveness and measure hedge results if the shortcut method was not or no longer is appropriate during the life of the hedging relationship[; and]
>
> b. The hedging relationship was highly effective on a prospective and retrospective basis in achieving offsetting changes in fair value or cash flows attributable to the hedged risk for the periods in which the shortcut method criteria were not met.[8]

If criterion (a) is not satisfied, the hedging relationship would be invalid in the period in which the shortcut method criteria were not satisfied and all subsequent periods; otherwise (if criterion (a) is met), the hedging relationship would be invalid in all periods in which criterion (b) was not satisfied.

Editor's Note

Even if an entity can continue the hedging relationship by using a quantitative effectiveness assessment and measurement method because both criteria are met, the entity still must apply the ASC 250[9] error correction guidance "to the difference, if any, between the results recorded from applying the shortcut method and the quantitative method documented [at hedge inception]." Doing so ensures that any material differences would still be treated as errors in the financial statements, although presumably the size of the error would not be significant if the hedging relationship was highly effective. If either criterion is not met, an entity must apply the error correction guidance to the difference between the results recognized through application of the shortcut method and the results of not applying hedge accounting. These types of errors are more likely to be material, although that ultimate determination will depend on the specific characteristics of the hedging relationship.

In addition, the proposal amends certain shortcut-method criteria to allow partial-term fair value hedges to qualify for the shortcut method.

The proposal also expedites an entity's ability to apply the critical-terms-match method to cash flow hedges of groups of forecasted transactions. If all other critical-terms-match criteria are satisfied, such hedges will qualify for the critical-terms-match method if all the forecasted transactions occur within 31 days of the hedging derivative's maturity.

Fair Value Hedges of Interest Rate Risk

Measurement of Changes in the Hedged Item's Fair Value

Under the proposal, for a fair value hedge of interest rate risk, an entity may choose to use either (1) total contractual coupon cash flows or (2) the benchmark rate component of those

[8] To make this effectiveness assessment, an entity should use the terms of the hedging instrument and hedged item that existed at the date the hedging relationship no longer met the shortcut method criteria. In cash flow hedges that use a hypothetical derivative as a proxy for the hedged item, the hypothetical derivative would be set to a value of zero as of hedge inception.

[9] FASB Accounting Standards Codification Topic 250, *Accounting Changes and Error Corrections*.

contractual coupon cash flows to calculate the change in the hedged item's fair value that is attributable to changes in the benchmark interest rate. However, if the current market yield of the hedged item is less than the benchmark interest rate at hedge inception (i.e., a "sub-benchmark" hedge), the entity would be required to use the total contractual coupon cash flows for its calculation.

Measuring the Fair Value of a Prepayable Instrument

For prepayable instruments such as callable debt, an entity would continue to consider the changes in the embedded prepayment option's fair value when determining the change in the fair value of the hedged instrument in a fair value hedge of interest rate risk. However, under the proposal, "the factors incorporated for the purpose of adjusting the carrying amount of the hedged item shall be the same factors that the entity incorporated for the purpose of assessing hedge effectiveness."

Therefore, when, for example, an entity (1) assessed hedge effectiveness in a fair value hedge of interest rate risk of callable debt and (2) measured the change in the fair value of callable debt attributable to changes in the benchmark interest rate, it could consider only how changes in the benchmark interest rate (and not changes in credit risk or other factors) would affect the obligor's decision to call the debt.

Partial-Term Hedges of Interest Rate Risk

The proposal also provides relief to entities that wish to enter into fair value hedges of interest rate risk for only a portion of the term of a financial instrument, which is typically unachievable under current U.S. GAAP. Under the proposed guidance, such partial-term hedges would be permissible, and an entity would measure the change in the fair value of the hedged item attributable to changes in the benchmark interest rate "using an assumed term that begins with the first hedged cash flow and ends with the last hedged cash flow." Also, the hedged item's assumed maturity would be the date on which the last hedged cash flow is due and payable.

Ability to Designate Components of Nonfinancial Assets as Hedged Items

The proposed guidance permits an entity to hedge the "risk of variability in cash flows attributable to changes in a contractually specified component"[10] in a cash flow hedge of a forecasted purchase or sale of a nonfinancial asset if the hedge meets the following criteria:

- "The purchase or sale contract for the nonfinancial asset creates an exposure related to the variability in cash flows attributable to changes in the contractually specified component throughout the life of the hedging relationship."
- "The stated components of the price of the nonfinancial contract all relate to the cost of purchasing or selling the nonfinancial asset in the normal course of business in a particular market."
- "All of the stated components of the price of the nonfinancial contract reflect market conditions at contract inception."

[10] A proposed amendment to the ASC master glossary defines a contractually specified component as "An index or price explicitly referenced in an agreement to purchase or sell a nonfinancial asset other than an index or price calculated or measured solely by reference to an entity's own operations."

Furthermore, an entity would be permitted to designate a hedge of a contractually specified component for a period that extends beyond the contractual term or when a contract does not yet exist to sell or purchase the nonfinancial asset if the criteria specified above will be met in a future contract and all the other cash flow hedging requirements are met.

Also, the proposal notes that an entity's ability to make a hedge designation would not be precluded if the variability in a hedged item's cash flows that is attributable to changes in the contractually specified component is limited by a cap or floor in the contract; however, the entity would need to consider such features in its assessment of hedge effectiveness.

Editor's Note

The Board believes that enabling entities to component hedge better reflects risk management activities in those entities' financial reporting. This decision also creates greater symmetry in the hedging models for financial and nonfinancial items because it will allow component hedging for both types of items.

Disclosure Requirements

The proposed ASU would add new disclosure requirements and amend existing ones. Also, to align the disclosure requirements with the proposed changes to the hedge accounting model, the proposal would remove the requirement for entities to disclose amounts of hedge ineffectiveness. In addition, entities would be required to provide:

- Tabular disclosure of (1) the total amounts reported in the statement of financial performance for each income and expense line item that is affected by hedging and (2) the effects of hedging on those line items.
- Disclosures about the carrying amounts and cumulative basis adjustments of items designated and qualifying as hedged items in fair value hedges.
- Qualitative disclosures describing (1) quantitative hedging goals, if any, established by an entity when developing its hedging objectives and strategies and (2) whether those goals were met.

These disclosures would be required for every annual and interim reporting period for which a statement of financial position and statement of financial performance are presented.

Transition and Adoption

Transition Method

Entities would adopt the proposal's provisions by applying a modified retrospective approach to existing hedging relationships[11] as of the adoption date. Under this approach, entities with cash flow or net investment hedges would record the cumulative effect of applying the new guidance related to recognition of hedging instruments in AOCI, with an offsetting adjustment to the opening balance of retained earnings as of the most recent period presented on the date of adoption. Furthermore, "the adjusted [AOCI] balance associated with the hedging relationship shall reflect the cumulative change in fair value of the hedging instrument since inception of the hedging relationship less any amounts" that would have been recognized in earnings.

After adoption, in all interim and annual periods, entities would begin to apply the new accounting and presentation model and provide the new and amended disclosures.

[11] Refers to hedging relationships in which "the hedging instrument has not expired, been sold, terminated, or exercised" and that have not been dedesignated by the entity as of the date of adoption.

In each annual and interim reporting period in the fiscal year of adoption, entities would also be required to provide certain disclosures required by ASC 250 about (1) the nature and reason for the change in accounting principle and (2) the cumulative effect of the change on the components of equity or net assets as of the date of adoption.

Transition Considerations for Fair Value Hedges of Interest Rate Risk

For fair value hedges of interest rate risk existing at the date of adoption, if an entity elects to apply the revised measurement methods related to (1) using the benchmark rate component of contractual coupon cash flows to measure changes in the hedged item's fair value attributable to changes in the benchmark interest rate or (2) hedging prepayable instruments, it would be required to consider that application as a dedesignation and redesignation of those hedging relationships. The entity would incorporate the cumulative basis adjustment of the hedged item from each dedesignated hedging relationship into the new hedging relationship. The entity would then adjust that amount to the amount that would have been recorded as of the adoption date had the entity applied the revised method in all periods for which the dedesignated hedging relationship was outstanding. The entity would make an offsetting adjustment to the opening balance of retained earnings as of the adoption date.

An entity that changes a tax-exempt financial instrument's hedged risk to the SIFMA benchmark interest rate would also have to essentially dedesignate and redesignate the hedging relationship. The entity would amortize the cumulative basis adjustment of the hedged item from the dedesignated hedge to earnings over the remaining life of the hedged item "on a level yield basis."

One-Time Transition Elections

Under the proposal, an entity can make the following one-time elections upon adoption:

- *For existing hedging relationships* — To amend hedge documentation to specify that subsequent prospective and retrospective effectiveness assessments will be performed qualitatively, without dedesignating the hedging relationship.
- *For existing shortcut-method hedging relationships* — To amend hedge documentation to specify how the entity will quantitatively assess hedge effectiveness and measure hedge results if it determines at a later date that use of the shortcut method was not or no longer is appropriate.
- *For existing cash flow hedging relationships that qualify for designation of (1) the variability in cash flows attributable to changes in a contractually specified component of the price for the purchase or sale of a nonfinancial asset or (2) a contractually specified variable interest rate as the hedged risk* — To, in the redesignated hedge, "create the terms of the instrument used to estimate changes in value of the hedged risk (either under the hypothetical derivative method or another acceptable method . . .) in the assessment of effectiveness on the basis of market data as of the inception of the dedesignated hedging relationship." Ineffectiveness previously recognized in the dedesignated hedging relationship (in which the hedged risk was the variability in total cash flows) would be included as part of the transition adjustment.

The proposal allows an entity to adopt any election it chooses — it does not have to adopt all the elections as a single package. Either of the first two elections above must be made by the end of the first fiscal year after adoption. An entity would need to make the third election on or before the first quarterly hedge effectiveness assessment date after adoption.

Comparison With IFRSs

ASC 815's current hedging guidance is similar to the hedge accounting model in IAS 39. To align the guidance on hedge accounting with an entity's risk management activities, the IASB issued amendments to IFRS 9 in 2013 that introduced a new general hedge accounting model to IFRSs. However, the FASB is proposing to largely retain the existing U.S. GAAP hedge accounting framework and instead incorporate targeted improvements to address various practice issues. Accordingly, many aspects of the hedge accounting models under IFRS 9 and U.S. GAAP would differ significantly. See Deloitte's November 26, 2013, ***Heads Up*** for additional information about the IFRS 9 hedge accounting model. Also, refer to Appendix B.

Appendix A — Questions for Respondents

The proposed ASU's questions for respondents are reproduced below for ease of reference.

Question 1: The Board decided it would allow an entity to designate the hedged risk as the variability in cash flows attributable to changes in a contractually specified component stated in the contract in a cash flow hedge of a forecasted purchase or sale of a nonfinancial asset. Do you agree with that decision? Please explain why or why not. If not, what specific alternatives should the Board consider? Please explain why those alternatives would be beneficial.

Question 2: The Board decided that it would retain the concept of benchmark interest rates for hedges of fixed-rate financial instruments and forecasted issuances or purchases of fixed-rate financial instruments, maintain the existing list of permissible benchmark rates, and add the SIFMA Municipal Swap Rate to the list.

a. Should the Board retain the current concept of benchmark interest rates for fair value hedges of fixed-rate financial instruments and for cash flow hedges of forecasted issuances or purchases of fixed-rate financial instruments? Please explain why or why not.

b. If the Board continues to maintain the current concept of benchmark interest rates, should the Board consider within the concept expectations that a rate will become widely used?

c. If the Board continues to maintain a list of rates, are there any other rates that should be added to the list? Please explain why a particular rate meets the definition of a benchmark rate.

d. Are there other alternatives to the current concept of benchmark interest rates the Board should consider (for example, a principles-based approach)? Please describe those alternatives.

Question 3: The Board decided that it would allow an entity to use either the full contractual coupon cash flows or the cash flows associated with the benchmark rate determined at hedge inception in calculating the change in the fair value of the hedged item attributable to interest rate risk, except when the current market yield of the financial instrument is below the benchmark rate at hedge inception. In that instance, the total contractual coupon cash flows would have to be used. Do you agree with this decision? Please explain why or why not.

Question 4: In regard to hedging forecasted transactions, paragraph 815-30-40-5, as amended, states that "a pattern of determining that hedged forecasted transactions are probable of not occurring would call into question both an entity's ability to accurately predict forecasted transactions and the propriety of using hedge accounting in the future for similar forecasted transactions." What is your policy on what constitutes a pattern? Are there certain instances or scenarios in which missed forecasts should not be incorporated into the consideration of this pattern?

Question 5: Are there hedging relationships that would be eligible to meet the requirements in the proposed amendments and IFRS 9, but the hedge results would be recognized and presented differently? If so, please describe the transaction and why it would be recognized and presented differently in accordance with IFRS 9.

Question 6: Do you agree with the following Board decisions on presentation? Please explain why or why not. If not, what other alternatives should the Board consider?

a. For qualifying fair value, cash flow, and net investment hedges, the proposed amendments would modify current GAAP by requiring the entire change in the fair value of the hedging instrument included in the assessment of hedge effectiveness to be presented in the same income statement line item in which the earnings effect of the hedged item is presented.

b. For qualifying fair value, cash flow, and net investment hedges, the proposed amendments would retain current GAAP by requiring changes in the fair value of the hedging instrument excluded from the assessment of effectiveness to be recorded currently in earnings. For qualifying fair value and cash flow hedges, the proposed amendments would modify current GAAP by requiring changes in the fair value of the hedging instrument excluded from the assessment of effectiveness to be presented in the same income statement line item in which the earnings effect of the hedged item is (or will be) presented. For qualifying net investment hedges, there will be no prescribed presentation requirements for changes in the fair value of the hedging instrument excluded from the assessment of effectiveness.

c. For cash flow hedges in which the hedged forecasted transaction is probable of not occurring, the proposed amendments would retain current GAAP by requiring amounts recorded in accumulated other comprehensive income to be reclassified to earnings immediately. However, the proposed amendments would require presentation of reclassified amounts in the same income statement line item in which the earnings effect of the hedged item would have been presented had the hedged forecasted transaction occurred.

Question 7: Do you agree with the proposed disclosure amendments in (a), (b), and (c) below? Please explain why or why not.

a. Cumulative basis adjustments related to fair value hedges
b. Quantitative hedge accounting goals, if any, that an entity sets when developing its hedge accounting objectives and strategies and whether it met those goals
c. Revised tabular disclosure for fair value and cash flow hedges that would focus on the effect of hedge accounting on income statement line items.

Question 8: Unless the hedging relationship meets one of the exceptions that assumes perfect offset at hedge inception, an entity would be required to perform an initial quantitative test of hedge effectiveness and would be allowed to perform subsequent hedge effectiveness assessments qualitatively unless facts and circumstances change. Do you agree with this proposed change? Please explain why or why not.

Question 9: The Board decided that an entity may elect at hedge inception to perform subsequent assessments of effectiveness qualitatively. However, certain changes in the facts and circumstances associated with the hedging relationship in subsequent periods may require a quantitative assessment of effectiveness to be performed. Once an entity determines that a quantitative assessment of effectiveness is required, the entity would be prohibited to return to qualitative testing in periods after this determination is made. Can situations arise in which an entity no longer may assert qualitatively that the hedging relationship continues to be highly effective but when tested quantitatively would be highly effective? If so, please describe those circumstances. Should an entity be allowed to return to qualitative testing after such a significant change in facts and circumstances precluded it in a prior period? If so, please discuss the factors that an entity should consider to justify a reasonable expectation that the hedge will once again be highly effective on a qualitative basis.

Question 10: Do you agree with the proposed amendment that would allow an entity to perform the initial quantitative testing portion of hedge documentation at any time between hedge inception and the quarterly effectiveness testing date using data applicable as of the date of hedge inception? Please explain why or why not.

Question 11: The proposed amendments related to the timing of the preparation of hedge documentation and subsequent qualitative testing apply to both public entities and private companies. Are there valid reasons why the content of or the timing of the preparation of hedge documentation should be different for public entities and private companies? If so, please describe the specific types of transactions for which different treatment should be considered.

Question 12: Should the effective date be the same for both public business entities and entities other than public business entities?

Question 13: How much time is needed to implement the proposed amendments? Should entities other than public business entities be provided more time? If so, how much more time?

Question 14: Do you agree with the proposed transition method and disclosures in paragraph 815-20-65-3? Do you agree with the Board's decision not to allow a retrospective transition approach? Please explain why or why not.

Appendix B — Comparison of Hedge Accounting Models

The table below compares certain aspects of the proposed amendments to the proposed hedge accounting model with current U.S. GAAP (ASC 815) and IFRS 9.

Subject	Current U.S. GAAP	Proposed Guidance (Tentative Approach)	IFRS 9
Proposed Amendments Applicable to All Hedges			
"Highly effective" threshold to qualify for hedge accounting	The hedging instrument must be highly effective at achieving offsetting changes in fair value or cash flows.	No changes would be made to existing requirements under U.S. GAAP.	A "highly effective" threshold concept does not exist; instead, IFRS 9 requires that (1) there is an economic relationship between the hedging instrument and the hedged item, (2) credit risk does not dominate the value changes that result from the economic relationship, and (3) the hedging relationship's hedging ratio reflects the actual quantity of the hedging instrument and the hedged item.
Quantitative assessment of hedge effectiveness	Entities must perform initial and ongoing quantitative prospective and retrospective assessments of effectiveness (unless the shortcut method is applied).	Generally requires an initial prospective quantitative test; however, entities can elect to subsequently perform only qualitative effectiveness assessments unless facts and circumstances change.	Does not specify a method for assessing effectiveness. Requires entities to make ongoing qualitative or quantitative assessments (at a minimum at each reporting date).
Hedge documentation and initial prospective quantitative hedge effectiveness assessment	Entities must complete all documentation at hedge inception.	Entities still must complete most hedge documentation at hedge inception; however, they need not complete the initial prospective quantitative hedge effectiveness assessment until the first quarterly hedge effectiveness assessment date (i.e., up to three months). Some circumstances may require earlier completion of the initial prospective quantitative effectiveness assessment.	Requires all documentation at hedge inception.
Income statement presentation	Income statement presentation of hedging results is not prescribed.	Requires presentation of the change in the hedging instrument's fair value in the same income statement line as the earnings effect of the hedged item (other than any fair value changes that are excluded from the hedge effectiveness assessment of net investment hedges, for which no specific income statement presentation is prescribed).	Does not prescribe income statement presentation of hedging results. Time value components that are not designated as part of the hedging instrument will generally be initially deferred in OCI and not recognized in current earnings.

(Table continued)

Subject	Current U.S. GAAP	Proposed Guidance (Tentative Approach)	IFRS 9
Proposed Amendments Applicable to All Hedges			
Voluntary dedesignation of a hedging relationship	Entities may voluntarily discontinue hedge accounting at any time by removing the designation of the hedging relationship.	No changes would be made to existing requirements under U.S. GAAP.	Entities may perform dedesignation only when the hedging relationship (or a part of a hedging relationship) ceases to meet the qualifying criteria.
Shortcut method	Permitted for hedging relationships involving an interest rate swap and an interest-bearing financial instrument that meet specific requirements.	Existing model retained; however, application of the long-haul method would be permitted if an entity determines that use of the shortcut method was not or is no longer appropriate as long as: • The entity documented at hedge inception the quantitative method it would use to assess hedge effectiveness and measure hedge results if the shortcut method could not be applied. • The hedge was highly effective for the periods in which the shortcut method criteria were not met. The qualifying criteria also would be amended to enable partial-term fair value hedges to qualify for shortcut accounting.	Not permitted.
Proposed Amendments Applicable to Cash Flow Hedges			
Measurement and recognition of hedge ineffectiveness — cash flow hedges	Entities must perform periodic measurement and recognition of hedge ineffectiveness (other than that arising from cumulative cash flow underhedges).	Eliminates the requirement for entities to recognize hedge ineffectiveness each reporting period.	Requires entities to perform measurement and recognition of hedge ineffectiveness (other than that arising from cumulative cash flow underhedges) in each reporting period.
Ability to designate a component of a forecasted purchase or sale of a nonfinancial asset as a hedged item	Entities are prohibited from designating changes in cash flows of a component of a nonfinancial item as the hedged risk, with the exception of the risk of changes in the functional-currency-equivalent cash flows attributable to changes in the related foreign currency exchange rate.	Permits entities to hedge the "risk of variability in cash flows attributable to changes in a contractually specified component" in a cash flow hedge of a forecasted purchase or sale of a nonfinancial asset, if the hedge meets certain criteria.	Entities may designate nonfinancial components as hedged items under the principle that a component may be designated as a hedged item if it is separately identifiable and reliably measurable. There is no requirement that the component be contractually specified.

(Table continued)

Subject	Current U.S. GAAP	Proposed Guidance (Tentative Approach)	IFRS 9
Proposed Amendments Applicable to Cash Flow Hedges			
Hedges of interest rate risk for variable-rate financial instruments	The only hedgeable component is the change in cash flows attributable to changes in the benchmark interest rate.	Entities may designate the contractually specified interest rate index as the hedged risk. The concept of benchmark interest rate hedging is eliminated.	Entities may designate components that are separately identifiable and reliably measurable.
Application of critical-terms-match method to a cash flow hedge of a group of forecasted transactions	Entities need to consider whether the amount of hedge ineffectiveness that arises from differences between the hedging derivative's maturity date and the dates of the forecasted transactions is more than de minimis; if so, entities cannot apply this method and may need to view this as an accounting error.	Entities may use the critical–terms-match method when cash flow hedging a group of forecasted transactions if (1) those forecasted transactions occur within the same 31-day period as the maturity of the hedging derivative and (2) all other method requirements are met.	No formal approach; however, entities may be able to qualitatively assess hedge effectiveness when the critical terms of the hedging instrument and those of the hedged item match.
Proposed Amendments Applicable to Fair Value Hedges of Interest Rate Risk			
Eligible benchmark interest rates	SIFMA is not an eligible benchmark interest rate. The only permissible U.S. benchmark interest rates are rates for U.S. Treasuries, LIBOR swap rates, and the Fed Funds Effective Swap Rate (Overnight Index Swap Rate).	SIFMA is added as an eligible benchmark interest rate in the United States in addition to those rates already permitted under current U.S. GAAP.	Entities may designate components that are separately identifiable and reliably measurable.
Partial-term fair value hedges of interest rate risk	Although not explicitly prohibited, such hedges would rarely satisfy all the hedging criteria (e.g., being highly effective).	Entities may designate a partial-term hedge by assuming that (1) the term of the hedged item begins with the first hedged cash flow and ends with the last hedged cash flow and (2) the maturity of the hedged item occurs on the date on which the last hedged cash flow is due and payable. This greatly increases the likelihood that the hedging relationship will meet the "highly effective" criterion.	Entities may perform partial-term hedging.

(Table continued)

Subject	Current U.S. GAAP	Proposed Guidance (Tentative Approach)	IFRS 9
Proposed Amendments Applicable to Fair Value Hedges of Interest Rate Risk			
Measuring the change in fair value of a prepayable instrument (e.g., callable debt)	In a hedge of benchmark interest rate risk on fixed-rate debt containing a call feature, entities must consider the effect of that embedded prepayment option on the change in value of the debt (unless the shortcut method is applied). This consideration includes all factors that might lead to debt prepayment (interest rates, credit spreads, and other factors), even if only interest rate risk is being hedged.	Would allow entities to consider only how changes in the benchmark interest rate (as opposed to how all variables, such as interest rate, credit, and liquidity factors) would affect the exercise of the call option when assessing hedge effectiveness and measuring the change in fair value of the debt attributable to changes in the benchmark interest rate.	Does not provide specific guidance; however, in order for a layer component containing a prepayment option to be eligible for fair value hedging, entities must include the changes in the fair value of the prepayment option as a result of changes in the hedged risk when measuring the change in the hedged item's fair value.
Measuring the change in fair value of the hedged item attributable to the change in the benchmark interest rate in a fair value hedge of interest rate risk	An entity must measure the change in the hedged item's fair value attributable to changes in the benchmark interest rate by considering all contractual coupon cash flows of the hedged item.	Permits an entity to use either the benchmark rate component of contractual coupon cash flows or the full contractual coupon cash flows when calculating the change in fair value of the hedged item. However, if the hedged item's effective interest rate is less than the benchmark interest rate on the date of hedge designation (a "sub-benchmark" hedge), the entity must use the full contractual coupon cash flows.	Entities may designate the benchmark interest rate cash flows as the hedged item if they are separately identifiable and reliably measurable.

Subscriptions

If you wish to receive *Heads Up* and other accounting publications issued by Deloitte's Accounting Services Department, please register at www.deloitte.com/us/accounting/subscriptions.

Dbriefs for Financial Executives

We invite you to participate in *Dbriefs*, Deloitte's webcast series that delivers practical strategies you need to stay on top of important issues. Gain access to valuable ideas and critical information from webcasts in the "Financial Executives" series on the following topics:

- Business strategy and tax.
- Driving enterprise value.
- Financial reporting.
- Financial reporting for taxes.
- Governance, risk, and compliance.
- Technology.
- Transactions and business events.

Dbriefs also provides a convenient and flexible way to earn CPE credit — right at your desk. Subscribe to *Dbriefs* to receive notifications about future webcasts at www.deloitte.com/us/dbriefs.

Technical Library and US GAAP Plus

Deloitte makes available, on a subscription basis, access to its online library of accounting and financial disclosure literature. Called Technical Library: The Deloitte Accounting Research Tool, the library includes material from the FASB, EITF, AICPA, PCAOB, IASB, and SEC, in addition to Deloitte's own accounting and SEC manuals and other interpretive accounting and SEC guidance.

Updated every business day, Technical Library has an intuitive design and navigation system that, together with its powerful search features, enable users to quickly locate information anytime, from any computer. Technical Library subscribers also receive *Technically Speaking*, the weekly publication that highlights recent additions to the library. For more information, including subscription details and an online demonstration, visit www.deloitte.com/us/techlibrary.

In addition, be sure to visit US GAAP Plus, our free Web site that features accounting news, information, and publications with a U.S. GAAP focus. It contains articles on FASB activities and updates to the *FASB Accounting Standards Codification*™ as well as developments of other U.S. and international standard setters and regulators, such as the PCAOB, AICPA, SEC, IASB, and IFRS Interpretations Committee. Check it out today!

Heads Up is prepared by the National Office Accounting Services Department of Deloitte as developments warrant. This publication contains general information only and Deloitte is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor.

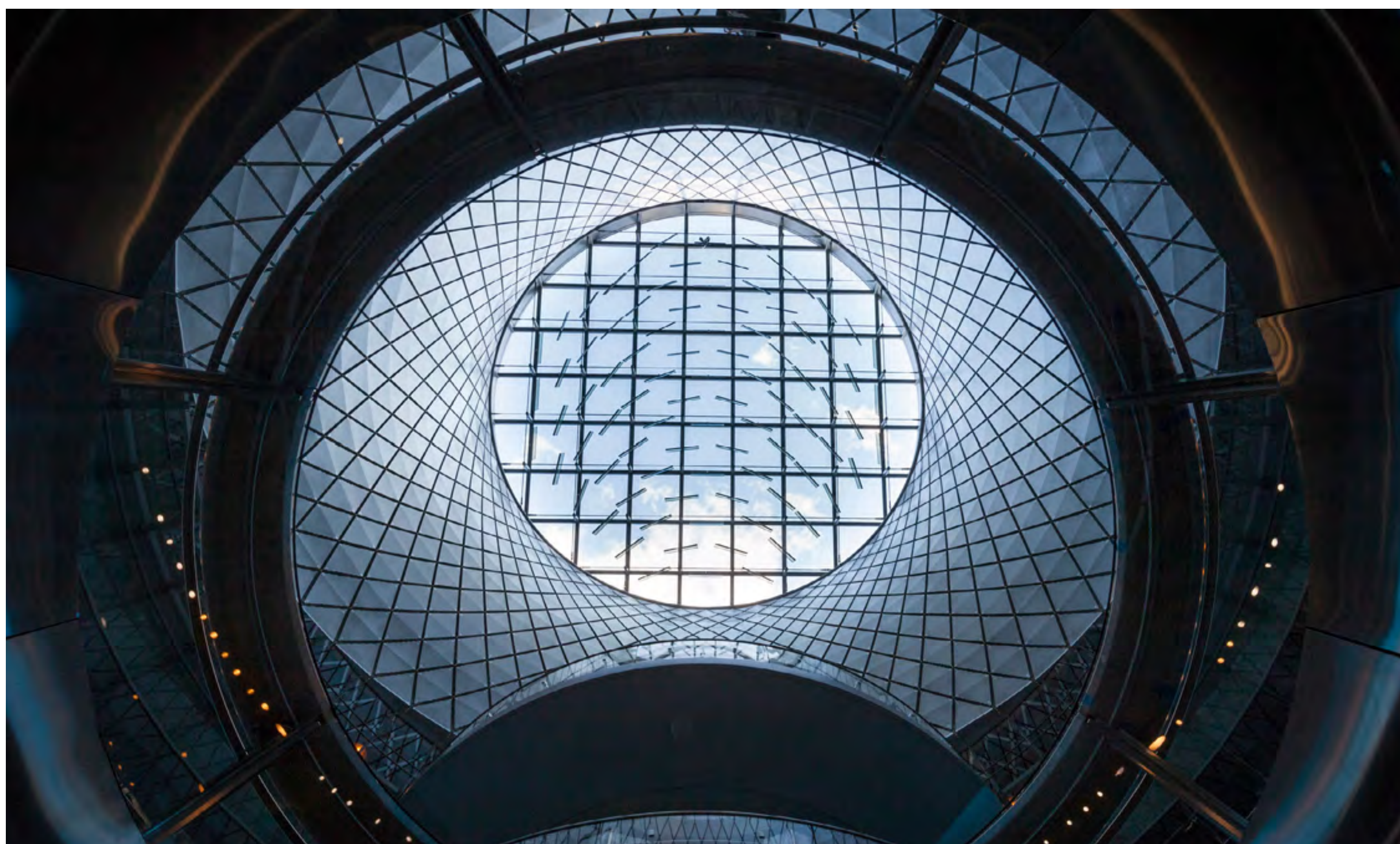
Deloitte shall not be responsible for any loss sustained by any person who relies on this publication.

As used in this document, "Deloitte" means Deloitte & Touche LLP, a subsidiary of Deloitte LLP. Please see www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries. Certain services may not be available to attest clients under the rules and regulations of public accounting.

Copyright © 2016 Deloitte Development LLC. All rights reserved.
Member of Deloitte Touche Tohmatsu Limited.

Deloitte.

Heads Up — July 18, 2016
Volume 23, Issue 20



SEC Proposes to Eliminate Outdated and Duplicative Disclosure Requirements

by Adrian Mills, Christine Mazor, and Ana Zelic, Deloitte & Touche LLP

On July 13, 2016, the SEC issued a proposed rule[1] that would amend certain of its disclosure requirements that may be redundant, duplicative, or outdated, or may overlap with other SEC, U.S. GAAP, or IFRS disclosure requirements. The proposal also seeks comment on whether certain of the SEC's disclosure requirements that overlap with U.S. GAAP requirements should be retained, modified, eliminated, or referred to the FASB for potential incorporation into U.S. GAAP. See the table below for a summary of some of the proposed changes.

The proposed amendments are the next step in the SEC's ongoing disclosure effectiveness initiative, which is a broad-based review of the Commission's disclosure, presentation, and delivery requirements for public companies. As part of the initiative, the SEC also issued a concept release[2] in April of this year that sought feedback on modernizing certain business

[1] SEC Proposed Rule Release No. 33-10110, *Disclosure Update and Simplification*. The proposal is also in response to a mandate under the Fixing America's Surface Transportation Act.
[2] See Deloitte's April 18, 2016, *Heads Up* for more information about the concept release.

and financial disclosure requirements of Regulation S-K as well as a request for comment[3] last September on the effectiveness of certain financial disclosure requirements in Regulation S-X.[4]

The proposed amendments to the disclosure requirements would affect U.S. issuers, foreign private issuers (FPIs), investment advisers, investment companies, broker-dealers, and nationally recognized statistical rating organizations. The effect on each type of issuer varies depending on the amendment proposed. The SEC intends to improve the disclosure requirements and simplify registrants' compliance efforts without significantly altering the total mix of information that is ultimately provided to investors.

Editor's Note

The implications of the proposal are likely to vary depending on the category of change (e.g., duplicate, overlapping, superseded). The effect of some changes may not be significant if their purpose is only to eliminate a duplicated or superseded requirement. Changes to address overlapping requirements could have a more significant effect since they can result in what the SEC describes as (1) disclosure location considerations and (2) bright-line threshold considerations (see discussion below).

The proposal's request for comment on overlapping requirements notes that "proposals related to some topics would result in the relocation of disclosures from outside to inside the financial statements, subjecting this information to annual audit and/or interim review, internal control over financial reporting, and XBRL tagging requirements." For example, the requirements in Regulation S-K, Item 103,[5] to disclose certain legal proceedings can in certain cases be more expansive than those in U.S. GAAP, under which loss contingencies must be disclosed. The Commission is seeking input on whether incorporation of Item 103, among other requirements, into U.S. GAAP may impose greater burdens on issuers and auditors related to the development and auditing of additional estimates and disclosures. The SEC also notes that the location of some disclosures in a filing could change as a result of the proposal to address overlapping requirements, which might affect users by changing the prominence of the disclosures.

The proposal may result in the removal or addition of a bright-line disclosure threshold (i.e., a threshold below which no disclosure is required), which may change the disclosure burden on issuers and the amount of information disclosed to investors. For example, unlike U.S. GAAP, Regulation S-K[6] requires disclosure of the amount of revenue from any class of similar products and services that account for 10 percent or more of revenue.

Comments on the proposed rule are due 60 days after its publication in the *Federal Register*. Constituent feedback will be critical to the success of the SEC's disclosure update and simplification initiative. The SEC has indicated that comments on the proposal and on the Regulation S-K concept release will further inform the Commission's actions related to enhanced disclosure.

[3] See Deloitte's October 6, 2015, *Heads Up* for more information about the request for comment.

[4] The SEC's disclosure rules are primarily contained in Regulation S-X, which addresses financial statement disclosure requirements, and Regulation S-K, which is the central respository for nonfinancial statement disclosures (e.g., risk factors and MD&A) for public companies.

[5] Regulation S-K, Item 103, "Legal Proceedings."

[6] See Item 101(c)(1)(i) of Regulation S-K.

The proposal would affect a diverse group of SEC disclosure requirements. The following table summarizes some of the proposed changes:

Types of Requirements Affected	Goal of Proposed Changes	Examples of Affected Disclosure Topics	Example
Redundant or duplicative requirements	Eliminate requirements that result in disclosure of substantially the same information as that required under other Commission rules, U.S. GAAP, or IFRSs.	• Foreign currency. • Consolidation. • Debt obligations. • Income tax disclosures. • Warrants, rights, and convertible instruments. • Related parties. • Contingencies. • Earnings per share. • Changes in accounting principles. • Interim financial statements (common-control transactions and dispositions).	*Debt obligations:* Under Regulation S-X,[7] registrants must disclose significant changes in issued amounts of debt after the latest balance sheet date. Because, the guidance in U.S. GAAP on subsequent events (ASC 855, *Subsequent Events*) requires similar disclosures, the SEC proposed to eliminate the S-X related disclosure.
Overlapping requirements	Eliminate requirements that convey reasonably similar information, or information that is not materially incremental to that required under other SEC requirements, U.S. GAAP, or IFRSs and that may no longer be useful to investors.	• Consolidation. • Derivative accounting policies. • Segments. • Research and development activities. • Real estate investment trusts (REITs). • Dividends. • Ratio of earnings to fixed charges.	*Segments:* The requirement in Regulation S-K[8] to disclose segment financial information and restatement of prior periods when reportable segments change would be deleted because similar disclosures are required by U.S. GAAP and other requirements in Regulation S-K.[9]
	Integrate certain disclosure requirements with other related Commission disclosure requirements.	• Foreign currency restrictions. • Restrictions on dividends and related items. • Geographic areas.	*Restrictions on dividends and related items:* A number of Commission requirements mandate disclosure about restrictions on the payment of dividends and related items.[10] The SEC proposes to streamline these disclosure requirements into a single requirement to disclose material restrictions on dividends.

[7] Regulation S-X, Rule 4-08(f), "Significant Changes in Bonds, Mortgages and Similar Debt."
[8] Regulation S-K, Item 101(b), "Financial Information About Segments."
[9] Regulation S-K, Item 303(b), "Interim Periods."
[10] For example, Regulation S-K, Item 201(c)(1), "Dividends," and Regulation S-X, Rules 4-08(d)(2), "Preferred Shares," and 4-08(e), "Restrictions Which Limit the Payment of Dividends by the Registrant."

Types of Requirements Affected	Goal of Proposed Changes	Examples of Affected Disclosure Topics	Example
Overlapping requirements (continued)	Modify or eliminate overlapping disclosures or refer them to the FASB for potential incorporation into U.S. GAAP.	• REITs. • Consolidation. • Discount on shares. • Assets subject to lien. • Obligations. • Preferred shares. • Income taxes. • Related parties. • Repurchase and reverse repurchase agreements. • Interim financial statements. • Products and services. • Major customers. • Legal proceedings. • Oil and gas producing activities.	*Income taxes:* Both Regulation S-X and U.S GAAP require disclosures about income taxes. However, Regulation S-X requires additional disclosures, such as the amount of domestic and foreign pretax income and income tax expense. The SEC is seeking comment on these disclosure differences to help it decide whether to refer them to the FASB for potential incorporation into U.S. GAAP.
Outdated requirements	Amend requirements that have become obsolete as a result of the passage of time or changes in the regulatory, business, or technological environment.	• Stale transition dates. • Income tax disclosures. • Available information (e.g., to require issuers to disclose their internet address). • Market price disclosure. • Exchange rate data. • FPI initial public offering[11] — age of financial statements.	*Market price disclosure:* The proposal would substitute disclosure of historical market price information with disclosure of the issuer's ticker symbol, which investors can use to obtain information on stock price from various Web sites.
Superseded requirements	Amend requirements that are inconsistent with new accounting, auditing, disclosure requirements, and more recently updated Commission disclosure requirements.	• Auditing standards. • Consolidation. • Extraordinary items.	*Extraordinary items:* References to extraordinary items would be eliminated from the SEC's rules and forms since the FASB eliminated extraordinary items from U.S. GAAP in January 2015.

[11] If adopted, the proposal would enable FPIs in an initial public offering to use, in Form F-1, audited financial statements that are older than 12 months (but not more than 15 months old) without obtaining a waiver from the SEC.

Subscriptions

If you wish to receive *Heads Up* and other accounting publications issued by Deloitte's Accounting Services Department, please register at www.deloitte.com/us/accounting/subscriptions.

Dbriefs for Financial Executives

We invite you to participate in *Dbriefs*, Deloitte's webcast series that delivers practical strategies you need to stay on top of important issues. Gain access to valuable ideas and critical information from webcasts in the "Financial Executives" series on the following topics:

- Business strategy and tax.
- Driving enterprise value.
- Financial reporting.
- Financial reporting for taxes.
- Governance, risk, and compliance.
- Technology.
- Transactions and business events.

Dbriefs also provides a convenient and flexible way to earn CPE credit — right at your desk. Subscribe to *Dbriefs* to receive notifications about future webcasts at www.deloitte.com/us/dbriefs.

Technical Library and US GAAP Plus

Deloitte makes available, on a subscription basis, access to its online library of accounting and financial disclosure literature. Called Technical Library: The Deloitte Accounting Research Tool, the library includes material from the FASB, EITF, AICPA, PCAOB, IASB, and SEC, in addition to Deloitte's own accounting and SEC manuals and other interpretive accounting and SEC guidance.

Updated every business day, Technical Library has an intuitive design and navigation system that, together with its powerful search features, enable users to quickly locate information anytime, from any computer. Technical Library subscribers also receive *Technically Speaking*, the weekly publication that highlights recent additions to the library. For more information, including subscription details and an online demonstration, visit www.deloitte.com/us/techlibrary.

In addition, be sure to visit US GAAP Plus, our free Web site that features accounting news, information, and publications with a U.S. GAAP focus. It contains articles on FASB activities and updates to the *FASB Accounting Standards Codification*™ as well as developments of other U.S. and international standard setters and regulators, such as the PCAOB, AICPA, SEC, IASB, and IFRS Interpretations Committee. Check it out today!

Heads Up is prepared by the National Office Accounting Services Department of Deloitte as developments warrant. This publication contains general information only and Deloitte is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor.

Deloitte shall not be responsible for any loss sustained by any person who relies on this publication.

As used in this document, "Deloitte" means Deloitte & Touche LLP, a subsidiary of Deloitte LLP. Please see www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries. Certain services may not be available to attest clients under the rules and regulations of public accounting.

Copyright © 2016 Deloitte Development LLC. All rights reserved.
Member of Deloitte Touche Tohmatsu Limited.

12 December 2016

2016 AICPA National Conference on Current SEC and PCAOB Developments

Compendium of significant accounting and reporting issues

In this issue:

Summary ... 1
Remarks of senior representatives ... 2
- Remarks by Wesley Bricker, Chief Accountant ... 2
- Remarks by Russell Golden, Chairman of the FASB ... 4
- Remarks by James Doty, Chairman of the PCAOB ... 5

Accounting and disclosure matters ... 6
- New accounting standards ... 6
- Existing accounting standards ... 11
- Non-GAAP financial measures ... 15

ICFR, audit standards and independence matters ... 16
- Internal control over financial reporting ... 16
- Implementation and monitoring of new audit standards ... 17
- Auditor independence matters ... 17

Accounting and SEC standard-setting update ... 18
- FASB Invitation to Comment ... 18
- Disclosure effectiveness and SEC rulemaking ... 18
- Interactions with the staff ... 19

International matters ... 19
- The IFRS footprint and outlook for IFRS ... 19
- Foreign private issuers and cross-border reporting challenges ... 20

SEC enforcement and PCAOB inspection matters ... 20
- Remarks of SEC enforcement staff ... 20
- PCAOB inspections ... 21

Appendix — Conference speeches ... 23

Summary

Representatives of the Securities and Exchange Commission (SEC or Commission), the Financial Accounting Standards Board (FASB or Board) and the International Accounting Standards Board (IASB) (collectively, the Boards) and the Public Company Accounting Oversight Board (PCAOB) shared their views on various accounting, financial reporting and auditing issues at the annual AICPA National Conference on Current SEC and PCAOB Developments (Conference) last week in Washington, DC.

Highlights included:

New accounting standards — The chairmen of the FASB and IASB discussed implementation efforts related to the significant new accounting standards on revenue, leases and financial instruments under both US GAAP and IFRS. Members of the SEC staff also discussed recent consultations related to implementation of the new standards, including their approach in evaluating the questions. The SEC staff stressed the importance of timely implementation efforts and robust disclosure that communicates how a company will be affected by the new standards and the status of its implementation efforts.

Non-GAAP financial measures — Regulators, standard setters, investors and preparers shared their perspectives on the use and disclosure of non-GAAP financial measures. Members of the SEC staff said companies have made significant progress in complying with the interpretations the staff updated in May 2016. They also discussed their views on specific measures and adjustments, as well as presentations that might give non-GAAP measures undue prominence. Standard setters discussed how and why investors use alternative performance measures and whether revisions to current presentation and disclosure requirements may be warranted to better meet the needs of investors. The PCAOB staff is monitoring the need for greater auditors' involvement with non-GAAP information derived from the audited financial statements, with input from the PCAOB's advisory groups.

EY

Building a better working world

Upcoming changes — Overall, change was the common theme at the Conference. Corporate executives spoke about their efforts to implement the major new accounting standards on revenue and leases, and the anticipated ongoing effects on resources, systems and processes. Staff members from the SEC Division of Corporation Finance (DCF) spoke about the future of the Commission's disclosure effectiveness initiative and other rulemaking activities. And PCAOB Chairman James Doty discussed the enhanced research and stakeholder outreach that the PCAOB is incorporating into its standard setting process. The PCOAB is also nearing completion of its proposed standard to redesign and modernize the audit report.

Remarks of senior representatives

Remarks by Wesley Bricker, Chief Accountant

SEC Chief Accountant Wesley Bricker focused his remarks on the importance of cooperation and coordination to advance high quality financial reporting in the US capital markets. Specifically, he focused on the roles of preparers, audit committees, auditors and standard-setters in advancing that shared responsibility.

'Investors look to [preparers] to evaluate, challenge, and ultimately address transactions, judgments, and risk areas with accurate and informative disclosures. Effective internal control supports your work.'
— Wesley Bricker, Chief Accountant

Role of preparers

Mr. Bricker said that high-quality financial reporting begins with preparers. Strong and effective internal controls and rigorous independent audits are necessary for companies to communicate reliable financial information to investors so they can raise necessary capital. Deficiencies in internal control over financial reporting (ICFR) can lead to lower quality financial reporting and, ultimately, higher restatement rates and a higher cost of capital. It will be important for companies to update and maintain effective internal controls as they implement the significant new accounting standards on revenue, leases, financial instruments and credit losses, which Mr. Bricker referred to as the "new GAAP standards."

Mr. Bricker encouraged preparers to implement the new GAAP standards in a timely manner, provide useful transition disclosures and adhere to the objectives of the new guidance. Regarding the new revenue standard, he commented that revenue is one of the single most important measures used by investors in assessing a company's performance. Given market expectations of comparability, companies cannot afford to "get the accounting for revenue wrong."

Consistent with Staff Accounting Bulletin (SAB) Topic 11.M, Mr. Bricker reiterated that the SEC staff expects registrants to disclose how they will be affected by Accounting Standards Codification (ASC) 606, *Revenue from Contracts with Customers* (ASC 606) and the other new GAAP standards as they make progress on implementation. For example, the SEC staff expects registrants to make more specific quantitative and qualitative disclosures in 2016 annual reports and in their 2017 periodic reports about the effects (quantitative or qualitative) of adopting the new revenue standard.

While Mr. Bricker observed that most companies have made progress on ASC 606 implementation since last year's Conference, he believes there is more to do. He encouraged companies that are behind in their implementation of the revenue standard to discuss the reasons for the delay with their audit committee and auditor. He also suggested that those companies provide enhanced disclosures about their implementation status in addition to the disclosures required by SAB Topic 11.M.

Mr. Bricker also said the staff of the Office of the Chief Accountant (OCA) has been working with companies on prefiling submissions on accounting positions related to the adoption of the new GAAP standards. When forming its conclusions, the staff of OCA considers the nature, design and substance of the transaction, the standard setter's basis for conclusions, relevant discussions by groups such as the Transition Resource Group (TRG) for Revenue

Recognition and the objectives of consistency and comparability. Mr. Bricker emphasized that it is important for preparers to fully understand the registrant's contracts with customers in order to clearly articulate the basis for the proposed accounting under the new standard. He also reminded the audience that similar considerations apply for the other new GAAP standards.

Mr. Bricker said that substantial progress has been made over the past year in addressing many of the problematic practices related to disclosures of non-GAAP financial measures. However, he still believes companies can further improve their evaluation of the appropriateness of particular non-GAAP measures, the prominence of their presentation and the effectiveness of the registrant's disclosure controls and procedures (DCP). Mr. Bricker encouraged audit committee members to understand management's judgments about the use of non-GAAP measures and how the company's approach differs from those followed by other companies.

Role of audit committees

Audit committees are critical to reliable financial reporting, and Mr. Bricker encouraged audit committee members to stay current on emerging issues and engage outside expert advisers when necessary. He also stressed the importance of the audit committee's relationship with the auditor in overseeing management's activities. To promote better communication, he suggested that audit committee members pose the following questions to auditors:

- If you were management and were solely responsible for preparing the company's financial statements, would the financial statements have in any way been prepared differently?
- If you were an investor, would you believe that you received the information you needed to understand the company's financial position and performance?
- Is the company following the same ICFR and internal audit procedures that would be followed if you were the chief executive officer?
- Have you made any recommendations that management has not followed?

Mr. Bricker also emphasized the audit committee's role in overseeing the terms of the audit engagement and the auditor's compensation. In particular, he recommended that audit committees make sure that an issuer's cost-cutting initiatives don't adversely affect audit scope, staffing or compensation. He also warned that normal corporate procurement policies and procedures may be inappropriate for auditor selection, retention and compensation.

Mr. Bricker said he was encouraged by audit committees' voluntary reporting, which was highlighted in a recent EY survey.[1]

Auditors and their independence

Auditors are the key gatekeepers for high-quality financial reporting, and Mr. Bricker emphasized the importance of rigorous and objective audits by independent auditors. Mr. Bricker reminded auditors of the general standard of independence,[2] adding that both auditors and audit committees should review their policies to make sure that the standard is met. Mr. Bricker also reminded auditors to remain aware of limitations on involvement with their clients' activities in implementing the new GAAP standards.

Role of the PCAOB

Mr. Bricker commended the PCAOB for the ongoing improvements to its inspection program and its decision to implement a new research agenda. He encouraged the PCAOB to continue to advance and finalize other important and challenging projects on its standard-setting agenda, including auditing accounting estimates.

Role of the FASB and IASB

Standard setters play an important role in assuring that new standards result in objective, neutral and useful information about economic activities even if the updated information affects the business decisions of market participants. Mr. Bricker commended both the FASB and IASB on their standard-setting activities for the benefit of investors and emphasized how important it is for the Boards to respond to investors' needs in a timely manner and to effectively use post-implementation reviews.

Mr. Bricker stated that his staff monitors the development of IFRS standards and interprets their application through the consultation process, thus integrating IFRS into all aspects of OCA's work. At the same time, he believes that for the foreseeable future, US GAAP will continue to best serve the needs of investors and other users who rely on financial reporting by US issuers. Mr. Bricker said it is worth continuing to consider his predecessor's proposal to allow domestic issuers to provide IFRS-based information as a supplement to their US GAAP financial statements without reconciliation as a non-GAAP measure.

Remarks by Russell Golden, Chairman of the FASB

FASB Chairman Russell Golden, who was recently appointed to another term ending in 2020, discussed the five priorities he set when he became Chairman in 2013: improvements, implementation, ideals, inclusiveness and international, which he referred to as the five "I's."

'Technology gives us our greatest opportunity to improve financial reporting.'

– Russell Golden, FASB Chairman

Improvements

Mr. Golden said the Board has improved US GAAP by completing several major projects. He called the new revenue recognition standard a major achievement in the Board's efforts to improve and converge US GAAP with IFRS on an important area of financial reporting that affects all companies. The new leases standard will result in a more faithful representation of leasing activities because it requires lessees to recognize most leases on their balance sheets. The current expected credit loss (CECL) model in the new credit loss standard also represents an improvement to today's "incurred loss" approach. Mr. Golden also said the FASB's simplification initiative has succeeded in reducing costs for preparers without compromising the quality of information provided to investors.

Mr. Golden said the FASB plans to continue improving US GAAP by issuing final standards in 2017 on hedge accounting and the accounting for long-duration contracts issued by insurers (e.g., life insurance, annuities). The FASB also plans to issue final standards on classifying debt as current or noncurrent and the accounting for non-employee share-based payment awards.

Mr. Golden said the Board received valuable feedback on its Invitation to Comment on future agenda priorities. Mr. Golden noted that some constituents said the Board should slow down on new projects until stakeholders have the chance to implement the major new standards, and the Board will consider this feedback when determining how to manage the pace of change while continuing to improve US GAAP.

How we see it

Over the next few years, we believe that the Board should focus its efforts on monitoring implementation of the new standards, completing major projects, including the Conceptual Framework, addressing additional issues that may arise and completing targeted improvements already on its agenda rather than beginning any major new projects.

Implementation

The FASB has taken a more proactive approach to support the implementation of new accounting standards. Mr. Golden commented on the success of the TRG for Revenue Recognition in which various stakeholders around the globe were involved. Mr. Golden said input from these stakeholders helped the Board quickly identify issues that could have led to diversity in practice. Based on that success, the Board convened a TRG on credit losses to address implementation issues before it issued that final standard. Members of that TRG were able to weigh in on the draft guidance, which Mr. Golden said should reduce the need to make technical corrections later.

Mr. Golden said the FASB did not create a TRG for the new leases standard because, in the Board's view, the changes in lease accounting are not as significant as revenue recognition and credit losses. He noted, however, that the FASB staff is monitoring the questions that are arising about implementation of the new leases standard and stands ready to address them.

Inclusiveness

Mr. Golden said the Board is making standard setting more inclusive by focusing on gaining a better understanding of the differences between large and small public companies, nonpublic companies and not-for-profit organizations and when those differences require different accounting. The FASB also has promoted inclusiveness through its outreach and through the introduction of new, plain English communications materials.

'By improving our economic analysis of standards under development, we can have greater confidence that the benefits of those new standards will justify their costs.'

– James Doty, PCAOB Chair

Ideals

The FASB continues to focus on its foundational projects on the conceptual framework and the disclosure framework. The conceptual framework gives the Board a starting point for addressing an accounting issue. The disclosure framework would serve a similar function, providing the FASB with a consistent methodology for approaching decisions about disclosures. Mr. Golden emphasized that the objective of the disclosure framework project is making disclosures more meaningful, not necessarily reducing the volume of disclosures.

International

Mr. Golden said the FASB continues to collaborate with the IASB and other international standard setters. The FASB has contributed to improving IFRS through its membership in the IASB's Accounting Standards Advisory Forum, and the FASB has met with standard setters from Canada, Japan, China, Korea and other nations to share ideas on how to improve accounting standards. The FASB expects to have joint meetings with these standard setters in 2017 to talk about priorities and future initiatives.

Mr. Golden reiterated that the completion of the joint revenue recognition standard by the FASB and the IASB will contribute to more comparable global accounting standards. Although the Boards reached different conclusions on certain aspects of the leases and credit losses standards, Mr. Golden emphasized that the Boards agree on the important principles that most leases belong on the balance sheet and that a more forward-looking model for credit losses is needed.

Remarks by James Doty, Chairman of the PCAOB

Mr. Doty said the PCAOB "has a unique and indispensable role in helping companies maintain investor trust, avoid financial reporting failures, and in turn has helped our economy and capital markets remain resilient and grow." He also said that the PCAOB has improved the overall landscape by improving audits and by changing firms' mindsets and execution.

Mr. Doty said that the PCAOB has forged a constructive relationship with audit firms, "albeit a somewhat adversarial one." Such a relationship "benefits our economic system, protects investors, provides clarity on essential standards, helps companies stay on track and contributes to capital formation," he said.

Inspections update

Mr. Doty said that the "issuance of regular inspection reports provides meaningful information that didn't exist before, and that helps all parties, including investors, audit committees, and companies, make better decisions." To preview its 2015 inspection findings and describe the scope and objectives of 2016 inspections of audits of public companies and broker-dealers, the PCAOB issued Staff Inspection Briefs this year. The PCAOB also issued its fifth annual inspection report on the temporary broker-dealer program, and Mr. Doty said the Board plans to develop a proposal for a permanent program based on the insights gained through past inspection cycles.

Improvements to the PCAOB's standard-setting process and other outreach efforts

Mr. Doty provided an overview of the PCAOB's standard-setting activities and discussed improvements the PCAOB has made to its process to issue "better and clearer standards related to the performance of audits." He also noted that the PCAOB created a research agenda to allow the PCAOB staff to perform "deeper research before embarking on new projects as well as enhancing outreach at all stages."

In 2016, the PCAOB continued to increase its outreach efforts to audit committees to enhance the Board's awareness of audit risks and challenges. The PCAOB also met with preparers, auditors and SEC staff members to understand challenges they have faced in assessments of ICFR. Finally, Mr. Doty noted that the PCAOB was nearing completion of its project to make the auditor's report more informative, and he highlighted some of the benefits that have been expressed by stakeholders in other jurisdictions that have implemented similar requirements.

'[DCF staff] will begin issuing comments on these [transition] disclosures when they are materially deficient.'

– Cicely LaMothe, Associate Director in the Division of Corporation Finance

PCAOB Center for Economic Analysis

Mr. Doty also discussed the PCAOB's efforts to build its capabilities in research and economic analysis through the Center for Economic Analysis (Center). Mr. Doty said the Center is evaluating both the potential effect of proposed rules and the effects of rules and audit standards the PCAOB has issued. "By improving our economic analysis of standards under development, we can have a greater confidence that the benefits of those new standards will justify their costs," he said. Mr. Doty also noted that the Center issued for public comment the PCAOB's first post-implementation review analyzing the effect of Auditing Standard (AS) 7, *Engagement Quality Review*. The Center also is studying many of the potential audit quality indicators on which the PCAOB sought comment in 2015.

Accounting and disclosure matters

New accounting standards

Transition disclosures

Sylvia Alicea, a staff member in OCA, reminded registrants that they need to disclose the effect of adopting new accounting standards in future periods in accordance with SAB Topic 11.M. She said that if a registrant does not know or cannot reasonably estimate the effect that the adoption of a new standard will have on its financial statements, it should make a statement to that effect and consider providing qualitative disclosures to help the reader assess the potential significance of the effect on the registrant's financial statements. These qualitative disclosures should include a description of the new standard's effect on the registrant's accounting policies and provide a comparison to the registrant's current accounting policies.

Jenifer Minke-Girard, Assistant Deputy Chief Accountant in OCA, said that in addition to the requirements of SAB 11.M, companies should consider qualitative disclosures that include a description of the process they are using to assess the effect of the new standard, where they are in the implementation process, what matters still need to be addressed and what additional steps they plan to take.

SEC staff members offered the following observations on transition disclosures:

- A registrant should not be reluctant to disclose reasonably estimable quantitative information (even if it's only for a subset of the registrant's arrangements such as one product category or revenue stream) merely because the ultimate effect of adoption may differ from the information disclosed.
- If a registrant's transition disclosures were prepared based on the best information available at the time and that information subsequently changes, the resulting change in disclosure would likely not indicate the existence of a control deficiency. However, if transitional disclosures are based on information that may subsequently change, the registrant should include a statement that the disclosures are preliminary in nature.
- Transition disclosures should be consistent with other information provided to the audit committee and investors, and the disclosures should be subject to effective ICFR.

How we see it

In addition to the disclosures discussed above, companies should consider the need for Management's Discussion and Analysis (MD&A) disclosures that discuss the effect the standards may have on their business (e.g., expected changes in contract arrangements, effect compliance with debt covenants).

Ernst & Young LLP (EY) resources

- *Financial reporting developments, Revenue from contracts with customers (ASC 606)* (SCORE No. BB3043)

Revenue recognition

Ms. Alicea and Ruth Uejio, staff members in OCA, discussed several matters related to the new revenue standard.

Definition of a contract

Certain contracts may be executed as part of a loss leader strategy in which a good is sold at a loss with an expectation that future sales contracts will result in higher sales and/or profits. In determining whether these anticipated contracts should be part of the accounting for the existing loss leader contract, Ms. Alicea observed that the definition of a contract in ASC 606 is based on enforceable rights and obligations in the existing contract. While it may be likely that the customer will enter into a future contract or the customer may even be compelled economically or by regulation to do so, it would not be appropriate to account for an anticipated contract due to the absence of enforceable rights and obligations.

Contract combination

The combination guidance in ASC 606 explicitly limits which contracts may be combined to those with the same customer or related parties of the customer. The SEC staff objected to extending the contract combination guidance beyond those parties even though other criteria for combination were met.

Consideration paid or payable to a customer

Ms. Uejio discussed accounting under the new revenue standard for payments made to customers. Given there are many reasons why a company may make payments to its customers, the accounting conclusions will depend on specific facts and circumstances. A company must first determine why the payment was made to determine its nature and substance, she said.

The staff in OCA would consider the following questions when evaluating the accounting for payments made to a customer under ASC 606:

- What are the underlying economic reasons for the transaction? Why is the payment being made?
- How did the company communicate and describe the nature of the customer payment to its investors?
- What do the relevant contracts governing the payment stipulate? Does the payment secure an exclusive relationship between the parties? Does the payment result in the customer committing to make a minimum level of purchases from the vendor?
- What is the accounting basis for recognizing an asset or recognizing an up-front payment immediately through earnings?

Once a company has determined the substance of the payment, a company should account for the payment using an accounting model that is consistent with the identified substance of the payment and relevant accounting literature, Ms. Uejio said. In doing this, companies should carefully and impartially evaluate all of the facts and circumstances and establish accounting policies that are consistently applied. In addition, Ms. Uejio expressed her view that matching the cost of the payment to the anticipated future revenue is not a determinative factor to support asset recognition for an up-front payment made to a customer.

Gross versus net presentation

Under the new revenue standard, an entity is a principal and therefore records revenue on a gross basis if it controls a specified good or service before transferring that good or service to the customer. An entity is an agent and records as revenue the net amount it retains for its agency services if its role is to arrange for another entity to provide the goods or services.

Ms. Uejio said that the determination of whether a company is the principal or the agent could be challenging for evolving business models and could be different from the conclusion reached under current US GAAP. In adopting ASC 606, companies should revisit their current principal versus agent conclusions based on whether they control the specified good or service before it is transferred to the customer.

Ms. Uejio cautioned against viewing either gross or net reporting as a default or a safe harbor. Instead, the specific facts and circumstances of an arrangement should drive the final accounting conclusion. Finally, Ms. Uejio said that the disclosures related to the principal versus agent determination are important because they allow investors to understand the registrant's role in the arrangement.

How we see it

Consistent with legacy US GAAP, entities will need to carefully evaluate whether a gross or net presentation is appropriate. While the new standard includes guidance that is similar to legacy GAAP, the key difference is that the new guidance focuses on control of the specified goods and services as the overarching principle for entities to consider in determining whether they are acting as a principal or an agent. This could result in entities reaching different conclusions than they do under legacy GAAP.

SAB Topic 13

Ms. Alicea said SAB Topic 13, *Revenue recognition,* will continue to apply to registrants prior to the adoption of the new revenue standard. However, for implementation-related consultations, the SEC staff's starting point is the new revenue standard, and registrants should apply ASC 606 instead of SAB Topic 13 when evaluating the post-adoption accounting for their revenue arrangements.

Disclosure matters

Cicely LaMothe, Associate Director in DCF, cautioned registrants that the staff will look outside of the financial statements (e.g., investor presentations, earnings releases, financial information reviewed by the chief operating decision maker (CODM)) to determine the adequacy of the disclosures of disaggregated revenue required by ASC 606-10-50 (e.g., disaggregation by type of goods or services, geographical region, customer).

EY resources

- *Technical Line, A closer look at the new credit impairment standard* (SCORE No. 03320-161US)

Credit losses

Sean May, a staff member in OCA, said that, given the wide range of financial assets that are affected by the new standard on credit losses, virtually every registrant will be affected. Mr. May encouraged registrants to start the implementation process early. He said the standard does not specify a "one-size-fits all" method for measuring expected credit losses, and he encouraged registrants to identify challenging implementation issues.

Mr. May also said that the guidance in Financial Reporting Release No. 28[3] and SAB No. 102[4] will continue to be relevant, given the need to incorporate reasonable and supportable forecasts in applying the new standard. He emphasized that in planning for implementation of the new standard, registrants engaged in lending activities should be preparing to support their expected credit loss estimates by documenting the systematic methodology they plan to apply, including the rationale supporting each reporting period's conclusion that these estimates are consistent with the principles of the standard.

Susan Cosper, FASB Technical Director and Chair of its Emerging Issues Task Force, highlighted some implementation activities relating to the credit losses standard. No implementation issues have been submitted for consideration by the TRG to date. The FASB staff has responded to technical inquiries seeking clarification about the standard's requirements, which were mostly confirmatory in nature regarding acceptable methodologies for determining expected credit losses.

Leases

Ms. Cosper discussed questions the FASB has received to date on implementation of the new leases standard, most of which relate to lessee accounting and transition. She said the FASB has not received many questions on the definition of a lease, which was surprising given the increased focus under the new standard on the definition of a lease.

No questions or issues raised to date have required formal standard setting. In the absence of a TRG, Ms. Cosper said a majority of the implementation questions have been raised by representatives of a professional accounting association, but questions also have been raised by large accounting firms and through the FASB's technical inquiry service.

Ms. Uejio said OCA has consulted with registrants on implementation questions and is actively monitoring the activities of stakeholders to understand how implementation issues will be addressed. She encouraged preparers, accounting firms and others to continue to work together to achieve consistent application of the new standard. She also emphasized the importance of ICFR and said it will be a key factor for preparers in arriving at well-reasoned judgments that are grounded in the principles of the new leases standard.

EY resources

Technical Line, A closer look at the new guidance on classifying and measuring financial instruments (SCORE No. BB3145)

Financial instruments recognition and measurement

Brian Staniszewski, a staff member in OCA, shared observations about implementation of the new standard on classifying and measuring financial instruments.[5] The new standard, among other things, requires entities that elect the fair value option in ASC 825, *Financial Instruments*, for financial liabilities, to present the change in fair value caused by a change in instrument-specific credit risk (i.e., the entity's own credit risk) separately in OCI.

Mr. Staniszewski discussed the applicability of the new standard to hybrid financial liability instruments such as a debt obligation that is indexed to the price of gold and requires cash settlement. Rather than bifurcating the embedded gold derivative under ASC 815,[6] the entity makes an irrevocable election under ASC 815[7] to initially and subsequently measure the entire hybrid financial liability at fair value through earnings. Mr. Staniszewski stated that US GAAP does not prescribe a sequence that must be followed when making a fair value election pursuant to ASC 815 or ASC 825. As such, he believes an entity that elects the fair value option under either guidance for an eligible hybrid instrument should follow the presentation requirements in the new guidance related to presenting a change in instrument-specific credit risk. Moreover, because the fair value of the instrument described in the example above would be affected by the price of gold, Mr. Staniszewski believes that use of the "base market risk method" (described in ASC 825-10-45-5) would not faithfully represent the portion of the total change in fair value attributable to instrument-specific credit risk.

Mr. Staniszewski also discussed the application of the new presentation guidance to nonrecourse financial liabilities. A nonrecourse financial liability is an instrument for which the payment is solely tied to the value or cash flows of an asset(s) pledged as collateral. That is, there is no recourse to the debtor. The risk of nonpayment, and the corresponding changes in the financial liability's fair value, are directly affected by the risk attributable to the performance of the underlying assets. In this fact pattern, Mr. Staniszewski believes that no portion of the change in the nonrecourse financial liability's fair value would be attributable to instrument-specific credit risk. Therefore, the entire change in fair value would be reported in earnings.

Insurance disclosures

Craig Olinger, Deputy Chief Accountant in DCF, discussed how insurance companies should present material acquisitions, dispositions and foreign currency in the claims development tables required by Accounting Standards Update (ASU) 2015-09, which does not prescribe specific requirements for such transactions or foreign currency translation.

Mr. Olinger said that retrospectively restating the claims development tables for material acquisitions generally would achieve the objectives of ASU 2015-09 while reflecting the acquisitions prospectively from the acquisition date might not. If registrants nevertheless choose to use a prospective approach to depict the acquired business, separate claims development tables should be presented for the acquired liabilities and the registrants' existing business, said Mr. Olinger. He also stressed that registrants should carefully evaluate the definition of accident year under the new standard, and depicting the year of acquisition as the accident year for acquired liabilities would not be consistent with that definition.

For material dispositions, Mr. Olinger said a retrospective approach that removes the disposed business from the claims development tables would be consistent with the objectives of the new standard to reflect liabilities that exist at the most recent balance sheet date.

As for the effect of foreign currency exchange rates, Mr. Olinger said that recasting all of the data in the claims development tables using current-period exchange rates or presenting separate claims development tables by each functional currency would be consistent with the objectives of the new standard. In his view, the use of multiple foreign currency translation rates may not be appropriate because it could distort trends and other useful information.

Mr. Olinger said insurance companies do not need to continue to disclose a consolidated 10-year claims development table in MD&A once they begin disclosing the claims development tables required by ASU 2015-09, and the staff has updated its Financial Reporting Manual to reflect this view.[8]

Reporting considerations for new standards

Nili Shah, Deputy Chief Accountant in DCF, explained how a company's adoption of a new accounting standard will affect registration statements filed or amended in the year of adoption. In new or amended registration statements filed after reporting the first interim period reflecting adoption of the new standard, companies that use the full retrospective transition method to adopt ASC 606 must provide retrospectively recasted financial statements for the most recent annual periods required to be included (or incorporated by reference). This would not apply if a company uses the modified retrospective method because it does not require recasting any periods before the date of adoption.

While the same requirements also apply to new or amended registration statements filed after a company adopts the leasing standard, the modified retrospective transition provisions in ASC 842, *Leases,* limit recasting to the date of initial application, which is defined as the beginning of the earliest comparative period presented in the year of adoption. As a result, only the most recent two years (one year for a smaller reporting company) would need to be retrospectively revised for purposes of the registration statement.

While the SEC does not intend to change the registration form requirements to eliminate or modify this requirement, the SEC staff did highlight that ASC 250-45-5 related to accounting changes provides an exception if retrospective revision is impracticable. While preclearance would not be required to rely on the exception, DCF-OCA staff is available to discuss fact patterns with companies.

Keith Higgins, Director of DCF, highlighted that the SEC staff would not object if companies and their securities counsel conclude that the adoption of new accounting standards like revenue and leasing are not "fundamental changes" for purposes of drawing on an effective shelf registration statement. A fundamental change would require a post-effective amendment to the shelf registration statement, which would trigger the need to recast as discussed above.

Existing accounting standards

Accounting policies

ASC 250[9] provides guidance on the accounting for and reporting of accounting changes. ASC 250 is clear that once an accounting principle is adopted, it must be used consistently in accounting for similar events and transactions. An entity may change an accounting principle only if it justifies the use of an allowable alternative accounting principle on the basis that it is preferable.

Mr. May said that OCA has had recent consultations with registrants that, unrelated to the adoption of a new ASU, applied an alternative accounting policy to certain new transactions or events. He observed that judgment is required when determining whether transactions or events are clearly different in substance from those occurring in the past and could warrant adoption of a new accounting principle rather than applying an existing accounting principle. Mr. May emphasized the following:

- Clear documentation regarding the nature of the transactions or events that resulted in the existing accounting policy is the starting point of the analysis
- Determining whether transactions or events are clearly different in substance from those occurring in the past requires judgment

- That identifiable differences between certain transactions or events do not necessarily equate to a clear difference in substance that justify applying a new or revised accounting principle

EY resources

- *Financial reporting developments, Equity method investments and joint ventures* (SCORE No. BB02230)
- *Financial reporting developments, Consolidation: Determination of a controlling financial interest and accounting for changes in ownership interests* (SCORE No. BB02856)
- *Technical Line, A closer look at the new definition of a public business entity* (SCORE No. BB2708)

Equity method accounting and the definition of 'public business entity'

US GAAP defines a public business entity (PBE) broadly, saying a business is a PBE if it meets certain criteria including:

> "(a) it is required to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in the filing)."

As a result, equity method investees whose financial statements or summarized financial information are included in a registrant's filing under Regulation S-X, Rule 3-09, *Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons*, Regulation S-X, Rule 3-05, *Financial Statements of Businesses Acquired or to Be Acquired*, or Regulation S-X, Rule 4-08(g), *Summarized Financial Information*), are considered PBEs for the purposes of such financial statements or financial information. This would require those investees to use PBE effective dates for new accounting standards such as ASC 606.[10]

When equity method investees meet the definition of a PBE, Jonathan Wiggins, a staff member in OCA, said that the registrant's equity method accounting should be based on the investees' financial statements prepared using the PBE effective dates of new standards.

Mr. Wiggins said this wouldn't be the case for an equity method investee that doesn't otherwise meet the definition of a PBE such as when a registrant just uses the investee's financial information as a basis for recording equity method earnings or losses. Mr. Wiggins said that "amounts recognized by a registrant in applying the equity method of accounting would not be considered financial information included in a filing with the SEC under the FASB's definition of public business entity." Therefore, such equity method investees would not be required to use the effective dates for PBEs solely for purposes of the registrant's equity method accounting.

Equity method investees that trigger summarized information or separate financial statements will need to apply PBE adoption dates in the registrant's financial statements for purposes of equity method accounting.

How we see it

Rule 4-08(g) requires summarized financial information about equity method investees in the notes to the financial statements if the investees individually or *in the aggregate*, exceed 10% significance under any of the significant subsidiary tests in Rule 1-02(w) of Regulation S-X. For this reason, individually insignificant equity method investees may meet the definition of a PBE if their significance, when considered in the aggregate with the investor's other equity method investments, requires disclosure of summarized financial information to be included in the investor's financial statements (whether such information is presented individually or in the aggregate with other investees).

Joint ventures, strategic alliances and other collaborative-type arrangements

Mr. Wiggins discussed the accounting implications of joint ventures, strategic alliances and other collaborative-type arrangements. He said a company may need to consider several accounting topics to determine the appropriate accounting for these arrangements. In addition, the facts and circumstances of an arrangement can significantly affect the accounting for that arrangement. For example, Mr. Wiggins reminded companies that they should carefully consider whether their conclusions regarding decision-making authority are consistent with the substance of the underlying arrangements and the objective of the consolidation guidance.

Alternatively, when the activities of an arrangement are conducted outside of a legal entity or the entity is not consolidated, Mr. Wiggins encouraged registrants to carefully evaluate the facts and circumstances of the arrangement to identify the applicable accounting guidance. For example, he said a company will need to determine whether an arrangement meets the definition of a joint venture or collaborative arrangement or whether it is in the scope of ASC 606.

Income taxes

Accounting considerations

ASC 740 includes a presumption that all undistributed earnings of a subsidiary will be transferred to the parent entity, resulting in the parent entity accruing taxes on the undistributed earnings[11] unless the parent has sufficient evidence of specific plans such that the remittance to the parent company will be postponed indefinitely.[12]

Mr. Staniszewski said that OCA has questioned registrants when disclosures made outside of the audited financial statements appeared to contradict assumptions relied upon in asserting indefinite reinvestment, and in certain cases, has objected to a deferred tax liability not being recognized. Mr. Staniszewski suggested companies consider coordination among multiple business functions within a company's global organization (e.g., accounting, treasury, tax) when considering the accounting for undistributed earnings.

MD&A disclosure considerations

Ms. Shah expressed concerns about the quality of MD&A disclosures related to income taxes. She said that registrants' income tax disclosures in MD&A often aren't cohesive and don't tell a complete story about the company's tax positions and related trends and uncertainties.

Ms. Shah said that when reviewing the income tax disclosures in MD&A, the staff is primarily looking for robust MD&A disclosures related to:

- Reasons for historical changes in the effective tax rate
- Discussion about changes in reconciling items between the effective and statutory tax rates
- Insight into the extent to which past income tax rates are indicative of future tax rates
- Trends and uncertainties related to changes in unrecognized tax benefits
- Differences between trends in income tax expenses and cash taxes paid

Ms. Shah also said that companies could improve the quality of their MD&A disclosures related to income tax rate reconciliations and cash in foreign jurisdiction that is subject to permanent reinvestment assertions. Ms. Shah also expressed concerns about boilerplate disclosures in MD&A related to changes in valuation allowances on deferred tax assets, particularly when valuation allowances are released. She said companies should provide more specific disclosures about the possible sources of taxable income used to support the reversal of valuation allowances on deferred tax assets.

Discount rates used to measure the interest cost of defined benefit pension plans

Following up on a speech at last year's Conference on the discount rate used to measure the interest cost in defined pension plans, Ms. Uejio said that the SEC staff in OCA consulted on a different fact pattern this year proposing to use the spot rate approach when the yield curve methodology was not used to measure the pension benefit obligation (PBO) but a hypothetical bond matching methodology was used instead.

Recently, the staff objected to the use of the spot rate approach when the yield curve methodology was not used because the measurement of the PBO and the determination of interest cost are integrated concepts, she said. That is, the information used to measure the PBO was not proposed to be used to calculate interest cost. Ms. Uejio said companies should measure the PBO first and then attribute the change in the PBO to the various components of net pension cost, including interest expense. In computing the interest expense, a company should use the same information it used to measure the PBO.

Establishing a grant date for share-based payments

Mr. May discussed the need for careful consideration when determining under ASC 718[13] whether a grant date has been established for share-based payment awards that include key terms or conditions subject to discretion of the compensation committee or the board (e.g., clawback provisions). Mr. May said that when determining whether a mutual understanding has been reached and a grant date has been established, a registrant also should assess the past practices exercised by those with authority over compensation arrangements and how those practices may have evolved over time. As part of this evaluation, Mr. May said registrants should consider whether appropriate ICFR exists to monitor those practices and support the judgment made by the company.

EY resources

- *Financial reporting developments, Segment reporting (SCORE No. BB0698)*

Segment disclosures

Ms. Shah discussed themes in recent staff comments on segment reporting and said segment disclosures continued to be one of the top areas of staff comments in 2016.

Ms. Shah highlighted the following broad categories of recent comments on segments:

- *Identification of operating segments* — The SEC staff generally objects to a company's assertion that a component is not an operating segment because no shared operating costs are allocated to the component. Ms. Shah noted that if gross margins are available for a component, it may indicate that discrete financial information is available to classify a component as an operating segment.

- *Aggregation of operating segments* — Some registrants do not perform a robust analysis for qualitative similarities if their analysis of economic similarities supports the aggregation of operating segments. Ms. Shah emphasized the importance of performing an analysis of qualitative similarities because all the criteria for aggregation must be met. In particular, she said qualitative similarities should be considered in light of the scope and diversity of a company's products and services. Regarding the analysis of economic similarities, she noted that there is no bright line quantitative threshold in ASC 280, and registrants should use reasonable judgment, taking into account their understanding of the business and industry.

Ms. Shah also reminded registrants that they should evaluate all relevant data points when reaching their conclusions on operating segments including the CODM report, organization chart, compensation arrangements and budgeting process.

How we see it

In our latest SEC Comments and Trends publication, segment reporting was the fifth most frequent topic of staff comment during the 12 months ended 30 June 2016, up two spots from seventh in the prior year.

EY resources

- *To the Point, SEC staff updates guidance on non-GAAP financial measures* (SCORE No. 01108-161US)
- *Technical Line, Spotlight on non-GAAP financial measures* (SCORE No. 00785-161US)
- *Technical Line, A closer look at the SEC staff's scrutiny of non-GAAP financial measures* (SCORE No. 03290-161US)

In most cases, the staff is unlikely to object to non-GAAP measures that remove restructuring charges.

Non-GAAP financial measures

The SEC staff has stepped up its focus on non-GAAP measures over the past year. Mr. Higgins reiterated comments made at last year's Conference that the staff is focusing on non-GAAP financial measures because of the growing divergence between these measures and GAAP measures and the emphasis by third parties on non-GAAP measures.

Mark Kronforst, Chief Accountant in DCF, told the audience that the SEC staff is not trying to "eradicate" non-GAAP financial measures. He noted that companies' use of non-GAAP financial measures has improved over the course of the year, especially relating to prominence of their presentation, but that there is still some work to be done.

Mr. Kronforst expressed the staff's views on some specific non-GAAP measures and adjustments.

- *Stock compensation* — Mr. Kronforst indicated that the staff would not object to non-GAAP measures that include adjustments for stock compensation, but that there are best practices companies could follow to determine whether stock compensation adjustments are appropriate (e.g., considering whether stock compensation is integral to understanding the business).

- *Restructuring charges* — Despite recent staff comment letters asking companies whether adjustments for restructuring charges removed recurring cash operating expenses, the staff indicated it is unlikely to object to such adjustments in most cases. Any objections would likely be limited to fact patterns involving the constant monitoring and streamlining of costs to drive efficiency rather than individual "discrete restructuring plans," he said.

- *Business combinations* — Following a business combination, the staff will not object to non-GAAP adjustments that eliminate the effects of recording inventory or deferred revenue at fair value. However, the staff did not offer additional insight into other common non-GAAP adjustments related to business combinations such as acquisition costs or amortization of acquired intangibles.

- *Individually tailored accounting principles* — Mr. Kronforst said the staff has objected to a few types of non-GAAP measures that use individually tailored accounting principles.[14] These measures include those that accelerate revenue recognition, change the number of shares used in calculating earnings per share or alter consolidation principles by presenting financial statement measures using proportionate consolidation, for example. Mr. Kronforst clarified that, in limited situations, companies may make certain adjustments to revenue based on facts and circumstances (e.g., adjustments that reflect the expected effects of ASC 606) and that companies should discuss these adjustments in advance with the staff.

- *Prominence* — Companies' compliance with the rules on the relative prominence of non-GAAP financial measures has improved in recent earnings releases and filings. However, the staff is now issuing comments requesting that companies present the GAAP measure first in the required non-GAAP reconciliation (i.e., reconciling from GAAP to the non-GAAP measure) because presenting the non-GAAP measure first would give it undue prominence.

Mr. Kronforst said that until the staff performs additional outreach and research, it is unlikely to comment on measures with adjustments for certain aspects of pension accounting or unrealized gains or losses on derivatives. As it relates to non-GAAP measures and ASC 280 segment disclosures, companies cannot circumvent the non-GAAP rules by presenting multiple segment measures of profit in their financial statements nor should they present a segment measure of profit when there is only one reportable segment.

Members of a panel on non-GAAP measures also discussed whether non-GAAP measures presented in an earnings release or other communication would need to be included in the subsequent SEC filing (e.g., 10-K or 10-Q). While there is no legal requirement to do so, the consensus was that companies should consider whether the non-GAAP measures are integral to understanding the business through the eyes of management and therefore should be disclosed in MD&A.

Other non-GAAP considerations

Mr. Kronforst said the staff has given companies some flexibility to adjust their non-GAAP measures to conform to the updated interpretations over more than one interim period. This transition period was helpful for companies to give users time to adjust to using the revised non-GAAP measures.

The staff also mentioned that it will not consider changes made to implement the updated interpretations to be a deficiency in the company's prior DCP. However, companies should strengthen their DCP to help prevent future non-compliance. Representatives from the SEC's Division of Enforcement emphasized the importance of DCP and said that non-GAAP measures have become a significant area of focus for them.

Standard setters on non-GAAP

Standard setters within and outside the US are focusing on non-GAAP measures. The FASB and PCAOB are discussing with their advisory committees and stakeholders how and why investors use non-GAAP measures. In addition, Hans Hoogervorst, IASB Chairman, said that IASB members "share the SEC's concern that non-GAAP generally paints a rosier picture of a company's performance than GAAP … non-GAAP measures that consistently flatter a company's performance are probably not the best basis for sound business decisions." He said companies' audit and compensation committees need to challenge whether such measures are used appropriately.

The SEC staff has challenged whether PCAOB inspections findings are also indicative of deficiencies in management's assessment of ICFR.

ICFR, audit standards and independence matters

Internal control over financial reporting

The PCAOB held a number of outreach sessions in 2016 with various stakeholders to continue the dialogue that began in 2015 regarding concerns about ICFR assessments. PCAOB members and staff participated, along with auditors, audit committee members, financial statement preparers and observers from the SEC staff.

In a panel discussion on ICFR, PCAOB member Jay Hanson and Kevin Stout, Senior Associate Chief Accountant in OCA, characterized these discussions as constructive. They noted that while initiatives undertaken in 2015 hadn't yielded all the benefits that were expected due to their timing, progress appears to have been made in a number of areas. As a result, they emphasized the need for ongoing interaction between these parties to improve both the effectiveness and efficiency of ICFR assessments.

As they did at last year's Conference, members of the SEC staff stressed the importance of open and timely communication among management, the auditor and the audit committee regarding risk assessments, the extent of tests of controls and the level of evidence needed to support both management's assessment and the auditor's conclusions on ICFR.

Marc Panucci, who took over recently as Deputy Chief Accountant for Professional Practice in OCA, said that "timely and effective communication between these parties on ICFR remains of continued importance, not only for accurate assessments of ICFR, but also ultimately for more reliable financial reporting for the benefit of investors." Mr. Stout added that this

dialogue is critical to bridging the differences that may exist between management's and the auditor's risk assessments. Mr. Stout also emphasized that this dialogue should occur timely and at an appropriate level of detail to have a meaningful effect on the development of an effective and efficient ICFR audit plan.

ICFR continues to be a significant source of PCAOB inspection findings. Mr. Stout encouraged management and audit committees to view those findings broadly and consider whether they indicate deficiencies in management's processes. Specifically, Mr. Stout asked registrants to consider whether PCAOB inspection findings may indicate that management is:

- Placing unwarranted reliance on controls that are not designed at a sufficient level of precision to address the risk(s) of material misstatement
- Not considering whether the effectiveness of a control depends on the effectiveness of other controls, and properly assessing the effectiveness of those controls
- Improperly concluding on the design and operating effectiveness of certain controls without sufficient evidence

Members of the SEC staff also reminded management, auditors and audit committees that they need to consider ICFR when implementing and adopting new accounting standards, including controls over the transitional disclosures required prior to adoption of new accounting standards. Mr. Panucci stressed that "qualified accounting resources and appropriate processes and controls will be of vital importance in connection with the adoption of the new accounting standards."

How we see it

We continue to support the efforts of the SEC and the PCAOB to encourage dialogue between financial statement preparers, auditors and audit committees to promote more efficient and effective audits of ICFR. We also encourage the PCAOB to continue its efforts with respect to improving its standard-setting process and other outreach efforts.

Implementation and monitoring of new audit standards

Jennifer Todling, a staff member in OCA, stressed the importance of having a wide range of constituents involved in monitoring the implementation of new audit standards. Ms. Todling noted that while auditors will have direct responsibility for implementation, "other stakeholders, including audit committees, management, investors and academics should consider how they can contribute to help maximize the intended benefits and minimize potential unintended consequences of new auditing standards."

Specifically, Ms. Todling emphasized the importance of frequent communication among stakeholders to promote the efficient implementation of new auditing standards and the early identification of challenges. Regulators, including the PCAOB, "should also consider whether they have provided adequate guidance to facilitate successful implementation" and remain engaged with and responsive to stakeholders during the post-implementation period.

Auditor independence matters

Mr. Panucci emphasized that compliance with the auditor independence rules continues to be a significant topic of consultations with OCA, particularly with regard to the adoption and implementation of new accounting standards. The SEC staff has seen an increase in questions about relationships and/or services not specifically prohibited by Rule 2-01(c) of Regulation S-X and that require consideration under the general standard of auditor independence.

Mr. Panucci said these rules are important to keep in mind not only when the audit committee pre-approves permissible non-audit services but also throughout the delivery of the service. As non-audit services are provided, "scope creep" into prohibited services would impair the auditor's independence.

Mr. Panucci emphasized that the growth of audit firms' consulting practices continues to be an important area to monitor as audit quality and independence are critical to investor's confidence in the audit. Mr. Panucci said the PCAOB's recently issued strategic plan identifies the firms' multidisciplinary structure as an emerging threat to auditor independence that the PCAOB will continue to monitor. He added, "A sustainable and viable audit profession is critically important for investors."

Accounting and SEC standard-setting update

FASB Invitation to Comment

Ms. Cosper gave an overview of the responses to the FASB's Invitation to Comment, *Agenda consultation*. The FASB received 45 comment letters, and the majority were from practitioners and preparers. The top priorities cited by the respondents included addressing the complexity of distinguishing liabilities from equity and concerns about the balance sheet classification of intangible assets. She said that users generally believe that reporting performance and cash flows should be a priority. One general concern respondents had was that, given the significant efforts required to implement new accounting standards, the FASB should allocate sufficient resources to practice issues and implementation support. Some respondents said the FASB should slow the pace of accounting change.

Disclosure effectiveness and SEC rulemaking

Regulation S-X and S-K concept releases

Mr. Higgins highlighted the SEC's rulemaking initiatives, particularly in the area of disclosure effectiveness. DCF made significant progress over the last year on disclosure effectiveness initiatives and SEC rulemaking required by the Fixing America's Surface Transportation (FAST) Act. Mr. Higgins noted the issuance of the recent report to Congress as required under the FAST Act with recommendations to modernize and simplify Regulation S-K. He observed that the report is distinct from the broader disclosure effectiveness initiative and does not provide a comprehensive list of changes under consideration to enhance disclosure effectiveness. Based on comment letters received in response to the SEC's Request for Comment, DCF is working on recommendations to the Commission on the rules in Regulation S-X about financial statements for entities other than the registrant.

DCF is also considering feedback on its Regulation S-K concept release. While some respondents favored additional environmental, social and governance (ESG) disclosure requirements, Mr. Higgins said there are diverse views on whether mandating ESG disclosures would be relevant for investors. A separate panel discussed efforts by the Sustainability Accounting Standards Board and other groups to develop standards for ESG disclosures.

Disclosure Update and Simplification Proposing Release (DUSTR)

The SEC staff views DUSTR as a "technical clean up" to remove outdated and redundant disclosure requirements, or refer to the FASB the current SEC disclosure requirements that overlap with US GAAP, without significantly altering the mix of information available to investors. The SEC staff said the level of support for the specific proposals in this release varied significantly. Investors generally asked for more rather than less disclosure, such as in the area of income taxes, while others supported removing substantially all the redundant and duplicative disclosure requirements identified in DUSTR.

Future rulemaking

Looking ahead, Mr. Higgins suggested that the proposed legislation in the Financial CHOICE Act, which has been passed by the House Financial Services Committee, could affect past and future SEC rulemaking. Among other things, the bill calls for repeal of certain disclosures mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act, including those on conflict minerals, mine safety, resource extraction and the CEO pay ratio, in addition to other disclosures not yet adopted by the Commission. The CHOICE Act also would limit compensation clawbacks due to restatements to executives with responsibility for financial reporting, and it would expand exemptions under Section 404(b) of the Sarbanes-Oxley Act.

Interactions with the staff

OCA accounting consultation requests

Ms. Minke-Girard said OCA responded to approximately 125 accounting consultation requests over the past year, half of which came directly from registrants, while the rest came from the other SEC divisions and offices. She also said that approximately 30% of the accounting consultation requests involved smaller registrants and audit firms. She said the top three consultation topics were revenue recognition, business combinations and financial assets.

Division of Corporation Finance process matters

DCF staff provided practical advice about the SEC comment letter process. The staff characterized the comment letter process as a dialogue, observing that a registrant that receives a question from the staff should not necessarily presume that a change is warranted. The staff also recommended that registrants discuss materiality in their responses because the staff will not pursue further action on immaterial items. SEC staff members cautioned companies against analogizing to other registrants' fact patterns in published comment letters because the basis of resolution may not always be apparent from what is publicly available.

'Remember that a comment letter process is a dialogue and don't add disclosures just to end the review.'

– Cicely LaMothe, Associate Director in the Division of Corporation Finance

For transactional filings, the staff recommended that the registrants allow sufficient time for the staff to evaluate significant new information added to filings, which could influence the offering schedule and timing of the road show.

On interpretive and waiver letters submitted to DCF-OCA, the staff recommended that registrants seek the input and feedback of their auditors prior to submission to make the review more efficient. DCF staff is planning to revise their protocol to require the independent auditor be involved in requests to waive or modify financial statement requirements.

International matters

The IFRS footprint and outlook for IFRS

Mr. Hoogervorst thanked Chair White "for the constructive cooperation [between the SEC and the IASB]… and for the considerable time and effort she devoted to [the IASB's] cause." He also noted that the FASB and IASB have a very cordial relationship that will continue in the future.

Mr. Hoogervorst said that three quarters of the G20 countries will be using IFRS when Saudi Arabia adopts the standards in 2017. He added that the number of companies voluntarily using IFRS in Japan is rising and that there have been significant developments in India towards adopting IFRS.

Mr. Hoogervorst also discussed the outlook for the IASB's standard setting over the next 12 months. The IASB is in the process of finalizing its Conceptual Framework and will issue a new insurance contracts standard in the first half of 2017 that is expected to result in more consistent reporting across the globe. He said that with completion of this standard, the IASB will have filled most of the gaps in the IFRS suite of standards and that the IASB will focus in

the next couple of years on improving the current standards. He said the IASB needs to improve the communication value of financial reporting by addressing disclosure effectiveness, performance reporting and changes in how users obtain and use financial information.

Finally, Mr. Hoogervorst noted that the US continues to have an interest in IFRS given its widespread and expanding use around the globe. While IFRS is not required in the US, he noted that US investors have more than $7 trillion dollars invested in companies that report under IFRS.

Foreign private issuers and cross-border reporting challenges

Mr. Olinger said that as of 31 December 2015, about 500 of the approximately 900 foreign private issuers (FPIs) registered with the SEC prepared their financial statements in accordance with IFRS as issued by the IASB, and about 400 FPIs prepared their financial statements in accordance with US GAAP. Very few FPIs prepare financial statements in accordance with home-country GAAP reconciled to US GAAP.

Mr. Olinger said that the staff's comments to companies reporting under IFRS are similar to those it issues to companies reporting under US GAAP. Many of these issues are complex, and the IFRS and US GAAP accounting standards that govern them are converged or largely converged. As a result, he said the staff's comments tend to be driven by the nature of the events or transactions at the company rather than differences in the accounting standards.

Mr. Olinger also shared insights about the staff organization and process when evaluating accounting issues. DCF-OCA's staff and OCA staff are generally organized by accounting topics and not by category of issuers (domestic vs FPI) or by GAAP (US GAAP vs IFRS). He emphasized that the staff is careful to adhere to the IFRS standards when applicable rather than applying a US GAAP bias.

SEC enforcement and PCAOB inspection matters

Remarks of SEC enforcement staff

Andrew Ceresney, Director of the SEC's Division of Enforcement, and Michael Maloney, Chief Accountant in the Division of Enforcement, discussed the SEC's enforcement actions over the past fiscal year. Mr. Ceresney said the SEC filed a record number of cases (868) and ordered over $4 billion of disgorgement and penalties in the fiscal year ended 30 September 2016. Mr. Ceresney said that these enforcement actions involved the full spectrum of the federal securities laws.

Mr. Ceresney said that the Commission continued to enhance its use of data analysis and other tools to identify potential cases of misconduct. In a separate panel discussion, Scott Bauguess, a Deputy Director and Deputy Chief Economist in the SEC's Division of Economic and Risk Analysis, said the SEC has enhanced its data analysis tools to more effectively gather and analyze unstructured data in SEC filings to identify anomalies that may indicate potential fraud or misconduct.

Mr. Maloney discussed enforcement actions related to financial reporting matters and observed that the number and nature of accounting and auditing enforcement cases did not significantly change from the last fiscal year. Mr. Maloney said that these cases were primarily related to allegations of recording unsupported revenues, inappropriate acceleration of revenue recognition, untimely rebate income and expense recognition, understatement of expenses and accrued liabilities, and asset valuation and impairment issues.

Mr. Maloney also said that the SEC has brought enforcement actions against auditors for independence violations involving close personal relationships with management, and for audit failures stemming from a lack of sufficient professional skepticism, overreliance on management representations, and failure to obtain adequate audit evidence.

Mr. Maloney highlighted one recent enforcement action in which fraudulent journal entries to reduce the effective tax rate were masked by complex and convoluted explanations by certain members of management to mislead the auditors. Mr. Maloney emphasized that auditors need to use professional care and seek help from experts as appropriate when dealing with complex accounting areas.

PCAOB inspections

Helen Munter, Director of Registration and Inspections at the PCAOB, said that she believes audit quality is improving as inspection findings continue to trend downward. Ms. Munter stated that audit firms are more engaged, and firms are focusing on timely root cause analyses and taking substantive remedial actions. However, Ms. Munter noted there are still opportunities for improvement in certain areas of recurring inspection findings, including management review controls and other aspects of ICFR, assessing and responding to risks of material misstatement, and auditing accounting estimates, including fair value measurements. Therefore, despite the extensive remedial actions taken by audit firms, "We are approaching a critical point where without elimination or significant reduction of the most troubling recurring findings, firms should not expect that they will be able to satisfy remediation requirements easily," Ms. Munter said.

The PCAOB staff also identified three positive trends during 2016 inspections:

- Auditors are doing a better job of understanding issuers' processes, transactions and controls.
- Auditors are doing a better job of coaching at both the team level and the individual level.
- Firms are doing a better job of monitoring audit team performance during the execution phase of the audit.

Ms. Munter addressed the PCAOB's inspection methodology, noting that it continues to evolve. In 2017, she anticipates the formation of a team of inspectors dedicated to inspecting financial services audits across multiple firms to give the PCAOB the ability to consistently articulate concerns "in an effort to drive rapid remediation efforts in this very challenging area." Ms. Munter also said the PCAOB plans to issue a report summarizing the PCAOB's inspection findings associated with the implementation of AS 2410, *Related Parties*.

Ms. Munter said the PCAOB's 2017 inspections will likely focus on:

- Areas of recurring deficiencies, including ICFR, assessing and responding to risks of material misstatement and auditing accounting estimates, including fair value measurements
- Going concern evaluations
- Audit areas affected by economic risks and higher financial reporting risks, such as those affected by fluctuations in oil and gas prices
- Implementation of the PCAOB's new auditing standard on auditor transparency

- Implementation efforts for new accounting standards, including how firms are managing change and preparing audit teams to evaluate a company's transition, how they are monitoring and maintaining independence in connection with the transition and how they are reporting any concerns about an issuer's readiness to the audit committee

As part of the inspection process, the PCAOB will also inform their standard setting agenda through:

- Gathering information about the auditor's consideration, if any, of a company's use of non-GAAP measures, and what auditors do if a company is more aggressive in its use of these measures
- Gathering information about firms' use of technology in the performance of audits, including data analytics

Endnotes:

---

[1] EY Center for Board Matters, *Audit Committee Reporting to Shareholders in 2016*

[2] Rule 2-01(b) of Regulation S-X.

[3] 401.09.b Procedural Discipline in Determining the Allowance and Provision for Loan Losses to be Reported.

[4] SEC SAB Topic 6.L, Accounting for Loan Losses.

[5] For public business entities (PBEs), ASU 2016-1, *Financial Instruments — Overall (Subtopic 825-10),* is effective for fiscal years beginning after 15 December 2017, including interim periods within those fiscal years. For all other entities, the ASU is effective for fiscal years beginning after 15 December 2018, and interim periods within fiscal years beginning after 15 December 2019. Non-PBEs may adopt the standard as of the effective date for PBEs. Early adoption is permitted for certain provisions, including the provision requiring the presentation of the fair value change from instrument-specific credit risk in Other Comprehensive Income (OCI) for financial liabilities measured using the Fair Value Option(FVO) in ASC 825.

[6] ASC 815-15-25-1.

[7] ASC 815-15-25-4 through 5.

[8] Financial Reporting Manual (Question 11310.1).

[9] ASC 250, *Accounting Changes and Error Corrections*.

[10] ASC 606, *Revenue from Contracts with Customers*.

[11] ASC 740-30-25-3.

[12] ASC 740-30-25-17.

[13] ASC 718-10-30-3.

[14] Compliance and Disclosure Interpretations on Non-GAAP Financial Measures - Question 100.04

EY | Assurance | Tax | Transactions | Advisory

© 2016 Ernst & Young LLP.
All Rights Reserved.

SCORE No. 04331-161US

ey.com/us/accountinglink

About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

Ernst & Young LLP is a client-serving member firm of Ernst & Young Global Limited operating in the US.

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

Appendix — Conference speeches

	Speech and link to source
SEC Chief Accountant, Wesley Bricker	▸ Speech by SEC Chief Accountant: Working Together to Advance High Quality Information in the Capital Markets
SEC Deputy Chief Accountant, Julie Erhardt	▸ Speech by SEC Deputy Chief Accountant: Remarks at the 2016 AICPA National Conference on Current SEC and PCAOB Developments
SEC Deputy Chief Accountant, Marc Panucci	▸ Speech by SEC Deputy Chief Accountant: Remarks before the 2016 AICPA National Conference on Current SEC and PCAOB Developments
SEC Assistant Deputy Chief Accountant, Jenifer Minke-Girard	▸ Speech by SEC Assistant Deputy Chief Accountant: Remarks before the 2016 AICPA National Conference on Current SEC and PCAOB Developments
SEC Associate Chief Accountant, Jonathan Wiggins	▸ Speech by SEC Associate Chief Accountant: Remarks before the 2016 AICPA National Conference on Current SEC and PCAOB Developments
SEC Professional Accounting Fellow, Sylvia Alicea	▸ Speech by SEC Professional Accounting Fellow: Remarks before the 2016 AICPA National Conference on Current SEC and PCAOB Developments
SEC Professional Accounting Fellow, Sean May	▸ Speech by SEC Professional Accounting Fellow: Remarks before the 2016 AICPA National Conference on Current SEC and PCAOB Developments
SEC Professional Accounting Fellow, Brian Staniszewski	▸ Speech by SEC Professional Accounting Fellow: Remarks before the 2016 AICPA National Conference on Current SEC and PCAOB Developments
SEC Professional Accounting Fellow, Jennifer Todling	▸ Speech by SEC Professional Accounting Fellow: Remarks before the 2016 AICPA National Conference on Current SEC and PCAOB Developments
SEC Professional Accounting Fellow, Ruth Uejio	▸ Speech by SEC Professional Accounting Fellow: Remarks before the 2016 AICPA National Conference on Current SEC and PCAOB Developments
PCAOB Chair, James Doty	▸ Speech by PCAOB Chair: PCAOB's Role in Enhancing Public Trust and Integrity in Audits
PCAOB Director of Enforcement, Claudius Modesti	▸ Speech by PCAOB Director of Enforcement: Protecting Investors through Enforcement
FASB Chairman, Russell Golden	▸ Speech by FASB Chairman: Remarks at the 2016 AICPA Conference on Current SEC & PCAOB Developments
IASB Chairman, Hans Hoogervorst	▸ Speech by IASB Chairman: Safety in numbers
CAQ Executive Director, Cindy Fornelli	▸ Speech by CAQ Executive Director: Profession Proud

No. 2016-24
12 October 2016

Technical Line

FASB — final guidance

A closer look at the new credit impairment standard

All entities will need to change the way they recognize and measure impairment of financial assets.

What you need to know

- The FASB issued credit impairment guidance that modifies or replaces existing models for trade and other receivables, debt securities, loans, beneficial interests held as assets, purchased-credit impaired financial assets and other instruments.
- For receivables, loans and held-to-maturity debt securities, entities will be required to estimate expected credit losses, which generally will result in the earlier recognition of credit losses.
- For available-for-sale debt securities, entities will be required to recognize an allowance for credit losses rather than a reduction to the carrying value of the asset.
- Entities will have to make significantly more disclosures, including disclosures by year of origination for certain financing receivables.
- The earliest effective date is 2020 for calendar-year public business entities that meet the definition of an SEC filer. Despite the long lead time, entities should be taking steps now to prepare for the potentially significant changes they will need to make. Early adoption is permitted beginning in 2019.

Overview

The Financial Accounting Standards Board (FASB or Board) issued an Accounting Standards Update (ASU)[1] that significantly changes how entities will account for credit losses for most financial assets and certain other instruments that are not measured at fair value through net income. The new standard will supersede today's guidance and apply to all entities.

Building a better working world

The FASB began working on the new guidance during the global financial crisis in 2008, when concerns were raised that today's guidance delays the recognition of credit losses and is too complex. The FASB initially worked with the International Accounting Standards Board (IASB) to develop converged guidance, but the two Boards ultimately reached different conclusions on certain significant issues. In July 2014, the IASB added new guidance on credit impairment to IFRS 9,[2] its comprehensive standard on accounting for financial instruments that covers recognition and measurement, credit impairment, hedging and other topics. The FASB issued targeted amendments to its guidance on the recognition and measurement of financial instruments, including amendments to the guidance on the impairment of equity investments not measured at fair value, in January 2016.[3] Similar to the new standard on revenue recognition, the FASB has formed a Transition Resource Group for Credit Losses (TRG) to address implementation issues.

The views we express in this publication are preliminary. We may identify additional issues as we analyze the standard and entities begin to interpret it, and our views may evolve during that process.

Summary of the new guidance

The ASU addresses the recognition, measurement, presentation and disclosure of credit losses on trade and reinsurance receivables, loans, debt securities, net investments in leases, off-balance-sheet credit exposures and certain other instruments. It replaces or modifies the guidance in today's US GAAP impairment models.

After implementing the standard, entities will account for credit impairment (also referred to as credit losses) of financial assets and certain other instruments as follows:

- ***Financial assets measured at amortized cost and certain other instruments***. For receivables, loans, held-to-maturity (HTM) debt securities, net investments in leases and off-balance-sheet commitments, entities will be required to use a current expected credit loss (CECL) model to estimate credit impairment. This estimate will be forward-looking, meaning management will be required to use forecasts about future economic conditions to determine the expected credit loss over the remaining life of an instrument. This will be a significant change from today's incurred credit loss model and generally will result in allowances being recognized more quickly than they are today. Allowances that reflect credit losses expected over the life of an asset are also likely to be larger than allowances entities record under today's incurred loss model.

- ***Available-for-sale debt securities.*** For available-for-sale (AFS) debt securities, entities will be required to recognize an allowance for credit losses rather than a direct reduction in the amortized cost of the asset, which is how these credit losses are recognized today. The new approach will allow an entity to reverse a previously established allowance for credit losses when there is an improvement in credit and immediately recognize the amount in the income statement. An entity will no longer be permitted to use the length of time a security has been in an unrealized loss position by itself or in combination with other factors to determine that a credit loss does not exist. Other aspects of today's impairment guidance won't change, including the requirement to use management's best estimate to measure credit losses.

- ***Certain beneficial interests.*** For certain beneficial interests in securitized financial assets that are not of high credit quality, entities generally will follow one of the two impairment models described above, depending on whether the beneficial interest is classified as HTM or AFS.

For items that are excluded from the scope of the new guidance, today's model for loss contingencies in Accounting Standards Codification (ASC) 450-20[4] will generally continue to apply. Specifically, the ASU excludes from its scope loans made to participants in certain employee benefit plans, an insurance entity's policy loan receivables, a not-for-profit entity's pledge receivables and related party loans and receivables between entities under common control. The standard amends the scope of ASC 450-20 to exclude items that are in the scope of the new credit impairment guidance but doesn't change the loss contingencies model.

The standard also eliminates today's accounting for purchased credit impaired (PCI) loans and debt securities in ASC 310-30.[5] Instead, an entity will determine whether all purchased financial assets (not just loans or debt securities) qualify as a purchased financial asset with credit deterioration (PCD asset) and, if that's the case, record the sum of (1) the purchase price and (2) the estimate of credit losses as of the date of acquisition, as the initial amortized cost. Thereafter, the entity will account for PCD assets using the approaches discussed above.

The standard also requires new disclosures, the most significant of which are:

- For financial assets measured at amortized cost, entities will be required to disclose information about changes in the factors that influenced management's estimate of expected credit losses, including the reasons for those changes.
- For most financing receivables[6] and net investments in leases[7] measured at amortized cost, entities will be required to significantly expand their disclosures about credit risk by presenting information that disaggregates the amortized cost basis of financial assets by each credit quality indicator and year of the asset's origination (i.e., vintage) for as many as five annual periods. For example, an entity that uses internal risk grades to monitor the credit quality of its commercial loans will need to disclose, by internal risk grade, the amortized cost basis of its commercial loans at the balance sheet date that were originated in each of the last five years.
- For AFS debt securities, the existing disclosure requirements will be modified to require a rollforward of the new allowance for credit losses on AFS debt securities.

Effective date and transition

The standard sets the following effective dates:

- For public business entities (PBEs) that meet the definition of a US Securities and Exchange Commission (SEC) filer, the standard is effective for annual periods beginning after 15 December 2019, and interim periods therein. That means calendar-year SEC filers will begin applying it in the first quarter of 2020.
- For other PBEs, the standard will be effective for annual periods beginning after 15 December 2020, and interim periods therein. That means calendar-year PBEs that are not SEC filers will begin applying it in the first quarter of 2021.
- For all other entities, the standard will be effective for annual periods beginning after 15 December 2020, and interim periods within annual periods beginning after 15 December 2021. That means these entities that have calendar years will begin applying it in their annual financial statements for 2021 and in interim statements in 2022.

Early adoption is permitted for all entities for annual periods beginning after 15 December 2018, and interim periods therein.

When deciding on the effective dates, the FASB cited the difficulty of implementing several major new standards over the next several years, including those involving revenue recognition and leases. Entities should consider the FASB's definition of an SEC filer when determining which effective date applies to them.

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Overall

Glossary

Securities and Exchange Commission (SEC) Filer

An entity that is required to file or furnish its financial statements with either of the following:

a. The Securities and Exchange Commission (SEC)

b. With respect to an entity subject to Section 12(i) of the Securities Exchange Act of 1934, as amended, the appropriate agency under that Section.

Financial statements for other entities that are not otherwise SEC filers whose financial statements are included in a submission by another SEC filer are not included within this definition.

Entities should be taking steps now to prepare for the potentially significant changes they will need to make.

The standard requires entities to record a cumulative-effect adjustment to the statement of financial position as of the beginning of the first reporting period in which the guidance is effective. For example, a calendar-year company that will adopt the standard in 2020 will record the cumulative effect adjustment on 1 January 2020 and provide the related transition disclosures in its first quarter 2020 Form 10-Q.

How we see it

With more than three years until the first effective date, entities may think they have ample time to implement the standard. But entities should be taking steps now to prepare for the potentially significant changes they will need to make.

Although financial institutions will likely experience the most change, virtually all entities will be affected. For example, entities will need to decide how to identify information (internal or external) that can be used to develop what the FASB calls a "reasonable and supportable" forecast to estimate expected credit losses on receivables, loans, HTM debt securities and other instruments. Further, even though it's unclear to what degree the standard may change the amount recognized as an allowance for entities with trade receivables, they will need to evaluate and modify their existing processes.

---

[1] ASU 2016-13, *Financial Instruments — Credit Losses (Topic 326), Measurement of Credit Losses on Financial Instruments*.

[2] IFRS 9, *Financial Instruments*.

[3] ASU 2016-01, *Financial Instruments — Overall (Subtopic 825-10), Recognition and Measurement of Financial Assets and Financial Liabilities*.

[4] ASC 450-20, *Loss Contingencies*.

[5] ASC 310-30, *Loans and Debt Securities Acquired with Deteriorated Credit Quality*.

[6] ASU 2016-13 defines financing receivables generally as a financing arrangement that is both a contractual right to receive money (on demand or on fixed or determinable dates) and is recognized as an asset on the balance sheet.

[7] ASU 2016-02, *Leases (Topic 842),* defines the net investment in the lease for a sales-type lease as the sum of the lease receivable and the unguaranteed residual asset and the net investment in a direct financing lease as the sum of the lease receivable and the unguaranteed residual asset, net of any deferred selling profit.

Contents

1 **Scope and scope exceptions** 6
- 1.1 The current expected credit loss impairment model (ASC 326-20) 6
- 1.2 The AFS debt security impairment model (ASC 326-30) 8
- 1.3 The model for certain beneficial interests (ASC 325-40) 8
- 1.4 The approach for initially recognizing purchased financial assets with credit deterioration 9

2 **The current expected credit loss model (ASC 326-20)** 10
- 2.1 The expected credit loss objective 10
- 2.2 Based on the asset's amortized cost 13
- 2.3 Reflect losses over an asset's remaining contractual life 16
- 2.4 Consider available relevant information 19
- 2.5 Reflect the risk of loss, even when that risk is remote 27
- 2.6 Measurement considerations for financial assets secured by collateral 30
- 2.7 Other considerations for developing an expected credit loss estimate 33
- 2.8 Interest income 39
- 2.9 Presentation of credit losses 40
- 2.10 Disclosures 41
- 2.11 Considerations for certain instruments 46

3 **The AFS debt security impairment model (ASC 326-30)** 52
- 3.1 Determining whether an AFS debt security is impaired 53
- 3.2 Impairment when an entity intends, or is required, to sell an AFS debt security 54
- 3.3 Assessing whether a credit loss exists 55
- 3.4 Measuring the credit impairment allowance 57
- 3.5 Interest income 61
- 3.6 Disclosures 62
- 3.7 Comparison of impairment models for AFS and HTM debt securities 63

4 **The model for certain beneficial interests (ASC 325-40)** 64
- 4.1 Initial recognition 64
- 4.2 Subsequent measurement 66

5 **Purchased financial assets** 67
- 5.1 Purchased financial assets with credit deterioration 67
- 5.2 Purchased financial assets that don't qualify as PCD assets 79

6 **Transition** 81
- 6.1 Application to purchased financial assets with credit deterioration 81
- 6.2 Application to debt securities with an other-than-temporary impairment 82
- 6.3 Transition disclosures 83
- 6.4 SEC SAB Topic 11.M disclosures 83
- 6.5 Interpretations and further guidance 84
- 6.6 Processes and controls 86
- 6.7 Next steps 86

Appendix: US GAAP vs. IFRS 88

1 Scope and scope exceptions

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Overall

Overview and Background

326-10-05-1

This Topic provides guidance on how an entity should measure credit losses on financial instruments.

326-10-05-2

Topic 326 includes the following Subtopics:

a. Overall

b. Financial Instruments — Credit Losses — Measured at Amortized Cost

c. Financial Instruments — Credit Losses — Available-for-Sale Debt Securities

Scope and Scope Exceptions

326-10-15-1

The guidance in this Subtopic applies to all entities.

The current expected credit loss model applies to most financial assets measured at amortized cost.

The standard applies to all entities and creates or modifies the following approaches to measuring credit impairment generally based on the classification of the financial instrument:

- The current expected credit loss or CECL impairment model (ASC 326-20)
- The AFS debt security impairment model (ASC 326-30)
- The model for certain beneficial interests (ASC 325-40)
- The approach for initially recognizing purchased financial assets with evidence of credit deterioration (included in ASC 326-20 and ASC 326-30)

The instruments to which each of these approaches applies are described in the following sections.

1.1 The current expected credit loss impairment model (ASC 326-20)

The current expected credit loss impairment model in ASC 326-20 replaces the impairment guidance in ASC 310-10 and applies to all of the following instruments that are not measured at fair value:

- Financial assets measured at amortized cost
- Net investments in leases
- Off-balance-sheet credit exposures not accounted for as insurance

1.1.1 Financial assets measured at amortized cost

The current expected credit loss impairment model applies to all financial assets measured at amortized cost, including:

- Financing receivables — A financing receivable is a recognized financial asset that represents a contractual right to receive money on demand or on fixed or determinable dates. Loans and notes receivable are examples.

- HTM debt securities — An HTM debt security means a reporting entity has the positive intent and ability to hold the debt security to maturity. The category includes beneficial interests that are classified as HTM and are not included in the scope of ASC 325-40 because they are of high credit quality.
- Receivables that result from revenue transactions — Receivables that result from revenue transactions within the scope of ASC 606[1] include contract assets as well as trade receivables.
- Reinsurance receivables — These receivables result from insurance transactions within the scope of ASC 944[2] on insurance.
- Receivables that relate to repurchase agreements and securities lending agreements — These receivables primarily relate to reverse repurchase agreements and securities borrowing transactions recognized pursuant to ASC 860.[3]

How we see it

We believe the FASB intended for the current expected credit loss model to apply broadly to financial assets measured at amortized cost. The list of examples provided in the ASU is not all inclusive and entities, including those outside the financial services industry, will need to review their financial statements for financial assets measured at amortized cost that will be subject to this model.

1.1.2 Net investments in leases

The CECL model also applies to a lessor's net investment in sales-type and direct financing leases. Generally, this consists of the lease receivable (the total lease payments discounted using the rate implicit in the lease and any guaranteed residual asset) and any unguaranteed residual asset (the lessor's right to the expected unguaranteed value of the leased asset at the end of the lease). For a direct financing lease, the lease receivable is also net of any deferred selling profit.

The lease receivable is generally considered a financial asset. While the unguaranteed residual asset does not meet the definition of a financial asset, the Board decided that it would be overly complex and provide little benefit to require entities to separately assess the lease receivable (under the ASC 326-20 expected credit loss impairment model) and the unguaranteed residual asset (under ASC 360[4]). Therefore, the entire lease receivable should be measured for credit losses pursuant to the new standard.

1.1.3 Off-balance-sheet credit exposures not accounted for as insurance

The ASU requires entities to measure credit losses using the CECL model for off-balance-sheet credit exposures including credit exposures on off-balance-sheet loan commitments, standby letters of credit, financial guarantees not accounted for as insurance and other similar instruments. However, it excludes instruments in the scope of ASC 815.[5]

---

[1] ASC 606, *Revenue from Contracts with Customers*.
[2] ASC 944, *Financial Services – Insurance*.
[3] ASC 860, *Transfers and Servicing*.
[4] ASC 360, *Property, Plant and Equipment*.
[5] ASC 815, Derivatives and Hedging.

1.1.4 *Items explicitly excluded from the scope of the model*

The Board decided to exclude the following items from the scope of the CECL model:

- Loans made to participants by defined contribution employee benefit plans
- Policy loan receivables of an insurance entity
- Pledges receivable of a not-for-profit entity
- Related party loans and receivables between entities under common control

Impairment of these items will continue to be measured under ASC 450-20.

Refer to Section 2, *The current expected credit loss model (ASC 326-20)*, for more information on how to apply this model to the instruments in its scope.

1.2 The AFS debt security impairment model (ASC 326-30)

The impairment model for AFS debt securities, previously contained in ASC 320 and now in ASC 326-30, applies to debt securities classified as AFS. The model also applies to:

- Beneficial interests (e.g., certain mortgage-backed securities) classified as AFS that are not included in the scope of ASC 325-40 because they are of high credit quality.
- Financial assets (except those that are in the scope of ASC 815-10) that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investments (as these instruments are measured like investments in debt securities classified as AFS, even if they do not meet the definition of a security) pursuant to ASC 860-20-35-2 and 35-3.

Refer to Section 3, *The AFS debt security impairment model (ASC 326-30)*, for more information on how to apply this model to the instruments in its scope.

1.3 The model for certain beneficial interests (ASC 325-40)

Beneficial interests are rights to receive all or portions of specified cash inflows from a trust or other entity. Beneficial interests may be created in connection with securitization transactions such as those involving collateralized debt obligations or collateralized loan obligations.

Beneficial interests subject to the guidance in ASC 325-40 can be either (1) beneficial interests retained in securitization transactions and accounted for as sales under ASC 860 or (2) purchased beneficial interests in securitized financial assets. The ASU modifies the accounting model for beneficial interests in ASC 325-40.

ASC 325-40 applies only to beneficial interests that have all of the following characteristics:

- They are either debt securities under ASC 320[6] or are required by ASC 860 to be accounted for like debt securities.
- They involve securitized financial assets that have contractual cash flows (e.g., loans, receivables, debt securities).
- They do not result in the holder of the beneficial interests consolidating the issuer of those interests.

---

[6] ASC 320, *Investments — Debt and Equity Securities.*

- They are not beneficial interests in securitized financial assets that (1) are of high credit quality and (2) cannot be contractually prepaid or otherwise settled in a way that the holder would not recover substantially all of its recorded investment.

ASC 325-40 provides that beneficial interests guaranteed by the US government, its agencies or other creditworthy guarantors and loans or securities that are sufficiently collateralized to make the possibility of credit loss remote are considered to be of high credit quality.

Additionally, ASC 325-40 currently does not apply to a beneficial interest that is in the scope of ASC 310-30 (a so-called purchased credit impaired asset). However, because ASC 310-30 has been eliminated by the ASU, beneficial interests that are otherwise in the scope of ASC 325-40 that meet the ASU's definition of a PCD asset will now be accounted for pursuant to ASC 325-40.

Refer to Section 4, *The model for certain beneficial interests (ASC 325-40),* for more information on how to apply this model to the instruments in its scope.

1.4 The approach for initially recognizing purchased financial assets with credit deterioration

For purchased financial assets that have experienced a more-than-insignificant deterioration in credit since origination (PCD assets), the standard requires an entity to record as the amortized cost basis the sum of the purchase price and the entity's estimate of credit losses as of the date of acquisition. Thereafter, PCD assets will be in the scope of the CECL impairment model, the AFS debt security impairment model or the model for certain beneficial interests.

Refer to Section 5, *Purchased financial assets,* for more information on how to apply this model to the instruments in its scope.

The following sections describe the accounting for credit losses under each of these models, including key changes from today's guidance and challenges entities will likely face in implementing the new requirements.

2 The current expected credit loss model (ASC 326-20)

ASU 2016-13 replaces today's "incurred loss" model with an "expected loss" model that requires consideration of a broader range of information to estimate expected credit losses over the lifetime of the asset. The primary conceptual differences between these models are as follows:

- Under an incurred model, the loss (or allowance) is recognized only when an event has occurred that causes the entity to believe that a loss is probable (i.e., that it has been "incurred"). Under an expected loss model, the loss (or allowance) is recognized upon initial recognition of the asset, in anticipation of a future event that will lead to a loss being realized, regardless of whether the future event is probable of occurring.
- Under an incurred model, the loss is generally estimated considering past events and current conditions. Under an expected loss model, management must include in its estimate its expectations of the future.

2.1 The expected credit loss objective

The standard does not define the term "expected credit loss," commonly referred to as the current expected credit loss or CECL model. Rather, the standard says the allowance for expected credit losses is intended to achieve a net asset measurement on the balance sheet that reflects the "net amount expected to be collected." The standard also does not define what is meant by the phrase "net amount expected to be collected." Instead the Board has articulated a credit loss objective.

The allowance for expected credit losses represents the portion of the amortized cost of a financial asset that an entity does not expect to collect.

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Initial Measurement

326-20-30-1

The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial asset(s) to present the net amount expected to be collected on the financial asset. At the reporting date, an entity shall record an allowance for credit losses on financial assets within the scope of this Subtopic. An entity shall report in net income (as a credit loss expense) the amount necessary to adjust the allowance for credit losses for management's current estimate of expected credit losses on financial asset(s).

In other words, the allowance for credit losses should represent the portion of the amortized cost basis of a financial asset that an entity does not expect to collect. The standard is best understood when considering the following core concepts that illustrate the Board's objective.

Objective

Recognize an allowance for credit losses that results in the financial statements reflecting the net amount expected to be collected from the financial asset

Core concepts

Based on an asset's amortized cost	Reflect losses over an asset's contractual life	Consider available relevant information	Reflect the risk of loss

The current expected credit loss estimate should:

- Be based on an asset's amortized cost
- Reflect losses expected over the remaining contractual life of an asset, recognizing that voluntary prepayments reduce credit losses
- Consider available relevant information about the collectibility of cash flows, including information about past events, current conditions, and reasonable and supportable forecasts
- Reflect the risk of loss, even when that risk is remote, meaning that an estimate of zero credit loss would be appropriate only in limited circumstances

The standard permits companies to use estimation techniques that are practical and relevant to their circumstances, as long as they are applied consistently over time and aim to faithfully estimate expected credit losses using the concepts listed above. The standard requires management to apply judgment when estimating expected credit losses.

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Initial Measurement

326-20-30-3

The allowance for credit losses may be determined using various methods. For example, an entity may use discounted cash flow methods, loss-rate methods, roll-rate methods, probability-of-default methods, or methods that utilize an aging schedule. An entity is not required to utilize a discounted cash flow method to estimate expected credit losses. Similarly, an entity is not required to reconcile the estimation technique it uses with a discounted cash flow method.

Implementation Guidance and Illustrations

326-20-55-7

Because of the subjective nature of the estimate, this Subtopic does not require specific approaches when developing the estimate of expected credit losses. Rather, an entity should use judgment to develop estimation techniques that are applied consistently over time and should faithfully estimate the collectibility of the financial assets by applying the principles in this Subtopic. An entity should utilize estimation techniques that are practical and relevant to the circumstance. The method(s) used to estimate expected credit losses may vary on the basis of the type of financial asset, the entity's ability to predict the timing of cash flows, and the information available to the entity.

The standard does not prescribe approaches for estimating the allowance for expected credit losses. Rather, the Board decided that, given the subjective nature of the estimate, an entity should use judgment to develop an approach that faithfully reflects expected credit losses for financial assets and can be applied consistently over time. The standard lists, but does not define, several common credit loss methods that should continue to be acceptable under the new guidance, including:

- Discounted cash flow (DCF) methods
- Loss-rate methods
- Roll-rate methods
- Probability-of-default (PD) and loss-given-default (LGD) methods

- Methods that use an aging schedule (which are commonly used today for allowances for bad debts on trade accounts receivable)

All of these methods are used today with many different variations. Although the ASU says these methods would be acceptable under the new guidance, these methods will need to be adjusted to account for the differences between an incurred loss model and the CECL model. The adjustments will be required to provide an estimate of expected credit losses over the remaining contractual life of an asset and should be able to incorporate reasonable and supportable forecasts about future economic conditions and the effect of those conditions on historical loss information.

Bank regulatory perspectives

The US banking regulators issued a Joint Statement on the New Accounting Standard on Financial Instruments — Credit Losses[7] (Joint Statement) on 17 June 2016 to provide initial information about the new standard to banks, savings associations, credit unions and financial institution holding companies of all sizes.

The Joint Statement said: "The new accounting standard does not specify a single method for measuring expected credit losses; rather, institutions should use judgment to develop estimation methods that are well documented, applied consistently over time, and faithfully estimate the collectability of financial assets by applying the principles in the new accounting standard."

"The new accounting standard allows expected credit loss estimation approaches that build on existing credit risk management systems and processes, as well as existing methods for estimating credit losses (e.g., historical loss rate, roll-rate, discounted cash flow, and probability of default/loss given default methods). However, certain inputs into these methods will need to change to achieve an estimate of lifetime credit losses. For example, the input to a loss rate method would need to represent remaining lifetime losses, rather than the annual loss rates commonly used under today's incurred loss methodology. In addition, institutions would need to consider how to adjust historical loss experience not only for current conditions as is required under the existing incurred loss methodology, but also for reasonable and supportable forecasts that affect the expected collectability of financial assets."

How we see it

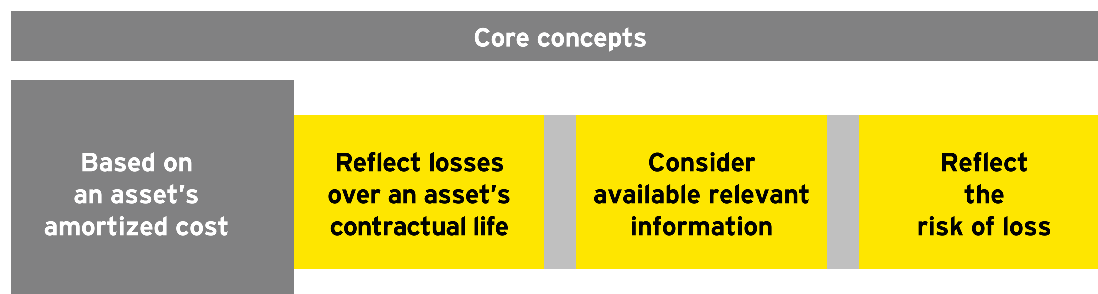
During the FASB's deliberations, certain constituents cautioned against taking a rules-based approach that would explicitly define expected credit losses and require entities to consider the time value of money. These constituents asked the FASB to strike a balance between providing enough guidance to make the objective clear and articulating the accounting model in a way that gives entities the flexibility to develop reasonable methods, considering cost/benefit limitations on data availability, forecasting and loss modeling.

Given the flexibility provided by the new guidance, we expect an implementation challenge to be determining whether certain modeling approaches are too simple to satisfy the Board's objective.

---

[7] Joint Statement on the New Accounting Standard on Financial Instruments — Credit Losses, Issued by the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration and Office of the Comptroller of the Currency on 17 June 2016.

2.2 Based on the asset's amortized cost



The standard requires the allowance for credit losses estimated by entities to be based on the underlying financial instrument's amortized cost basis.

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

General

326-20-30-4

If an entity estimates expected credit losses using methods that project future principal and interest cash flows (that is, a discounted cash flow method), the entity shall discount expected cash flows at the financial asset's effective interest rate. When a discounted cash flow method is applied, the allowance for credit losses shall reflect the difference between the amortized cost basis and the present value of the expected cash flows. If the financial asset's contractual interest rate varies based on subsequent changes in an independent factor, such as an index or rate, for example, the prime rate, the London Interbank Offered Rate (LIBOR), or the U.S. Treasury bill weekly average, that financial asset's effective interest rate (used to discount expected cash flows as described in this paragraph) shall be calculated based on the factor as it changes over the life of the financial asset. Projections of changes in the factor shall not be made for purposes of determining the effective interest rate or estimating expected future cash flows.

326-20-30-5

If an entity estimates expected credit losses using a method other than a discounted cash flow method described in paragraph 326-20-30-4, the allowance for credit losses shall reflect the entity's expected credit losses of the amortized cost basis of the financial asset(s) as of the reporting date. For example, if an entity uses a loss-rate method, the numerator would include the expected credit losses of the amortized cost basis (that is, amounts that are not expected to be collected in cash or other consideration, or recognized in income). In addition, when an entity expects to accrete a discount into interest income, the discount should not offset the entity's expectation of credit losses. An entity may develop its estimate of expected credit losses by measuring components of the amortized cost basis on a combined basis or by separately measuring the following components of the amortized cost basis, including both of the following:

a. Amortized cost basis, excluding premiums, discounts (including net deferred fees and costs), foreign exchange, and fair value hedge accounting adjustments (that is, the face amount or unpaid principal balance)

b. Premiums or discounts, including net deferred fees and costs, foreign exchange, and fair value hedge accounting adjustments.

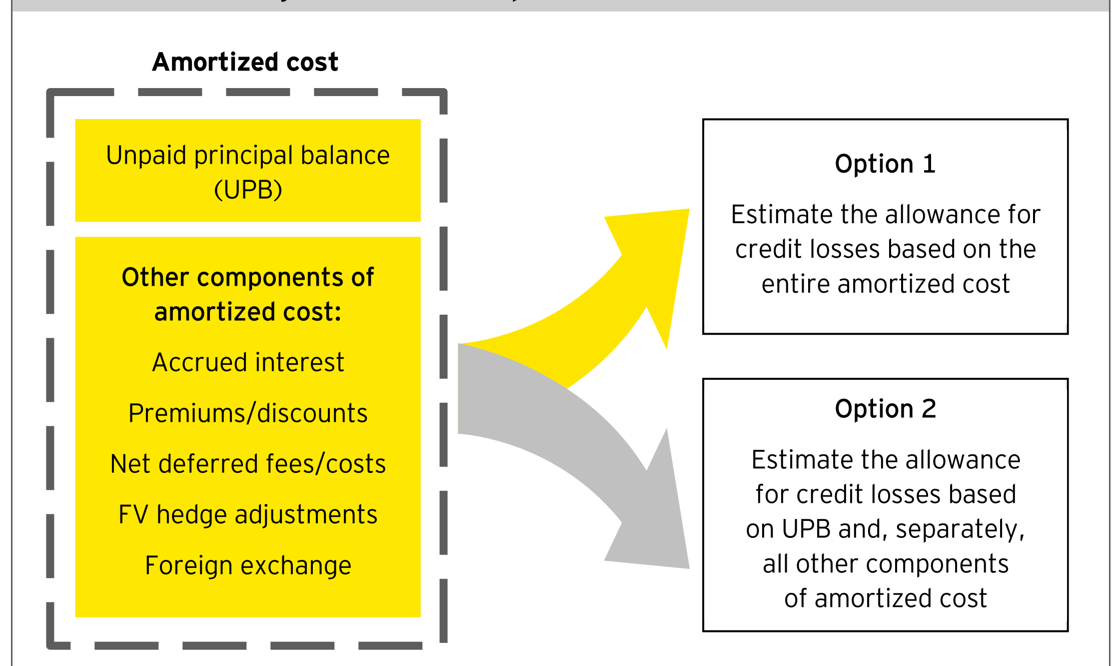
Glossary

Amortized Cost Basis

The amortized cost basis is the amount at which a financing receivable or investment is originated or acquired, adjusted for applicable accrued interest, accretion, or amortization of premium, discount, and net deferred fees or costs, collection of cash, writeoffs, foreign exchange, and fair value hedge accounting adjustments.

Regardless of how an entity determines the allowance, the standard requires credit losses to reflect expected losses of the amortized cost basis of an asset. An entity can develop that estimate based on the entire amortized cost of the asset. The standard also permits an entity to develop an estimate of expected credit losses by measuring components of the amortized cost separately or on a combined basis, as highlighted in ASC 326-20-30-5 and illustrated below. We understand that the FASB included this guidance to allow entities to use their current systems to make the estimate. That is, because some entities currently have systems that estimate their allowance on the unpaid principal balance, the FASB allowed entities to separately consider the components of amortized cost. Whichever approach is used, the objective is to recognize an allowance for credit losses that results in the financial statements reflecting the net amount expected to be collected from the financial asset.

Illustration 1 — Basing the estimate of expected credit losses on an asset's amortized cost



Although the ASU requires the estimate to be based on a financial asset's amortized cost, it also says that when an entity expects to accrete a discount into interest income, the discount should not offset the entity's expectation of credit losses. For example, currently some entities do not recognize any allowance at initial recognition when the amount of discount is greater than the calculated allowance (even though the discount is accreted over time). These entities recognize an allowance when the discount is accreted to an amount that is less than the required allowance. Under the new guidance, in such situations the estimate of credit loss would not be based on the total amortized cost of the financial asset, since you would ignore the discount component of the amortized cost in estimating the allowance.

How we see it

An entity's loss history could include only write-offs of the unpaid principal balance, or it could include all components of amortized cost (e.g., premiums, discounts, net deferred fees and costs). If only the unpaid principal balance write-offs are considered in an entity's loss history, adjustments would need to be made to make sure all elements of amortized cost are considered in the allowance estimate. We understand that some entities today apply historical loss rates to unpaid principal balances and then assess the need for additional allowances on the remaining components of amortized cost. The standard allows these practices to continue.

2.2.1 Effective interest rate when using DCF models

Although the standard does not mandate the use of certain loss estimation models, it does say that when an entity uses a DCF model, under which expected cash flows are forecasted and then discounted to a present value, the cash flows should be discounted using the financial asset's original effective interest rate. The following illustrates one way an entity might use a DCF approach to estimate the allowance for credit losses on an individual financial asset.

Illustration 2 — Estimating credit losses using a DCF approach

Assume that at 31 December 20X0, Company A originates a note receivable with the following characteristics:

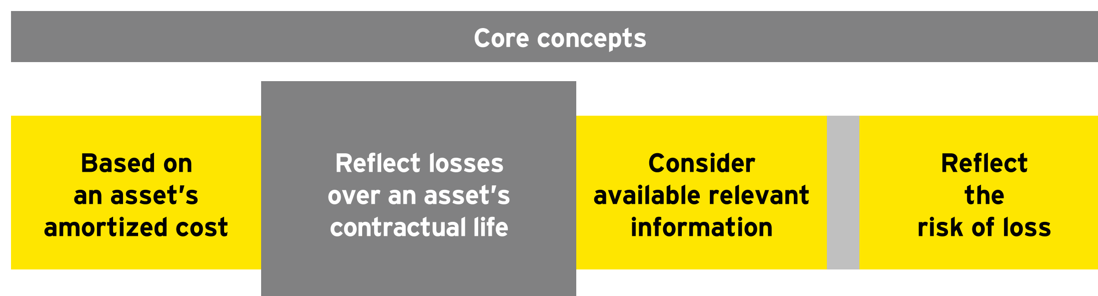
- Par value (or unpaid principal balance) of $1,000,000
- Contractual interest rate of 10%
- Amortized cost of $980,000
- Effective interest rate of 10.64%

The note matures on 31 December 20X4 with the contractual cash flows presented below in the first column. Company A uses the concepts in ASU 2016-13 to estimate the cash flows it expects to receive, which are shown in the table below. Company A estimates the allowance on the note using the guidance in ASC 326-20-30-4 as follows:

	Contractual cash flows	Estimated expected cash flows
31 December 20X1	$ 100,000	$ 95,000
31 December 20X2	100,000	95,000
31 December 20X3	100,000	95,000
31 December 20X4	1,100,000	1,060,000
Total gross cash flows	$1,400,000	$1,345,000
Present value of cash flows discounted at 10.64%		$ 941,010
Amortized cost basis		980,000
Difference between the amortized cost basis and the present value of the expected cash flows		$ 38,990

Based on the expected cash flows forecasted by management, Company A would recognize an allowance for credit losses of $38,990 as of 31 December 20X0.

2.3 Reflect losses over an asset's remaining contractual life



Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Initial Measurement

326-20-30-6

An entity shall estimate expected credit losses over the contractual term of the financial asset(s) when using the methods in accordance with paragraph 326-20-30-5. An entity shall consider prepayments as a separate input in the method or prepayments may be embedded in the credit loss information in accordance with paragraph 326-20-30-5. An entity shall consider estimated prepayments in the future principal and interest cash flows when utilizing a method in accordance with paragraph 326-20-30-4. An entity shall not extend the contractual term for expected extensions, renewals, and modifications unless it has a reasonable expectation at the reporting date that it will execute a troubled debt restructuring with the borrower.

The standard states that expected credit losses should reflect losses expected over the contractual life of an asset, with two important clarifications:

- Prepayments reduce potential loss by shortening the time period over which the lender (investor) is expected to be exposed to credit losses to a period of time less than the full contractual term. As a result, the estimate of expected credit losses should reflect expected prepayments.
- The life of an asset generally should not include extensions, renewals and modifications that would extend the expected remaining life beyond the contractual term, unless the entity has a reasonable expectation that it will execute a troubled debt restructuring (TDR) with the borrower, as discussed later. As a result, future losses that could result from an extension should only be considered in the estimate of expected credit losses when there is a reasonable expectation of a TDR.

These clarifications are intended to result in an estimate of expected credit losses that reflects losses expected over the remaining period of time that the lender is expected to be exposed to losses on outstanding borrowings.

2.3.1 Prepayments

Prepayments reduce an entity's outstanding credit exposure (e.g., amortized cost outstanding in any given year). If these prepayments had not occurred, total losses on the portfolio might have been higher. An entity needs to understand how prepayments affect its historical loss statistics, and the guidance in paragraph ASC 326-20-30-6 explains the treatment of prepayments under both a DCF approach (i.e., ASC 326-20-30-4) and a non-DCF approach (i.e., ASC 326-20-30-5).

How to consider prepayments when estimating expected credit losses

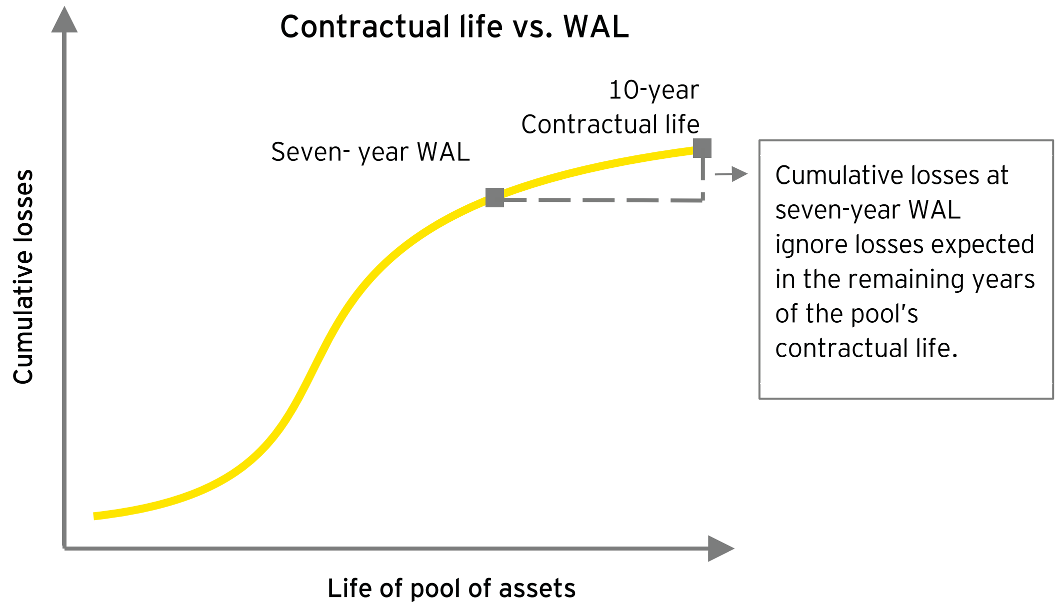
When using an approach that discounts expected cash flows	When using an approach that does not rely on discounted expected cash flows
▸ Prepayments can be reflected in the timing and amount of future cash flows used as inputs into the DCF calculation	▸ Prepayments can be embedded in the historical credit loss statistics used to estimate expected credit losses ▸ Prepayments can be a separate input in the approach or method used to estimate expected credit losses

We believe there is a difference between estimating losses over the contractual life of a pool of assets, recognizing that prepayments reduce loss, and using the weighted average life (WAL) of the pool of assets (i.e., the typical duration for the product). Illustration 3 below shows this difference.

Estimating losses on a pool of assets over the pool's weighted average life will ignore losses that occur later in the contractual life on assets that aren't prepaid.

Illustration 3 — Contractual life versus WAL considering prepayments

This illustration depicts the cumulative losses of a pool of assets with a 10-year contractual life and a seven-year WAL (i.e., the weighted average duration of this pool of assets based on the entity's past prepayment experience with similar loans). If expected credit loss is calculated only on the WAL, there is an element of credit risk in the later years of the pool's life that is not considered.



How we see it

Estimating losses over the contractual life of an asset rather than the WAL is more consistent with the Board's objective because it reflects the risk of losses occurring late in the life of an asset. However, it is not clear whether estimating losses over the WAL of an asset combined with other adjustments would meet the objective of the standard.

This isn't an issue under today's guidance, which doesn't require a lifetime loss estimate for non-impaired financial assets.

2.3.2 *Extensions, renewals and modifications*

As noted above, the ASU provides that the contractual term over which credit losses are established shouldn't include expected extensions, renewals and modifications. However, an exception is provided when an entity reasonably expects to execute a TDR with the borrower in the future. In those circumstances, the entity's estimate of credit losses should cover the expected life of the loan, including extensions, modifications and renewals. For example, if commercial real estate values have declined significantly, borrowers in commercial real estate loans may experience financial difficulty and may be unable to meet the terms of their contracts. If it is reasonably expected that the lender will modify the loan by executing a TDR, the expected extension period would be considered part of the life of a loan for purposes of estimating expected credit losses. To determine whether a TDR is reasonably expected, the lender would need to evaluate its past history and whether it expects a borrower to be able to refinance the loan on similar terms with another lender. This exception for "reasonably expected" TDRs is consistent with the Board's view that a loan that is modified in a TDR is a continuation of the original loan, not a new loan.

How we see it

By using the words "reasonable expectation" and "with the borrower," we believe the FASB is indicating that entities need to have expectations that they will execute TDRs that are more precise than general forecasts. For example, an entity may not have this type of expectation when it offers a program modification with more favorable terms to a large group of borrowers. That's because the entity wouldn't be able to identify the loans it reasonably expects to restructure in a TDR, even though it may have a general sense of the percentage of loans it will restructure in TDRs. However, as time passes, the entity should be able to develop an expectation at a more granular level.

2.3.3 *Modeling considerations*

In modeling credit losses under today's guidance, most entities pool financial assets without regard to remaining term to maturity. This is because today's guidance doesn't require an estimate of credit losses over the remaining life of a loan unless that loan's credit quality has deteriorated to the point where the loan is considered impaired under ASC 310-10. One question that has arisen is whether pooling assets with varying remaining terms to maturity and estimating losses over a WAL is an acceptable alternative to segregating financial assets by remaining term to maturity. The following illustration shows the potential differences between these two approaches.

Illustration 4 — Remaining contractual life versus WAL for a pool of assets

This illustration shows the difference between estimating expected credit losses using the contractual remaining life of individual assets in a pool and using the WAL of the assets in the pool.

Description	Amortized cost	Remaining life (years)	Rating	Cumulative PD	LGD	Expected credit loss
Contractual life calculation						
Loan #1	$ 1,000,000	1	A	0.095	20%	$ 190
Loan #2	$ 1,000,000	3	A	0.584	20%	1,168
Loan #3	$ 1,000,000	5	A	1.244	20%	2,488
						$ 3,846
WAL calculation						
Loan pool average	$ 3,000,000	3	A	0.584	20%	$ 3,504
				Difference		$ 342

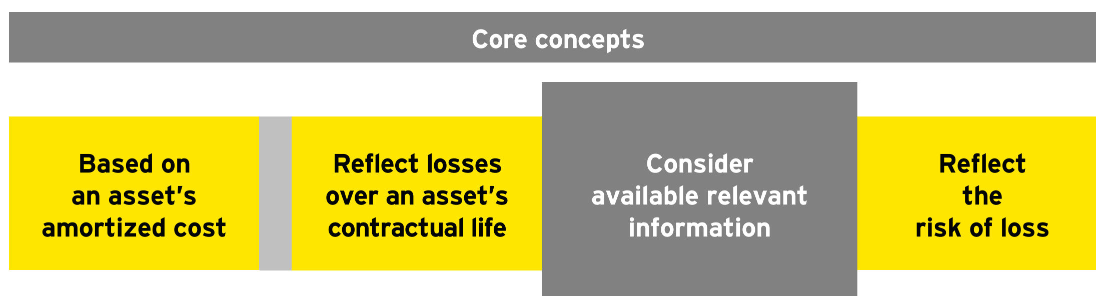
Expected credit loss is calculated considering the number of years until each individual loan matures and applying the PD that corresponds to the remaining life of the loan. (Note that PDs vary, based on the length of time to maturity.) For example, Loan #1 has one year until maturity and an associated PD of 0.095 (based on historical experience adjusted for current conditions and reasonable and supportable forecasts), which results in an expected loss of $190 for that individual loan. By adding each loan's expected credit loss based on the contractual years to maturity, the entity would calculate its total expected loss for the pool as $3,846.

However, the amount of the expected credit loss will be different if it is calculated based on the WAL of the pool. The pool has a three-year weighted average remaining life and an associated three-year PD of 0.584. This results in a total expected credit loss for the pool of $3,504. That is, in this example, there is a difference of $342 or approximately 9% between the expected credit loss using the WAL and the expected credit loss using the individual contractual lives of each loan in the pool.

How we see it

As Illustration 4 shows, there could be a significant difference between these two approaches. As indicated above, we believe one of the more challenging aspects of implementing the ASU will be determining which modeling simplifications are appropriate and faithfully represent the concepts described by the FASB.

2.4 Consider available relevant information



The standard requires an entity's estimate of expected credit losses to reflect available information that is relevant to assessing the collectibility of cash flows. Entities should consider information about past events, current conditions and forecasts about the future that are reasonable and supportable. This may include information that is (1) internal or external, (2) qualitative or quantitative and (3) related to the specific borrower or the broader environment in which the entity operates (e.g., the macroeconomic environment).

Bank regulatory perspectives

The Joint Statement states that "to implement the new accounting standard, institutions should collect data to support estimates of expected credit losses in a way that aligns with the method or methods that will be used to estimate their allowances for credit losses. Depending on the method selected, institutions may need to capture additional data. Institutions also may need to retain data longer than they have in the past on loans that have been paid off or charged off."

In a significant change from today's guidance, the ASU requires an entity to incorporate reasonable and supportable forecasts in its estimate of expected credit losses. Because it's more difficult to accurately forecast the future over longer time horizons, the new standard requires entities to use forecasts only if they are reasonable and supportable. While some entities may be able to develop reasonable and supportable forecasts for longer periods than other entities, we do not believe it will be acceptable for an entity to say it cannot develop such a forecast and just use historical losses.

The standard states that an entity is only required to use information that is "reasonably available without undue cost and effort." The standard also says that internal information may be more relevant than external information.

How we see it

A question that we believe will need to be addressed is whether it is acceptable for management to take a contrarian view of the future when establishing its allowance. For example, if the ASU had been in effect in 2007 and a bank's management had forecasted that a global economic crisis would begin in 2008, most "experts" at the time likely would have disagreed with that forecast.

We believe that the FASB intended for management to use its expectation of the future when estimating credit losses, regardless of whether that is a contrarian view, as long as the forecast is reasonable and supportable. What is reasonable and supportable will be a matter of judgment. We generally believe the terms "reasonable" and "supportable" provide parameters around the types of forecasted information that is acceptable in an estimate of expected credit loss. Clearly, a forecast that is either unreasonable or unsupportable would not be acceptable. Entities will have different forecasts of the future and as long as they are reasonable and supportable, they will be acceptable.

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Initial Measurement

326-20-30-7

When developing an estimate of expected credit losses on financial asset(s), an entity shall consider available information relevant to assessing the collectibility of cash flows. This information may include internal information, external information, or a combination of both

relating to past events, current conditions, and reasonable and supportable forecasts. An entity shall consider relevant qualitative and quantitative factors that relate to the environment in which the entity operates and are specific to the borrower(s). When financial assets are evaluated on a collective or individual basis, an entity is not required to search all possible information that is not reasonably available without undue cost and effort. Furthermore, an entity is not required to develop a hypothetical pool of financial assets. An entity may find that using its internal information is sufficient in determining collectibility.

The standard provides guidance in the following areas to assist an entity in considering relevant information:

- Obtaining relevant historical loss information
- Assessing current conditions
- Developing reasonable and supportable forecasts about the future
- Adjusting for current conditions and reasonable and supportable forecasts

2.4.1 Obtaining relevant historical loss information

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Initial Measurement

326-20-30-8

Historical credit loss experience of financial assets with similar risk characteristics generally provides a basis for an entity's assessment of expected credit losses. Historical loss information can be internal or external historical loss information (or a combination of both). An entity shall consider adjustments to historical loss information for differences in current asset specific risk characteristics, such as differences in underwriting standards, portfolio mix, or asset term within a pool at the reporting date or when an entity's historical loss information is not reflective of the contractual term of the financial asset or group of financial assets.

Implementation Guidance

326-20-55-2

In determining its estimate of expected credit losses, an entity should evaluate information related to the borrower's creditworthiness, changes in its lending strategies and underwriting practices, and the current and forecasted direction of the economic and business environment. This Subtopic does not specify a particular methodology to be applied by an entity for determining historical credit loss experience. That methodology may vary depending on the size of the entity, the range of the entity's activities, the nature of the entity's financial assets, and other factors.

326-20-55-3

Historical loss information generally provides a basis for an entity's assessment of expected credit losses. An entity may use historical periods that represent management's expectations for future credit losses. An entity also may elect to use other historical loss periods, adjusted for current conditions, and other reasonable and supportable forecasts. When determining historical loss information in estimating expected credit losses, the information about historical credit loss data, after adjustments for current conditions and reasonable and supportable forecasts, should be applied to pools that are defined in a manner that is consistent with the pools for which the historical credit loss experience was observed.

The guidance states that historical information about losses generally provides a basis for the estimate of expected credit losses. That is, historical credit loss experience for similar assets is likely a relevant data point for estimating the credit losses that will emerge for assets currently held by the entity.

The standard doesn't specify a particular approach for determining an entity's historical credit loss information. However, the implementation guidance indicates that it is important that the historical loss information (after adjustments for current conditions and reasonable and supportable forecasts) be applied to pools that are defined in a manner that is consistent with the pools for which the historical credit loss experience was observed. For example, if an entity is estimating expected credit losses on its portfolio of five-year auto loans to borrowers with prime Fair Isaac Company (FICO) scores, one would generally expect that the historical information used in that estimate to reflect information for five-year auto loans to borrowers with prime FICO scores.

Management will need to consider the historical time period and any required adjustments to reflect current expectations of lifetime credit loss (i.e., current conditions and reasonable and supportable forecasts). For example, if management expects an economic downturn, it might either:

- Use historical credit loss information reflecting a downturn in a previous economic cycle
- Use long-term historical credit loss statistics that include an economic cycle, and adjust those statistics for its assessment of current conditions (including the current point in the economic cycle) and the forecasted direction of the economic cycle

We believe management's choice between these or other alternatives would likely be influenced by data availability and how management judges its ability to estimate the current point in the economic cycle and correlate it to previous economic cycles.

How we see it

Entities will need to evaluate the contractual lives of their products and determine whether they possess sufficient historical data to meet the new standard's objective of estimating lifetime expected losses. Today, many loss rate and PD methods for loss estimation under ASC 450 use an annual loss rate or a 12-month PD, which would be inconsistent with the objective of estimating expected credit losses over the contractual life of an asset if that period is longer than 12 months. Under the expected credit loss model, a lifetime loss will be booked upon origination or purchase of the asset.

2.4.2 *Assessing and adjusting for current conditions and reasonable and supportable forecasts*

Assessing and adjusting historical loss information for current conditions and reasonable and supportable forecasts generally will require an entity to perform the following steps:

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Initial Measurement

326-20-30-9

An entity shall not rely solely on past events to estimate expected credit losses. When an entity uses historical loss information, it shall consider the need to adjust historical information to reflect the extent to which management expects current conditions and reasonable and supportable forecasts to differ from the conditions that existed for the period over which historical information was evaluated. The adjustments to historical loss information may be qualitative in nature and should reflect changes related to relevant data (such as changes in unemployment rates, property values, commodity values, delinquency, or other factors that are associated with credit losses on the financial asset or in the group of financial assets). Some entities may be able to develop reasonable and supportable forecasts over the contractual term of the financial asset or a group of financial assets. However, an entity is not required to develop forecasts over the contractual term of the financial asset or group of financial assets. Rather, for periods beyond which the entity is able to make or obtain reasonable and supportable forecasts of expected credit losses, an entity shall revert to historical loss information determined in accordance with paragraph 326-20-30-8 that is reflective of the contractual term of the financial asset or group of financial assets. An entity shall not adjust historical loss information for existing economic conditions or expectations of future economic conditions for periods that are beyond the reasonable and supportable period. An entity may revert to historical loss information at the input level or based on the entire estimate. An entity may revert to historical loss information immediately, on a straight-line basis, or using another rational and systematic basis.

326-20-55-4

Because historical experience may not fully reflect an entity's expectations about the future, management should adjust historical loss information, as necessary, to reflect the current conditions and reasonable and supportable forecasts not already reflected in the historical loss information. In making this determination, management should consider characteristics of the financial assets that are relevant in the circumstances. To adjust historical credit loss information for current conditions and reasonable and supportable forecasts, an entity should consider significant factors that are relevant to determining the expected collectibility…

The assessment of how to adjust historical loss information to reflect current conditions and reasonable and supportable forecasts may include consideration of factors that are borrower-specific (e.g., the borrower's credit rating) and those that are more macro-economic (e.g., unemployment, growth in gross domestic product or GDP). To adjust historical information for current conditions and reasonable and supportable forecasts, an entity should consider significant factors that are relevant in determining the expected collectibility of cash flows. The implementation guidance in the ASU describes factors that may be relevant to determining the expected collectibility of cash flows. These factors are generally consistent with those in SEC Staff Accounting Bulletin (SAB) Topic 6.L, Accounting for Loan Losses (SAB 102).[8]

[8] SEC Staff Accounting Bulletin (SAB) Topic 6.L, Financial Reporting Release 28 — Accounting for Loan Losses by Registrants Engaged in Lending Activities.

The ASU provides examples of factors an entity may consider, depending on the nature of the asset. Keep in mind that not all of the following factors may be relevant to every situation, and factors not on the list may be relevant:

Potential factors for an entity to consider in assessing collectibility

Credit profile of the customer or borrower	An entity's other considerations
▸ Customer's or borrower's financial condition, credit rating, asset quality or business prospects ▸ Customer's or borrower's failure to make scheduled interest or principal payments ▸ Remaining payment terms of the financial asset ▸ Remaining time to maturity and the timing and extent of prepayments on the financial asset ▸ Value of underlying collateral when the collateral dependent practical expedient has not been used ▸ Environmental factors of a customer or borrower	▸ Nature and volume of the entity's financial assets ▸ Volume and severity of past due financial assets and the volume and severity of adversely classified or graded financial assets ▸ Lending policies and procedures, including changes in underwriting standards and collection, write-offs and recovery practices ▸ Quality of the entity's credit review system ▸ Experience and ability of the entity's management and other relevant staff ▸ Areas in which the entity's credit is concentrated

Entities will revert to historical loss information during periods over which they can't develop or obtain reasonable and supportable forecasts.

The ASU provides relatively little implementation guidance on how an entity should develop its forecast, or which factors to consider. We expect most entities to focus on the economic variables that management believes most significantly affect the collectibility of cash flows. The following table highlights some economic variables that may be relevant in this analysis.

Potential economic variables used in developing forecasts

- Gross domestic product
- Inflation
- Unemployment rates
- Interest rate environment
- Credit spreads
- Business confidence metrics
- Housing price indices
- Factory orders
- Bankruptcies
- Stock market indices
- Savings rates

The standard acknowledges that an entity may not be able to develop forecasts over the full remaining life of a financial asset. The Board decided that an entity should revert to using historical loss information when it is no longer able to develop or obtain a reasonable and supportable forecast. This decision reflects the Board's view that it is not useful to assign a credit loss estimate of zero to certain periods merely because an entity is unable to precisely estimate future economic conditions for those periods. Rather, the Board indicated in the Background Information and Basis for Conclusions (BC45) that historical information about loss is a relevant metric upon which to base an entity's current estimate of credit losses for periods beyond which the entity believes it is able to develop or obtain reasonable and supportable forecasts.

Importantly, the ASU requires entities to revert to historical loss information, but doesn't prescribe how an entity should do this. In practice, we expect an entity will likely determine how to revert to historical loss information based on the depth of its historical loss information and its ability to use systems or processes to efficiently and effectively redefine the calculation parameters for key historical loss statistics. For example, an entity might develop a projection of lifetime losses based on historical loss information and adjust the estimate for only the periods over which the entity is able to develop a reasonable and supportable forecast about the future. After that period, the entity would revert back to historical loss experience. Under this approach, the entity is effectively using an "immediate reversion" to historical loss amounts because it is starting with an estimate based on historical information and only adjusting for the periods that it is able to forecast. Alternatively, an entity might have the data and modeling capabilities to forecast a more gradual change in factors, and that entity may choose to revert to historical information over time using a rational and systematic approach.

How we see it

Economic cycles are often influenced by forces that are difficult to predict and model. Entities are likely to hold a variety of views about where the economy is in the cycle at each reporting date.

An entity will need to apply forecasts consistently across the organization. Management will need to maintain robust processes and controls to mitigate the risks associated with the use of highly subjective forecasts in estimating credit losses.

An entity will need to consider how historical loss patterns differ from current expectations (including both current conditions and reasonable and supportable forecasts). This process may be very challenging and may require significant judgment. When performing this analysis, entities will likely compare the economic indicators they used in developing their forecasts to historical economics factors. The standard requires an entity to then adjust its historical credit loss experience, as necessary, for its current expectations.

The guidance states that adjustments to historical loss experience may be qualitative in nature. For example, business confidence surveys may suggest that there is a perception that the economy is weakening, or surveys of credit underwriting standards may suggest that there is a loosening of credit. This may indicate that the estimate of expected credit losses should be raised. The practical challenge is for management to translate qualitative factors like this, and other forecasted information, into an appropriate amount to adjust the estimate of expected credit loss.

The ASU provides the following example to illustrate one way in which forecasts might be incorporated into the estimate of expected credit losses:

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Implementation Guidance and Illustrations

Example 1: Estimating Expected Credit Losses Using a Loss-Rate Approach (Collective Evaluation)

326-20-55-18

This Example illustrates one way an entity may estimate expected credit losses on a portfolio of loans with similar risk characteristics using a loss-rate approach.

326-20-55-19

Community Bank A provides 10-year amortizing loans to customers. Community Bank A manages those loans on a collective basis based on similar risk characteristics. The loans within the portfolio were originated over the last 10 years, and the portfolio has an amortized cost basis of $3 million.

326-20-55-20

After comparing historical information for similar financial assets with the current and forecasted direction of the economic environment, Community Bank A believes that its most recent 10-year period is a reasonable period on which to base its expected credit-loss-rate calculation after considering the underwriting standards and contractual terms for loans that existed over the historical period in comparison with the current portfolio. Community Bank A's historical lifetime credit loss rate (that is, a rate based on the sum of all credit losses for a similar pool) for the most recent 10-year period is 1.5 percent. The historical credit loss rate already factors in prepayment history, which it expects to remain unchanged. Community Bank A considered whether any adjustments to historical loss information in accordance with paragraph 326-20-30-8 were needed, before considering adjustments for current conditions and reasonable and supportable forecasts, but determined none were necessary.

326-20-55-21

In accordance with paragraph 326-20-55-4, Community Bank A considered significant factors that could affect the expected collectibility of the amortized cost basis of the portfolio and determined that the primary factors are real estate values and unemployment rates. As part of this analysis, Community Bank A observed that real estate values in the community have decreased and the unemployment rate in the community has increased as of the current reporting period date. Based on current conditions and reasonable and supportable forecasts, Community Bank A expects that there will be an additional decrease in real estate values over the next one to two years, and unemployment rates are expected to increase further over the next one to two years. To adjust the historical loss rate to reflect the effects of those differences in current conditions and forecasted changes, Community Bank A estimates a 10-basis-point increase in credit losses incremental to the 1.5 percent historical lifetime loss rate due to the expected decrease in real estate values and a 5-basis-point increase in credit losses incremental to the historical lifetime loss rate due to expected deterioration in unemployment rates. Management estimates the incremental 15-basis-point increase based on its knowledge of historical loss information during past years in which there were similar trends in real estate values and unemployment rates. Management is unable to support its estimate of expectations for real estate values and unemployment rates beyond the reasonable and supportable forecast period. Under this loss-rate method, the incremental credit losses for the current conditions and reasonable and supportable forecast (the 15 basis points) is added to the 1.5 percent rate that serves as the basis for the expected credit loss rate. No further reversion adjustments are needed because Community Bank A has applied a 1.65 percent loss rate where it has immediately reverted into historical losses reflective of the contractual term in accordance with paragraphs 326-20-30-8 through 30-9. This approach reflects an immediate reversion technique for the loss-rate method.

326-20-55-22

The expected loss rate to apply to the amortized cost basis of the loan portfolio would be 1.65 percent, the sum of the historical loss rate of 1.5 percent and the adjustment for the current conditions and reasonable and supportable forecast of 15 basis points. The allowance for expected credit losses at the reporting date would be $49,500.

In the example above, Bank A determined that a 15-basis-point increase from its historical lifetime credit loss rate was reasonable for Year 1 and Year 2, due to its forecast of certain macroeconomic factors. However, the example does not explain how Bank A determined how much each factor would increase losses in years 1 and 2. That is, it isn't clear why the forecasted decrease in real estate values would lead to a 10-basis-point increase in losses rather than a 20-basis-point increase. The standard does not provide an example that demonstrates how to quantify adjustments to historical information.

The example also illustrates an immediate reversion to historical losses. As noted above, Bank A added 15 basis points to the historical lifetime credit loss rate representing the additional lifetime credit losses it expects, based on current conditions and its reasonable and supportable forecasts of the primary factors that could affect the expected collectibility of the amortized cost basis of the loan portfolio (in this example the reasonable and supportable forecast period is two years). Bank A makes no further adjustment to this loss rate for potential changes in these factors beyond the two years because it is unable to make a reasonable and supportable forecast of those factors beyond that point. Because no changes in the factors are assumed for years beyond the reasonable and supportable forecast period, Bank A is immediately reverting to their historical lifetime credit loss rate. It should be noted that in this illustration, Bank A has chosen to revert based on the entire estimate (and not at the input level).

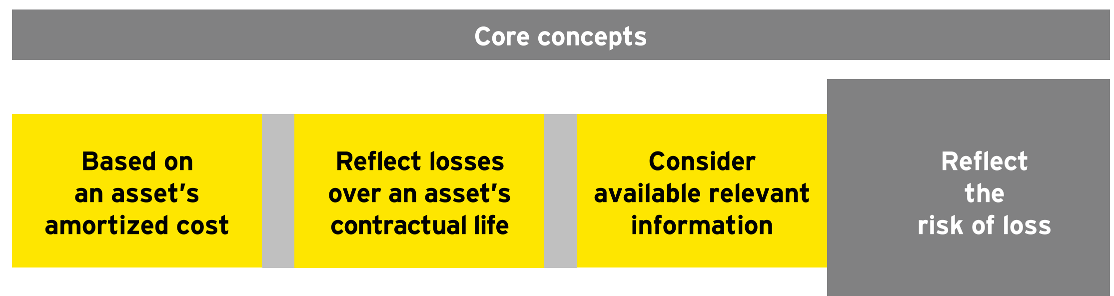
An entity's allowance for credit losses should reflect the risk of loss, even when that risk is remote.

How we see it

We believe quantifying the adjustment to historical credit loss rates will be one of the more challenging aspects of applying the new standard, and we expect there to be diversity in practice in how entities convert the effect of reasonable and supportable forecasts into a quantitative adjustment to the allowance.

Further, diversity in practice will also result from the fact that, after the reasonable and supportable forecast period, entities can revert to historical loss information immediately, on a straight-line basis or using another rational and systematic basis and because they can revert at either the input level or based on the entire estimate.

2.5 Reflect the risk of loss, even when that risk is remote



The standard requires an entity's allowance for credit losses to reflect the risk of loss, even when that risk is remote. This is required whether the entity is estimating the allowance for an individual asset or a group of assets.

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Initial Measurement

326-20-30-10

An entity's estimate of expected credit losses shall include a measure of the expected risk of credit loss even if that risk is remote, regardless of the method applied to estimate credit losses. However, an entity is not required to measure expected credit losses on a financial asset (or group of financial assets) in which historical credit loss information adjusted for current conditions and reasonable and supportable forecasts results in an expectation that nonpayment of the amortized cost basis is zero. Except for the circumstances described in paragraphs 326-20-35-4 through 35-6, an entity shall not expect nonpayment of the amortized cost basis to be zero solely on the basis of the current value of collateral securing the financial asset(s) but, instead, also shall consider the nature of the collateral, potential future changes in collateral values, and historical loss information for financial assets secured with similar collateral.

For example, if there is a 97% chance that the loss will be zero and a 3% chance of a total loss, the expected loss estimate under the new standard would reflect the 3% likelihood of a total loss. The ASU requires a collective approach when assets share similar risk characteristics because a pool-based approach produces an outcome that is consistent with the "risk of loss" principle. However, this principle also applies to the estimate of an expected credit loss for an individual asset.

How we see it

The requirement to reflect the risk of loss in the estimate of expected credit loss will change practice for HTM debt securities and will create a difference between how impairment will be measured for HTM securities and AFS debt securities.

Today, impairment for an HTM debt security is measured considering the best estimate of the present value of the cash flows expected to be collected. This "best estimate" frequently does not reflect the risk of loss when that risk is low (e.g., a 3% likelihood of loss).

Under the ASU, there will be an allowance for HTM securities measured using the "risk of loss" concept. Impairment for an AFS debt security will continue to be measured on a best-estimate basis (as discussed later).

2.5.1 When an entity may reasonably expect 'zero loss'

The new standard provides that there would not be an expected credit loss when historical credit loss experience adjusted for current conditions and reasonable and supportable forecasts provides an expectation that nonpayment of the amortized cost basis is zero.

However, the standard is clear that in the case of a financial asset that is secured by collateral (e.g., a commercial real estate loan), an entity is not permitted to estimate a loss of zero simply because the current value of the collateral exceeds the amortized cost basis of the asset. Rather, an entity should consider potential future changes in collateral value (e.g., potential changes in the value of a specific commercial property or the broader commercial real estate index) and historical loss experience for financial assets that were secured by similar collateral.

The following example from the standard illustrates the zero loss expectation for US Treasury securities.

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

326-20-55-48

This Example illustrates one way, but not the only way, an entity may estimate expected credit losses when the expectation of nonpayment is zero. This example is not intended to be only applicable to U.S. Treasury securities.

326-20-55-49

Entity J invests in U.S. Treasury securities with the intent to hold them to collect contractual cash flows to maturity. As a result, Entity J classifies its U.S. Treasury securities as held to maturity and measures the securities on an amortized cost basis.

326-20-55-50

Although U.S. Treasury securities often receive the highest credit rating by rating agencies at the end of the reporting period, Entity J's management still believes that there is a possibility of default, even if that risk is remote. However, Entity J considers the guidance in paragraph 326-20-30-10 and concludes that the long history with no credit losses for U.S. Treasury securities (adjusted for current conditions and reasonable and supportable forecasts) indicates an expectation that nonpayment of the amortized cost basis is zero, even if the U.S. government were to technically default. Judgment is required to determine the nature, depth, and extent of the analysis required to evaluate the effect of current conditions and reasonable and supportable forecasts on the historical credit loss information, including qualitative factors. In this circumstance, Entity J notes that U.S. Treasury securities are explicitly fully guaranteed by a sovereign entity that can print its own currency and that the sovereign entity's currency is routinely held by central banks and other major financial institutions, is used in international commerce, and commonly is viewed as a reserve currency, all of which qualitatively indicate that historical credit loss information should be minimally affected by current conditions and reasonable and supportable forecasts. Therefore, Entity J does not record expected credit losses for its U.S. Treasury securities at the end of the reporting period. The qualitative factors considered by Entity J in this Example are not an all-inclusive list of conditions that must be met in order to apply the guidance in paragraph 326-20-30-10.

How we see it

We believe that entities will be able to establish a "zero loss" expectation only in very limited cases. While the amounts entities will calculate for expected credit losses for many individual "very low risk" financial assets may not be individually significant, entities should consider whether expected losses for these assets could be significant in the aggregate.

While the ASU provides an example of a zero loss expectation for US Treasury securities and says they aren't the only instruments for which an entity could have a zero loss expectation, it's not clear when else such an expectation would be appropriate. For example:

- ***Corporate bonds***. While an entity may have no history (or expectation) of loss for a particular corporate borrower, corporate bond default studies generally demonstrate that there is a risk of loss, even for highly rated bonds. As a result, it might be challenging for an entity to establish a "zero loss" expectation for a highly rated (e.g., AAA) corporate bond it classifies as HTM.
- ***Indirect obligations of the US Government***. It is not clear whether it would be reasonable for an entity to develop a "zero loss" expectation for indirect obligations of the US Government, such as an obligation of a government-sponsored enterprise (e.g., Fannie Mae, Freddie Mac) that it classifies as HTM.

2.6 Measurement considerations for financial assets secured by collateral

2.6.1 Measuring expected credit losses when foreclosure is probable

Similar to today's guidance, the standard requires an entity to measure expected credit losses using the fair value of the collateral when the entity determines that foreclosure is probable.

2.6.2 Practical expedients for financial assets secured by collateral

The standard provides two practical expedients that an entity can use for measuring expected credit losses on financial assets secured by collateral even when foreclosure is not probable.

2.6.2.1 Collateral-dependent financial assets

An entity is permitted to estimate credit losses on certain collateral-dependent financial assets as the difference between the collateral's fair value and the amortized cost basis of the financial asset. Both of the following criteria must be met for an entity to use this practical expedient for an individual asset:

- The entity expects repayment of the financial asset to be provided substantially through the operation or sale of the collateral.
- The entity has assessed that the borrower is experiencing financial difficulty as of the report date.

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Subsequent Measurement

326-20-35-5

An entity may use, as a practical expedient, the fair value of the collateral at the reporting date when recording the net carrying amount of the asset and determining the allowance for credit losses for a financial asset for which the repayment is expected to be provided substantially through the operation or sale of the collateral when the borrower is experiencing financial difficulty based on the entity's assessment as of the reporting date (collateral-dependent financial asset). If an entity uses the practical expedient on a collateral-dependent financial asset and repayment or satisfaction of the asset depends on the sale of the collateral, the fair value of the collateral shall be adjusted for estimated costs to sell (on a discounted basis). However, the entity shall not incorporate in the net carrying amount of the financial asset the estimated costs to sell the collateral if repayment or satisfaction of the financial asset depends only on the operation, rather than on the sale, of the collateral. For a collateral-dependent financial asset, an entity may expect credit losses of zero when the fair value (less costs to sell, if applicable) of the collateral at the reporting date is equal to or exceeds the amortized cost basis of the financial asset. If the fair value of the collateral is less than the amortized cost basis of the financial asset for which the practical expedient has been elected, an entity shall recognize an allowance for credit losses on the collateral-dependent financial asset, which is measured as the difference between the fair value of the collateral, less costs to sell (if applicable), at the reporting date and the amortized cost basis of the financial asset. An entity also shall consider any credit enhancements that meet the criteria in paragraph 326-20-30-12 that are applicable to the financial asset when recording the allowance for credit losses.

Current US GAAP provides a similar practical expedient but defines "collateral dependent" as a loan for which the repayment is expected to be provided "solely by the underlying collateral." In the new standard, the FASB modified this definition to say "substantially through the operation or sale of the collateral" and to emphasize the financial difficulty criterion. We generally believe application of this practical expedient will be similar to current practice.

The entity should consider costs to sell in addition to the collateral value when it expects the collateral to be sold to repay the financial asset. Costs to sell should not be considered if the entity expects that repayment will come through the operation of the collateral.

2.6.2.2 *Financial assets with collateral maintenance provisions*

If the financial asset being measured for credit losses includes a collateral maintenance agreement, an entity may be able to elect a practical expedient to compare the amortized cost basis of the financial asset with the fair value of collateral at the reporting date to measure the allowance for expected credit losses.

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Subsequent Measurement

ASC 326-20-35-6

For certain financial assets, the borrower may be required to continually adjust the amount of the collateral securing the financial asset(s) as a result of fair value changes in the collateral. In those situations, an entity may use, as a practical expedient, a method that compares the amortized cost basis with the fair value of collateral at the reporting date to measure the estimate of expected credit losses. An entity may determine that the expectation of nonpayment of the amortized cost basis is zero if the borrower continually replenishes the collateral securing the financial asset such that the fair value of the collateral is equal to or exceeds the amortized cost basis of the financial asset and the entity expects the borrower to continue to replenish the collateral as necessary. If the fair value of the collateral at the reporting date is less than the amortized cost basis of the financial asset, an entity shall limit the allowance for credit losses on the financial asset to the difference between the fair value of the collateral at the reporting date and the amortized cost basis of the financial asset.

This practical expedient can be used if the financial asset includes a collateral maintenance provision that requires the borrower to continually adjust the amount of collateral securing the financial asset.

An entity will need to assess whether the amount of collateral is "continually" adjusted. While the term "continually" is not defined, we expect that financial contracts requiring collateral to be adjusted daily would meet this requirement.

If the fair value of the collateral at the reporting date is less than the amortized cost basis of the financial asset, the standard provides that the entity limit the expected credit loss on the financial asset to the difference between the fair value of the collateral at the reporting date and the amortized cost basis of the financial asset.

How we see it

The FASB provided this practical expedient for "standard" repurchase (repo) agreements, as we learned in discussions with the FASB staff. It's unclear what is meant by "continually" adjusting the amount of collateral that secures the financial asset. We believe that certain lending arrangements with provisions to adjust collateral daily would qualify for this practical expedient. The less frequently the collateral is adjusted, the more challenging it will be for an entity to assert that collateral is continually adjusted. In any case, an entity will need to consider factors such as the liquidity of the collateral and the extent of overcollateralization to determine whether it can apply this practical expedient.

The paragraph that provides the practical expedient also illustrates when an entity may be able to establish a "zero loss expectation," that is, when an entity may conclude a loss of zero. An entity might reach this conclusion when:

- The collateral securing the financial asset is replenished continually, and the amount always equals or exceeds the amortized cost basis of the financial asset.
- The entity expects the borrower to continue to replenish the collateral under the collateral maintenance agreement.

This may occur in repurchase arrangements where the "repo party" borrows funds in exchange for highly liquid security collateral that is valued daily. The amount of the collateral is adjusted up or down frequently for changes in the fair value of the underlying securities transferred. This collateral maintenance provision is designed so that at any point during the arrangement, the fair value of the collateral held by the lender (also referred to as the "reverse repo party") equals or is greater than the amortized cost basis of the "loan" (i.e., the financial asset, which in this case is the reverse repurchase arrangement).

The following example illustrates one way an entity may apply the practical expedient.

Illustration 5 — Applying the collateral maintenance practical expedient to a secured receivable under a reverse repurchase agreement

Dealer B (the repo party or borrower) holds a security with a fair value of $1,000 and a coupon rate of 7% that will mature in three years. The security is highly liquid. Bank A (the reverse repo party or lender) enters into a reverse repurchase agreement with Dealer B to provide short-term financing in exchange for Dealer B's security, which is used as collateral.

Under the agreement, Dealer B transfers the security to Bank A and Bank A transfers $980 in cash to Dealer B. Dealer B agrees to repurchase the identical security from Bank A in one year for $1,020. The agreement also requires Dealer B to maintain a collateralization level of 102% of the repurchase price (i.e., the purchase price of $980 plus interest accrued at such time) throughout the life of the transaction. To maintain sufficient levels of collateralization, the collateral is adjusted daily based on the current market value of the securities transferred. If Dealer B defaults on the repurchase, Bank A can liquidate the collateral to recover some or all of its cash.

Assume that the transfer of the security collateral is accounted for as a secured borrowing because the requirements of ASC 860-10-40-24 are met. As a result, Bank A will not recognize the security it received from Dealer B but will initially record a receivable from Dealer B for the cash it has transferred ($980). Subsequently, Bank A will accrete the receivable of $980 to $1,020 over one year using an interest method. In addition, the amount of the collateral is adjusted up or down daily for daily changes in the fair value of the underlying securities so that the fair value of the collateral will always equal 102% of the amortized cost of the receivable.

In this case, the collateral is adjusted "continually" for changes in the market price of the underlying securities. Bank A elects to apply the practical expedient in ASC 326-20-35-6 to measure the expected credit losses for the receivable by comparing the fair value of the collateral at the reporting date with the amortized cost basis of the receivable.

The collateral maintenance provision in the arrangement makes sure that the fair value of the collateral equals or is greater than the amortized cost basis of the receivable. Furthermore, Bank A has the right to sell or pledge the security collateral, which is highly liquid. Bank A also expects Dealer B to continue to be able to adjust the collateral in the future based on an assessment of the counterparty's credit profile. In this situation, Bank A believes a "zero loss expectation" for its receivable is appropriate.

How we see it

For financial assets secured by collateral maintenance provisions, we believe entities will need to understand both the contractual terms of the agreements and how these terms are put into effect to determine whether they qualify for this practical expedient. An entity that does not intend to enforce its contractual right related to collateral maintenance should not apply this practical expedient.

2.7 Other considerations for developing an expected credit loss estimate

The ASU also provides guidance on the following matters that should be considered when developing the CECL allowance:

- Level of aggregation
- Credit enhancements
- Write-offs and recoveries
- Modifications of financial assets
- Judgments

2.7.1 Level of aggregation

Entities will measure expected credit losses on pools of financial assets when they have similar risk characteristics.

The ASU requires an entity to measure expected credit losses of financial assets on a collective basis or pool of assets unless the assets do not have similar risk characteristics.

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Initial Measurement

326-20-30-2

An entity shall measure expected credit losses of financial assets on a collective (pool) basis when similar risk characteristic(s) exist (as described in paragraph 326-20-55-5). If an entity determines that a financial asset does not share risk characteristics with its other financial assets, the entity shall evaluate the financial asset for expected credit losses on an individual basis. If a financial asset is evaluated on an individual basis, an entity also should not include it in a collective evaluation. That is, financial assets should not be included in both collective assessments and individual assessments.

Implementation Guidance

326-20-55-5

In evaluating financial assets on a collective (pool) basis, an entity should aggregate financial assets on the basis of similar risk characteristics, which may include any one or a combination of the following (the following list is not intended to be all inclusive):

a. Internal or external (third-party) credit score or credit ratings

b. Risk ratings or classification

c. Financial asset type

d. Collateral type

e. Size

f. Effective interest rate

g. Term

h. Geographical location

i. Industry of the borrower

j. Vintage

k. Historical or expected credit loss patterns

l. Reasonable and supportable forecast periods

In requiring a pool-based estimate, the FASB reasoned that while an entity may expect an individual asset to fully recover, an entity that, for example, has a pool of 1,000 similar assets may reasonably expect that some portion of those assets will default, even if it isn't sure which individual asset will default. In the Basis for Conclusions (BC 49) in the ASU, the FASB said that "because there is no 'trigger' for recognition, the method should reflect changes in the status of the assets, as well as changes in the entity's experience and expectations in a timely manner, and the allowance should be commensurate with the expected losses inherent in the assets held at the reporting date." The FASB believes that the "risk of loss" concept is easier to understand and reflect in the estimate when assets are pooled; however, the estimate must still consider the risk of loss when expected losses are measured for an individual asset.

Today, many entities segment their portfolios as a means to better manage credit risk within their entities. This segmentation is often used for estimating the allowance for credit losses. The ASU allows an entity to continue to estimate the allowance for credit losses based on the way it manages credit risk today by allowing the entity to pool assets with similar risk characteristics. Regardless, entities should consider whether changes are needed to their existing pools based on how they monitor credit risk.

The standard provides flexibility for entities to segment a portfolio of financial assets. That is, ASC 326-20-55-5 says that an entity should aggregate based on "any one or a combination" of the characteristics listed in that paragraph. What's more, the list includes characteristics that are not typically associated with credit quality (e.g., size, term, industry of the borrower), suggesting that some assets with different credit profiles could be grouped together based on their other characteristics. We expect entities to generally elect to use the same approach or a similar approach for grouping assets as they do today. Furthermore, although we expect segmentation will be similar for many entities, in the case where vintage is not used as a similar risk characteristic, entities may further disaggregate these pools for determining their allowance estimates to reflect differing time to maturities of the assets within the pool.

Entities should not include financial assets in both their collective assessments and their individual assessments.

Bank regulatory perspectives

The Joint Statement provides the following observations about portfolio segmentation:

"The new accounting standard requires institutions to measure expected credit losses on a collective or pool basis when similar risk characteristics exist. Although the new accounting standard provides examples of such characteristics, smaller and less complex institutions may continue to follow the practices they have used for appropriately segmenting the portfolio under an incurred loss methodology or they may refine those practices."

"Further, if a financial asset does not share risk characteristics with other financial assets, the new accounting standard requires expected credit losses to be measured on an individual asset basis. As with practices applied under the incurred loss methodology, financial assets on which expected credit losses are measured on an individual basis should not also be included in a collective assessment of expected credit losses."

How we see it

We believe the standard provides flexibility in how entities can choose to pool assets. That is, we believe that entities will be able to use their internal risk management policies and practices to determine which assets to aggregate.

2.7.2 Credit enhancements

An entity should consider the mitigating effects of certain credit enhancements, such as guarantees and subordinated interests, when estimating expected credit losses.

Excerpt from Accounting Standards Codification

Financial Instruments– Credit Losses — Measured at Amortized Cost

Initial Measurement

326-20-30-12

The estimate of expected credit losses shall reflect how credit enhancements (other than those that are freestanding contracts) mitigate expected credit losses on financial assets, including consideration of the financial condition of the guarantor, the willingness of the guarantor to pay, and/or whether any subordinated interests are expected to be capable of absorbing credit losses on any underlying financial assets. However, when estimating expected credit losses, an entity shall not combine a financial asset with a separate freestanding contract that serves to mitigate credit loss. As a result, the estimate of expected credit losses on a financial asset (or group of financial assets) shall not be offset by a freestanding contract (for example, a purchased credit-default swap) that may mitigate expected credit losses on the financial asset (or group of financial assets).

The guidance prohibits an entity from considering how freestanding credit enhancements, such as purchased credit-default swaps, would mitigate expected credit losses on financial assets. The standard defines a freestanding contract as one that is entered into either (1) separate and apart from any of the entity's other financial instruments or equity transactions or (2) in conjunction with some other transaction and is legally detachable and separately exercisable. A guarantee that is not freestanding would be considered in the assessment of expected credit loss. For example, in the case of a residential mortgage loan, a lender may require a borrower with a low credit profile to obtain a guarantee from a second individual with a higher credit profile (or income level) (also known as a guarantor) to co-sign the mortgage agreement. In such a case, this guarantee from the guarantor is embedded in the contract and would be considered in the assessment of credit loss.

How we see it

We believe a credit enhancement is generally not freestanding if it "travels" with the related financial asset. For example, if a holder of a financial asset that is the subject of the credit enhancement transfers that financial asset to a new investor and that new investor is now the beneficiary of the credit enhancement, the credit enhancement is not freestanding and should be considered in the estimate of expected credit losses.

2.7.3 *Write-offs and recoveries*

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Subsequent Measurement

326-20-35-8

Write-offs of financial assets, which may be full or partial write-offs, shall be deducted from the allowance. The write-offs shall be recorded in the period in which the financial asset(s) are deemed uncollectible. Recoveries of financial assets and trade receivables previously written off shall be recorded when received.

The standard retains existing guidance for both write-offs and recoveries on receivables and extends that guidance to all assets within the scope of the expected credit loss model. It also clarifies that an entity may write off either a portion of a financial asset or the full amount. As a result, when an entity deems all or a portion of the financial asset to be uncollectible, it should reduce the allowance for expected credit losses by the same amount as the portion that is being written off. The standard does not define what "deemed uncollectible" means; however, an asset is generally considered uncollectible when all efforts at collection have been exhausted. Some entities may apply accounting policies that deem a financial asset to be uncollectible at some point in time before all efforts at collection have been exhausted. For example, some regulated financial institutions may use regulatory guidance as a basis to write off or charge down certain consumer loans after they are a certain number of days (e.g., 120 or 180) past due.

If, at a later date, the entity receives consideration (e.g., cash) in satisfaction of some or all of the amounts previously written off, the guidance in ASC 326-20-35-8 states that the recovery may be recognized by either (1) increasing the allowance for expected credit losses or (2) increasing earnings directly. In providing two alternatives, the Board acknowledged today's differences in practice. For example, entities in some industries currently credit such recoveries directly to earnings, while financial institutions typically credit recoveries to the allowance for credit losses. Ultimately, if an entity recognizes a recovery by immediately increasing the allowance for expected credit losses and then determines at the end of the reporting period that the increase in the allowance was not necessary, the same credit to earnings will occur (i.e., the recovery will be recognized through earnings).

How we see it

This guidance will result in a change in practice for entities with HTM debt securities. Under today's other-than-temporary impairment (OTTI) model, entities write off the amortized cost basis of a debt security when they recognize an OTTI. Under the new standard, they will initially recognize an allowance, and then later write off the amortized cost basis when the security is deemed uncollectible. As such, entities will need to develop accounting policies to consistently reflect write-offs for HTM debt securities. This is also the case for AFS debt securities.

2.7.4 *Modifications of financial assets*

Excerpt from Accounting Standards Codification

Financial Instruments Measured at Amortized Cost — Credit Losses

310-40-35-10

A loan restructured in a troubled debt restructuring shall not be accounted for as a new loan because a troubled debt restructuring is part of a creditor's ongoing effort to recover its investment in the original loan. Topic 326 provides guidance on measuring credit losses on financial assets and requires credit losses to be recorded through an allowance for credit loss account, including concessions given to the borrower upon a troubled debt restructuring.

US GAAP will continue to require that an entity evaluate whether a modification made to a financial asset qualifies as a TDR under ASC 310-40. The effective interest rate on the asset modified in a TDR will continue to be the asset's original effective interest rate.

Similarly, like expected losses on all other financial assets under the ASC 326-20 expected credit loss model, expected losses on assets that have undergone TDRs will be recognized using a valuation allowance. While current guidance requires that the allowance for an asset that has undergone a TDR be measured using a DCF technique, the new standard eliminates that requirement and permits an entity to measure the allowance using the broader principles of the ASC 326-20 expected loss model. For example an entity may estimate the allowance using a loss rate method or PD method. Nevertheless, we expect many entities to continue to use a DCF approach because that process is well established.

How we see it

Some TDR's are simply an interest rate concession. Under today's guidance, entities reflect these interest rate concessions provided to borrowers in their allowance estimates through their use of a DCF approach. This will not change for entities that use a DCF approach under the new standard. However, entities that elect to use a non-DCF approach under the new standard will need to consider how to reflect an interest rate concession provided to the borrower in the allowance for credit losses.

For modifications that are not TDRs, entities will continue to look to the guidance in ASC 310-20-35-9 through 35-11 to determine when a modification results in a new loan or the continuation of an existing loan. Specifically, if the terms of the refinanced or restructured loan are at least as favorable to the lender as the terms for comparable loans to other customers with similar collection risks who are not refinancing or restructuring a loan with the lender, the refinanced loan should be accounted for as a new loan. This condition is met if the effective yield of the new loan is at least equal to the effective yield for such loans, and if modifications to the original loan are more than minor. To make a determination regarding whether a modification is more than minor, an entity first determines whether there is at least a 10% difference between the present value of the cash flows under the terms of the new loan and the present value of the remaining cash flows under the terms of the original loan. If there is a least a 10% difference, the modification is more that minor. If the difference is less than 10%, the entity then evaluates whether the modification is more than minor based on the facts and circumstances (and other relevant considerations) of the refinancing or restructuring.

2.7.5 *Judgments*

The implementation guidance describes a number of the judgments an entity may need to make when estimating expected credit losses.

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Implementation Guidance

326-20-55-6

Estimating expected credit losses is highly judgmental and generally will require an entity to make specific judgments. Those judgments may include any of the following:

a. The definition of default for default-based statistics

b. The approach to measuring the historical loss amount for loss-rate statistics, including whether the amount is simply based on the amortized cost amount written off and whether there should be adjustments to historical credit losses (if any) to reflect the entity's policies for recognizing accrued interest

c. The approach to determine the appropriate historical period for estimating expected credit loss statistics

d. The approach to adjusting historical credit loss information to reflect current conditions and reasonable and supportable forecasts that are different from conditions existing in the historical period

e. The methods of utilizing historical experience

f. The method of adjusting loss statistics for recoveries

g. How expected prepayments affect the estimate of expected credit losses

h. How the entity plans to revert to historical credit loss information for periods beyond which the entity is able to make or obtain reasonable and supportable forecasts of expected credit losses

i. The assessment of whether a financial asset exhibits risk characteristics similar to other financial assets.

Estimating expected credit losses will require significant judgment and entities will need to develop effective controls over the process.

This list illustrates the highly subjective nature of the estimate. It is also important to remember that the list of judgments the standard provides is not all inclusive, and management may need to consider other key judgments based on the entity's facts and circumstances.

Wesley R. Bricker, Interim Chief Accountant at the SEC, recently told attendees at the AICPA National Bank Conference on Banks and Savings Institutions that "the new credit loss standard will require significantly more judgments. This highlights the importance of another element of a company's control environment — setting the right "tone at the top" and expectations for appropriate conduct throughout the organization. Appropriate tone at the top is the foundation for the consistent application of the sound judgments required by the new standard. Management should consider whether the existing control environment is adequate to support the formation and enforcement of sound judgments that will be necessary in executing control activities or whether changes are necessary."[9]

[9] Speech by SEC Interim Chief Accountant Wesley R. Bricker at the AICPA National Conference on Banks and Savings Institutions, 21 September 2016, https://www.sec.gov/news/speech/bricker-remarks-aicpa-national-conf-banks-savings-institutions.html.

Bank regulatory perspectives

The Joint Statement states that "similar to the agencies' expectations under an incurred loss methodology, institutions should develop and document their allowance methodology and apply it in a thorough, disciplined, and consistent manner. Estimating allowance levels, including assessments of qualitative adjustments to historical lifetime loss experience, involves a high degree of management judgment, is inevitably imprecise, and results in a range of estimated expected credit losses. For these reasons, institutions are encouraged to build strong processes and controls over their allowance methodology."

2.8 Interest income

Excerpt from Accounting Standards Codification

Financial Instruments- Credit Losses — Measured at Amortized Cost

Initial Recognition

ASC 326-20-35-10

This Subtopic does not address how a creditor shall recognize interest income. See paragraphs 310-10-35-53A through 35-53C for guidance on recognition of interest income on purchased financial assets with credit deterioration. See paragraph 326-20-45-3 for presentation guidance.

The standard does not address interest income recognition, except for PCD assets as discussed later in this publication. An entity will continue to apply the interest method outlined in ASC 835-30 (including the requirement to impute interest when there is no stated interest rate) and the guidance in ASC 310-20 for nonrefundable fees and other costs, premiums and discounts.

The standard does not provide nonaccrual guidance for assets other than PCD assets and eliminates the nonaccrual guidance in ASC 310-10 that relates to impaired loans. In addition, the new revenue recognition guidance specifically excludes from its scope financial instruments and other contractual rights that are within the scope of ASCs 310, 320 and 325 (e.g., receivables, debt securities, certain beneficial interests). As a result, entities will have no specific US GAAP guidance for determining whether to apply a nonaccrual policy.

How we see it

The Board decided not to include nonaccrual guidance for financial assets in the standard because it didn't want to change current practice in this area. Entities are already required to make disclosures about financial assets on nonaccrual status. The standard continues to require these disclosures. Accordingly, we believe entities will have latitude in determining whether, and if so, how, to apply a nonaccrual approach. As such, we expect many entities to continue using their existing approach. We also believe that US banking regulators will continue to require regulated financial institutions to apply certain nonaccrual approaches in specific situations.

2.9 Presentation of credit losses

The standard provides the following guidance on the presentation of credit losses:

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Other Presentation Matters

326-20-45-1

For financial assets measured at amortized cost within the scope of this Subtopic, an entity shall separately present on the statement of financial position, the allowance for credit losses that is deducted from the asset's amortized cost basis.

326-20-45-2

For off-balance-sheet credit exposures within the scope of this Subtopic, an entity shall present the estimate of expected credit losses on the statement of financial position as a liability. The liability for credit losses for off-balance-sheet financial instruments shall be reduced in the period in which the off-balance-sheet financial instruments expire, result in the recognition of a financial asset, or are otherwise settled. An estimate of expected credit losses on a financial instrument with off-balance-sheet risk shall be recorded separate from the allowance for credit losses related to a recognized financial instrument.

326-20-45-3

When a discounted cash flow approach is used to estimate expected credit losses, the change in present value from one reporting period to the next may result not only from the passage of time but also from changes in estimates of the timing or amount of expected future cash flows. An entity that measures credit losses based on a discounted cash flow approach is permitted to report the entire change in present value as credit loss expense (or reversal of credit loss expense). Alternatively, an entity may report the change in present value attributable to the passage of time as interest income. See paragraph 326-20-50-12 for a disclosure requirement applicable to entities that choose the latter alternative and report changes in present value attributable to the passage of time as interest income.

326-20-45-4

The fair value of the collateral of a collateral-dependent financial asset may change from one reporting period to the next. Changes in the fair value of the collateral shall be reported as credit loss expense or a reversal of credit loss expense when the guidance in paragraphs 326-20-35-4 through 35-6 is applied.

Disclosure

326-20-50-12

Paragraph 326-20-45-3 explains that a creditor that measures expected credit losses based on a discounted cash flow method is permitted to report the entire change in present value as credit loss expense (or reversal of credit loss expense) but also may report the change in present value attributable to the passage of time as interest income. Creditors that choose the latter alternative shall disclose the amount recorded to interest income that represents the change in present value attributable to the passage of time.

Under the standard, the balance sheet presentation of the estimate of expected credit losses for recognized assets differs from the presentation of the estimate of expected credit losses for off-balance-sheet exposures. The estimate of expected credit losses for recognized financial assets is presented as an allowance that reduces the amortized cost basis of the asset, while estimates of expected credit losses for off-balance-sheet credit exposures (e.g., loan commitments, standby letters of credit, financial guarantees) are presented as a liability.

An entity that uses the guidance for collateral-dependent financial assets and financial assets secured by collateral maintenance provisions should present subsequent changes in the fair value of the collateral as credit loss expense or a reversal of credit loss expense.

2.9.1 Presenting changes attributable to the passage of time when using a DCF approach

Consistent with current US GAAP, the standard allows an entity to present as interest income the change in present value attributable to the passage of time, when using a DCF method to estimate the allowance for credit losses. Alternatively, this change can be presented as credit loss expense.

2.10 Disclosures

The ASU says the required disclosures are intended to help financial statement users to understand:

- The credit risk inherent in a portfolio and how management monitors the related credit quality
- Management's estimate of expected credit losses
- Information about the changes in the estimate of expected credit losses that have taken place during the period

The standard requires information to be provided by either portfolio segment or class of financing receivable as defined in the standard. The same disclosure requirements apply to net investments in leases (including the unguaranteed residual asset). For HTM debt securities, the ASU requires information to be provided by major security type. The following chart describes these categorizations.

Portfolio segment	Class of financing receivables	Major security type
The level at which an entity develops and documents a systematic methodology to determine its allowance for credit losses. All of the following are examples of portfolio segments: ‣ Type of financing receivable ‣ Industry sector of the borrower or customer ‣ Risk rating	A class of financing receivables is a level of disaggregation beyond a portfolio segment that is determined on the basis of both of the following: ‣ Risk characteristics of the financing receivable ‣ An entity's method for monitoring and assessing credit risk An entity should base its principal determination of class of financing receivable by disaggregating to the level that the entity uses when assessing and monitoring the risk and performance of the portfolio for various types of financing receivables. In its assessment, the entity should consider the risk characteristics of the financing receivables.	Major security types are based on the nature and risks of the security. In determining whether disclosure for a particular security type is necessary and whether it is necessary to further separate a particular security type into greater detail, an entity should consider the following: ‣ Shared activity or business sector ‣ Vintage ‣ Geographic concentration ‣ Credit quality ‣ Economic characteristic

Entities will need to determine the appropriate level of disclosure for portfolio segments and classes of financial assets. The objective is to provide information at a level that provides sufficient detail for a user to understand the portfolio or class without being overwhelmed by insignificant data.

The standard's disclosure requirements related to CECL are described in the sections that follow.

2.10.1 *Credit quality information*

An entity is required to provide information that allows a financial statement user to both understand how it monitors credit quality of its financial assets and assesses the quantitative and qualitative risks that arise because of the associated credit quality. An entity must therefore provide, by class of financing receivable and major security type, information about the credit quality, including a description of each credit quality indicator and when the information was last updated for that credit quality indicator (i.e., according to date or range of dates). In addition, an entity will need to disclose the amortized cost basis by each credit quality indicator. PBEs will be required to further disaggregate the amortized cost basis by credit quality indicator and the year of the financial asset's origination for up to the past five annual periods.

Although the standard doesn't specify how an entity should develop its credit quality indicators, including the granularity of its indicators, the example disclosure in the standard suggests that an entity should provide more disaggregated credit quality information than it does today.

Public business entities will be required to disclose the amortized cost basis by credit quality indicator and the year of the financial asset's origination for up to the past five annual periods.

The following illustration highlights one way a PBE might meet the standard's requirement to provide tabular credit quality information by year of origination requirement and is based on Example 15, *Disclosing Credit Quality Indicators of Financing Receivables by Amortized Cost Basis,* in the ASU.

Illustration 6 — Example tabular disclosure of amortized cost basis by year of origination and credit quality indicator

Amortized cost basis by year of origination and credit quality indicator

	20X5	20X4	20X3	20X2	20X1	Prior	Revolving Loans Amortized Cost Basis	Total
Residential mortgage:								
FICO:								
780 and greater	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
720-779	-	-	-	-	-	-	-	-
660-719	-	-	-	-	-	-	-	-
600-659	-	-	-	-	-	-	-	-
Less than 600	-	-	-	-	-	-	-	-
Total residential mortgage	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$-
Current-period gross write-offs	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Current-period recoveries	-	-	-	-	-	-		-
Current-period net write-offs	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Consumer:								
Loan delinquency:								
Current	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
30-59 days past due	-	-	-	-	-	-		-
60-89 days past due	-	-	-	-	-	-		-
90-119 days past due	-	-	-	-	-	-		-
120+ days past due	-	-	-	-	-	-		-
Total consumer	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Current-period gross write-offs	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Current-period recoveries	-	-	-	-	-	-		-
Current-period net write-offs	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -

Illustration 6 — Example tabular disclosure of amortized cost basis by year of origination and credit quality indicator (continued)

	20X5	20X4	20X3	20X2	20X1	Prior	Revolving Loans Amortized Cost Basis	Total
Commercial business:								
Risk rating:								
1-2 internal grade	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
3-4 internal grade	-	-	-	-	-	-		-
5 internal grade	-	-	-	-	-	-		-
6 internal grade	-	-	-	-	-	-		-
7 internal grade	-	-	-	-	-	-		-
Total commercial business	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Current-period gross write-offs	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Current-period recoveries	-	-	-	-	-	-		-
Current-period net write-offs	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Commercial mortgage:								
Risk rating:								
1-2 internal grade	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
3-4 internal grade	-	-	-	-	-	-		-
5 internal grade	-	-	-	-	-	-		-
6 internal grade	-	-	-	-	-	-		-
7 internal grade	-	-	-	-	-	-		-
Total commercial mortgage	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Current-period gross write-offs	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Current-period recoveries	-	-	-	-	-	-	-	-
Current-period net write-offs	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -

As illustrated, the amortized cost basis of financing receivables with revolving features, like credit cards, is shown in total and is not disaggregated by year of origination. Receivables measured at the lower of amortized cost or fair value and trade receivables due within one year or less (except for credit card receivables that result from revenue transactions within the scope of ASC 606) are not included in this tabular disclosure.

To determine the year of origination, an entity should use the guidance in ASC 310-20-35-9 through 35-12 for evaluating whether a loan refinancing or restructuring results in a new loan. Under that guidance, a refinancing or restructuring (other than a TDR) will result in a new loan if the new terms are at least as favorable to the lender as the terms for comparable loans to other customers with similar collection risks. See section 2.7.4, *Modifications of financial assets*, for discussion of this guidance.

How we see it

Entities will have to provide more disclosures about the credit quality of their financial assets than they do today. PBEs will need to implement new processes and controls to gather and summarize the information required to produce vintage disclosures.

Furthermore, an entity will need to consider its determination of whether a modification results in a new loan or the continuation of an old loan (i.e., applying the guidance in ASC 310-20-35-9 through 35-11) when making the new vintage disclosures (i.e., disclosures by year of origination) for financing receivables.

2.10.2 Allowance for credit losses and management's estimation process

The standard requires an entity to provide information that allows users to understand its methods for developing its allowance for credit losses, the information used in developing its current estimate of expected credit losses and the changes in those estimates within the period. Specifically, the new guidance requires, by portfolio segment and major security type, a discussion of:

- How expected loss estimates are developed
- The entity's accounting policies and methodology to estimate the allowance for credit losses, as well as a discussion of the factors that influenced management's current estimate of expected credit losses, including:
  - Past events
  - Current conditions
  - Reasonable and supportable forecasts about the future
- Risk characteristics relevant to each portfolio segment
- Changes in the factors that influenced management's current estimate of expected credit losses and the reasons for those changes (e.g., changes in portfolio composition or underwriting practices, significant events or conditions that affect the current estimate but were not contemplated or relevant during a previous period)
- Changes to the entity's accounting policies and changes to the methodology from the prior period, the entity's rationale for making those changes and the quantitative effect of the changes
- Reasons for significant changes in the amount of write-offs, if applicable
- The reversion method applied for periods beyond the reasonable and supportable forecast period
- The amount of any significant purchases of financial assets during each reporting period
- The amount of any significant sales of financial assets or reclassifications of loans to held for sale during each reporting period

Due to the inherent subjectivity of forecasting, management will need to provide information related to the judgments incorporated into this process. For example, an entity will likely need to provide information about its assessment of the point in the economic cycle and how that affected management's estimate of expected credit losses. These disclosures will be important for understanding the differences in estimates among different entities.

2.10.3 Rollforward of the allowance for credit losses

The standard requires an entity to provide information that allows users to understand the changes in the allowance for expected credit losses for each period by requiring an entity to disclose, by portfolio segment and major security type, the following amounts:

- Beginning balance of the allowance
- Current-period provision for expected credit losses
- Initial allowance for credit losses recognized on purchased financial assets with credit deterioration, if applicable

- Write-offs charged against the allowance, if applicable
- Recoveries of amounts previously written off, if applicable
- Ending balance of the allowance

How we see it

To produce the allowance rollforward for HTM securities and net investments in leases, entities will need to develop new processes and controls to collect the required information. This disclosure requirement also applies to accounts receivable arising from the sale of goods or services.

2.10.4 Past due and nonaccrual assets

Like today's guidance, the standard requires an entity to provide an aging analysis of the amortized cost for financial assets that are past due as of the reporting date, disaggregated by class of financing receivable and major security type. Under the new guidance, an entity will also be required to disclose its policy for determining when a financial asset is past due. The requirement to disclose past-due status will not apply to receivables measured at the lower of amortized cost or fair value, or trade receivables due in one year or less (except for credit card receivables that result from revenue transactions within the scope of ASC 606).

For financial assets that are on nonaccrual status, the standard requires an entity to disclose all of the following, disaggregated by class of financing receivable and major security type:

- The amortized cost basis of financial assets on nonaccrual status as of the beginning of the reporting period and the end of the reporting period
- The amount of interest income recognized during the period on nonaccrual financial assets
- The amortized cost basis of financial assets that are 90 days or more past due but are not on nonaccrual status as of the reporting date
- The amortized cost basis of financial assets on nonaccrual status for which there is no allowance for credit losses as of the reporting date

An entity also will be required to disclose its policies for placing financial assets on nonaccrual status, for recording payments received on these assets (i.e., cost recovery method, cash basis method, a combination of both methods), for resuming the accrual of interest, for determining past due or delinquency status, and for recognizing write-offs within the allowance for credit losses. The requirement to disclose nonaccrual status will not apply to receivables measured at the lower of amortized cost or fair value, or trade receivables due in one year or less (except for credit card receivables that result from revenue transactions within the scope of ASC 606).

2.10.5 Purchased financial assets with credit deterioration

For PCD assets that were purchased during the period, the standard requires an entity to disclose a reconciliation of the difference between the purchase price and the par value. This reconciliation must include the purchase price, the allowance for expected credit losses at the acquisition date as determined by the entity, the discount (or premium) attributable to other factors and the par value. This is the only separate disclosure about PCD assets required because, after they are purchased, these assets are treated like other assets.

2.10.6 *Collateral-dependent financial assets*

For collateral-dependent financial assets (a financial asset for which repayment is expected to be provided substantially through the operation or sale of the collateral and the borrower is experiencing financial difficulty), an entity is required to describe, by class of financial receivable and major security type, the type of collateral and the extent to which collateral secures its financial assets, including an explanation of significant changes in the extent to which collateral secures the financial assets, regardless of whether the change is the result of a general deterioration or some other reason. An example of a general deterioration might be a decline in real estate values in a particular geography.

2.10.7 *Off-balance-sheet credit exposures*

The standard requires an entity to disclose the accounting policies and methodology it uses to estimate its liability for off-balance-sheet credit exposures and related charges for those credit exposures, including a description of the factors that influenced management's judgment and the risk elements relevant to particular categories of financial instruments. These disclosure requirements apply to credit exposures on off-balance-sheet loan commitments, standby letters of credit, financial guarantees not accounted for as insurance and other similar instruments, except for instruments within the scope of ASC 815.

2.11 Considerations for certain instruments

2.11.1 *Lessor's net investments in sales-type and direct financing leases*

Lessors will measure impairment of their net investments in a sales-type and direct financing lease using the CECL model.

Excerpt from Accounting Standards Codification

Amendments to Subtopic 842-30, Leases — Lessor

Subsequent Measurement

Sales-type and Direct Financing Leases

Credit losses on the Net Investment in the Lease

842-30-35-3

A lessor shall determine credit losses related to the net investment in the lease and shall record any credit losses in accordance with Subtopic 326-20 on financial instruments measured at amortized cost. When determining the loss allowance for a net investment in the lease, a lessor shall take into consideration the collateral relating to the net investment in the lease. The collateral relating to the net investment in the lease represents the cash flows that the lessor would expect to derive from the underlying asset during the remaining lease term, which excludes the cash flows that the lessor would expect to derive from the underlying asset following the end of the lease term (for example, cash flows from leasing the asset after the end of the lease term).

Master Glossary

Net Investment in the Lease

For a sales-type lease, the sum of the lease receivable and the unguaranteed residual asset.

For a direct financing lease, the sum of the lease receivable and the unguaranteed residual asset, net of any deferred selling profit.

The new leases guidance in ASC 842 requires lessors to evaluate their net investment in a sales-type lease and a direct financing lease for impairment using the guidance for financial receivables. The FASB indicated in the Basis for Conclusions (BC310) of ASU 2016-02, that even though the unguaranteed residual asset component of the net investment in the lease

does not meet the definition of a financial asset in US GAAP, it would be overly complex and provide little benefit to financial statement users to require entities to separately assess the unguaranteed residual asset for impairment in accordance with ASC 360 while the receivable (i.e., the financial asset) is evaluated for impairment in accordance with financial receivable literature. Therefore lessors will be required to evaluate the entire net investment in the lease, including the unguaranteed residual asset, for impairment as a financial asset measured at amortized cost.

When determining the loss allowance for a net investment in the lease, a lessor takes into consideration the collateral relating to the net investment in the lease, which represents the cash flows that the lessor would expect to derive from the underlying asset during the remaining lease term. The collateral relating to the net investment in the lease excludes the cash flows that the lessor would expect to derive from the underlying asset following the end of the lease term (e.g., cash flows from leasing the asset after the end of the lease term).

How we see it

It is unclear why a lessor would exclude the cash flows that it expects to derive from this underlying asset following the end of the lease term in determining the loss allowance for the entire net investment in the lease, which includes the unguaranteed residual asset.

2.11.2 Reinsurance receivables

Reinsurance receivables represent the portion of an insurance company's losses from claims that can be recovered from reinsurance companies. Reinsurance receivables include the amounts owed to the insurer by the reinsurer for paid and unpaid claims and claim settlement expenses, including estimated amounts receivable for unsettled claims, claims incurred but not reported and other policy benefits. A variety of risks (e.g., contractual coverage disputes) affect the collectibility of reinsurance receivables by the ceding entity, but only expected losses relating to the credit risk of the reinsurer (e.g., the assuming entity) are subject to the CECL model.

The first step in determining the allowance for credit losses associated with reinsurance receivables will be determining whether to do so on a collective or individual basis. This will depend on whether individual reinsurance agreements have similar risk characteristics. One factor to consider is the attachment point (e.g., the point at which reinsurance coverage applies). For example, reinsurers that cover high severity but low frequency losses may have a higher credit risk than reinsurers that cover high frequency but low severity risks, given that a few large events could strain the reinsurer's finances. Other factors that should be considered in determining whether similar risk characteristics exist include the size and financial condition of the reinsurers, jurisdictions in which the reinsurers write business (e.g., global, domestic) and the existence of state-sponsored reinsurance programs.

The ASU provides an example of considerations for reinsurance receivables such as whether the reinsurance agreement allows the insurer to retain assets as collateral, as is the case in funds withheld arrangements, or incorporates credit enhancements, such as the reinsurer providing letters of credit from another financial institution. An insurer is not permitted to estimate a loss of zero simply because the current value of the collateral exceeds the amortized cost basis of the reinsurance receivable. Rather, the insurer should consider the terms of the collateral and any collateral maintenance provisions and potential fluctuation in the collateral assets. The insurer also should consider the terms of the credit enhancements as well as the credit risk of the third-party provider of the credit enhancement. Refer to earlier sections about financial assets secured by collateral (section 2.6.2) and credit enhancements (section 2.7.2) for additional discussion.

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Implementation Guidance and Illustrations

Example 17: Identifying Similar Risk Characteristics in Reinsurance Receivables

326-20-55-81

Reinsurance receivables may comprise a variety of risks that affect collectibility including:

a. Credit risk of the reinsurer/assuming company

b. Contractual coverage disputes between the reinsurer/assuming company and the insurer/ceding company including contract administration issues

c. Other noncontractual, noncoverage issues including reinsurance billing and allocation issues.

326-20-55-82

This Subtopic only requires measurement of expected losses related to the credit risk of the reinsurer/assuming company.

326-20-55-83

In situations in which similar risk characteristics are not present in the reinsurance receivables, the ceding insurer should measure expected credit losses on an individual basis. Similar risk characteristics may not exist because any one or a combination of the following factors exists, including, but not limited to:

a. Customized reinsurance agreements associated with individual risk geographies

b. Different size and financial conditions of reinsurers that may be either domestic or international

c. Different attachment points among reinsurance agreements

d. Different collateral terms of the reinsurance agreements (such as collateral trusts or letters of credit)

e. The existence of state-sponsored reinsurance programs.

326-20-55-84

However, similar risk characteristics may exist for certain reinsurance receivables because any one or combination of the following exists:

a. Reinsurance agreements that have standardized terms

b. Reinsurance agreements that involve similar insured risks and underwriting practices

c. Reinsurance counterparties that have similar financial characteristics and face similar economic conditions.

326-20-55-85

Judgment should be applied by ceding insurers in determining if and when similar risks exist within their reinsurance receivables.

To apply the new impairment model, an insurer will need to assess all available information relevant to the collectibility of cash flows including historical information, current conditions and expectations of future conditions. The standard says entities can use a loss rate approach or an aging schedule to measure the allowance for credit losses. Insurers may also consider

using an approach that applies default rates or impairment rates for similarly rated companies based on the duration of the receivables. Sources for such information may include insurance rating agencies' industry reports (e.g., A.M. Best's Impairment Rate Study).

How we see it

Applying the expected credit loss impairment model to reinsurance receivables could significantly change practice for insurers and require changes in processes and controls. Reinsurance receivables may need to be assessed on a collective basis rather than individually. Another change will be incorporating reasonable and supportable forecasts about the future into the assessment.

2.11.4 Off-balance-sheet commitments

When estimating expected credit losses on off-balance-sheet commitments (e.g., loan commitments), an entity will apply the CECL model. An entity likely will be able to estimate expected credit losses on loan commitments by using the same method it uses for estimating expected credit losses for loans except that it will need to also consider the probability that the unfunded commitment will become funded. The estimate of expected credit losses for off-balance-sheet credit commitments will be recognized as a liability (i.e., a reserve for credit losses instead of an allowance for credit losses).

An entity should consider the following when estimating credit losses for off-balance-sheet commitments:

- The contractual period in which the entity is exposed to credit risk because of a present contractual obligation to extend credit, unless that obligation is unconditionally cancelable by the entity
- The likelihood that funding will occur, which may be affected by a material adverse change clause, among other things
- An estimate of expected credit losses on commitments expected to be funded over its estimated life

In certain cases, a legal analysis of the commitment may be necessary to appropriately conclude whether the contract is unconditionally cancelable.

The following illustration from the standard shows how an entity will apply the new standard when the commitment provides the entity with the ability to unconditionally cancel it.

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Implementation Guidance and Illustrations

Example 10: Application of Expected Credit Losses to Unconditionally Cancellable Loan Commitments

326-20-55-54

This Example illustrates the application of the guidance in paragraph 326-20-30-11 for off-balance-sheet credit exposures that are unconditionally cancellable by the issuer.

326-20-55-55

Bank M has a significant credit card portfolio, including funded balances on existing cards and unfunded commitments (available credit) on credit cards. Bank M's card holder agreements stipulate that the available credit may be unconditionally cancelled at any time.

326-20-55-56

When determining the allowance for credit losses, Bank M estimates the expected credit losses over the remaining lives of the funded credit card loans. Bank M does not record an allowance for unfunded commitments on the unfunded credit cards because it has the ability to unconditionally cancel the available lines of credit. Even though Bank M has had a past practice of extending credit on credit cards before it has detected a borrower's default event, it does not have a present contractual obligation to extend credit. Therefore, an allowance for unfunded commitments should not be established because credit risk on commitments that are unconditionally cancellable by the issuer are not considered to be a liability.

How we see it

An entity will need to evaluate the terms of individual commitments to assess whether they include provisions that allow the issuing entity to unconditionally cancel the commitment. This likely will require new processes and controls.

2.11.5 Accounts receivable

Entities with trade accounts receivable will need to evaluate and update their current impairment processes to align with the objectives of the ASU.

The standard will change the recognition and measurement of expected credit losses for accounts receivable (e.g., trade receivables). Entities will be allowed to measure expected credit losses using certain current practices, such as a provision matrix (i.e., grouping receivables by age and applying historical loss rates). To estimate expected losses, an entity will need to consider adjustments to its existing processes for estimating credit losses on trade receivables, since those existing processes likely only capture incurred losses and do not reflect reasonable and supportable forecasts. In that regard, the entity will have to determine:

- Whether the historical loss rates calculated and applied to each aging bucket reflect current conditions and reasonable and supportable economic forecasts
- How to make sure the allowance for bad debts reflects the risk of loss, which will result in an entity including a loss factor for:
  - Current balances, even if historically no allowance has been estimated for such receivables
  - Individually significant balances for which an entity has historically concluded there is no risk of loss (e.g., major customers that have always paid on time, such as federal and municipal customers)

The following example from the standard shows how an entity might apply the new standard to its trade accounts receivable balance.

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Implementation Guidance and Illustrations

Example 5: Estimating Expected Credit Losses for Trade Receivables using an Aging Schedule

326-20-55-37

This Example illustrates one way an entity may estimate expected credit losses for trade receivables using an aging schedule.

326-20-55-38

Entity E manufactures and sells products to a broad range of customers, primarily retail stores. Customers typically are provided with payment terms of 90 days with a 2 percent discount if payments are received within 60 days. Entity E has tracked historical loss information for its trade receivables and compiled the following historical credit loss percentages:

a. 0.3 percent for receivables that are current

b. 8 percent for receivables that are 1–30 days past due

c. 26 percent for receivables that are 31–60 days past due

d. 58 percent for receivables that are 61–90 days past due

e. 82 percent for receivables that are more than 90 days past due.

326-20-55-39

Entity E believes that this historical loss information is a reasonable base on which to determine expected credit losses for trade receivables held at the reporting date because the composition of the trade receivables at the reporting date is consistent with that used in developing the historical credit-loss percentages (that is, the similar risk characteristics of its customers and its lending practices have not changed significantly over time). However, Entity E has determined that the current and reasonable and supportable forecasted economic conditions have improved as compared with the economic conditions included in the historical information. Specifically, Entity E has observed that unemployment has decreased as of the current reporting date, and Entity E expects there will be an additional decrease in unemployment over the next year. To adjust the historical loss rates to reflect the effects of those differences in current conditions and forecasted changes, Entity E estimates the loss rate to decrease by approximately 10 percent in each age bucket. Entity E developed this estimate based on its knowledge of past experience for which there were similar improvements in the economy.

326-20-55-40

At the reporting date, Entity E develops the following aging schedule to estimate expected credit losses.

Past-Due Status	Amortized Cost Basis	Credit Loss Rate	Expected Credit Loss Estimate
Current	$ 5,984,698	0.27%	$ 16,159
1–30 days past due	8,272	7.2%	596
31–60 days past due	2,882	23.4%	674
61–90 days past due	842	52.2%	440
More than 90 days past due	1,100	73.8%	812
	$ 5,997,794		$ 18,681

How we see it

It's unclear whether the new guidance will change the allowance for bad debts significantly from what an entity recognizes today as an incurred loss because many of these receivables have contractual maturities of less than one year. Entities will need to make sure their accounting policies, processes and controls are updated to reflect the added requirements of the new standard.

3 The AFS debt security impairment model (ASC 326-30)

The FASB decided that the CECL model should not apply to AFS debt securities. Instead, the Board made targeted amendments to the existing AFS debt security impairment model and reorganized the guidance in a new subtopic (i.e., ASC 326-30). As a result, different impairment models will exist for debt securities that are classified as AFS from those that are classified as HTM.

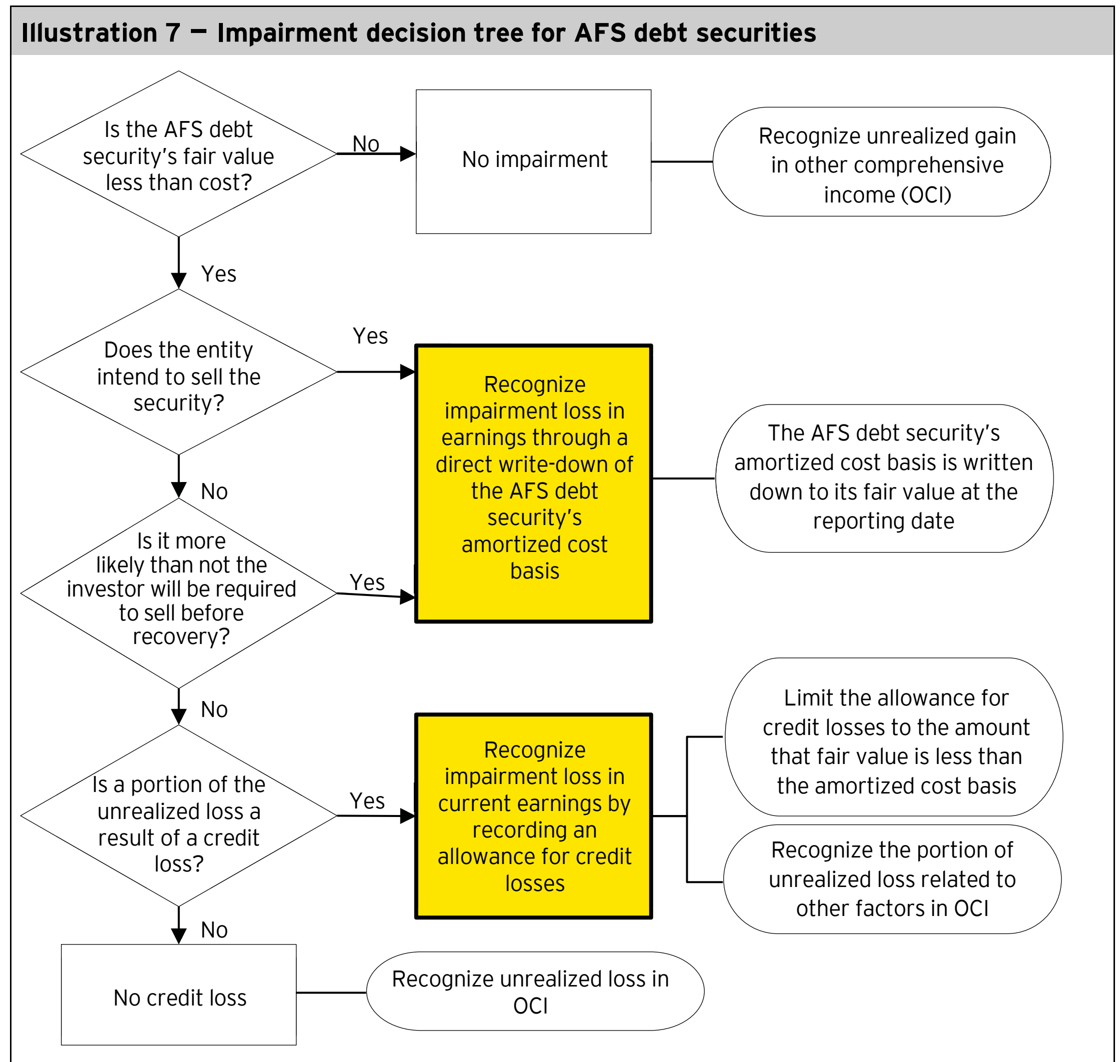
Under the new guidance, an entity will recognize an allowance for credit losses on AFS debt securities rather than recognize impairment as a reduction of the cost basis of the investment as is done today. Further, an entity will recognize subsequent improvements in estimated credit losses on AFS debt securities immediately in earnings as a reduction in the allowance and credit loss expense. Today, a recovery of an impairment loss on an AFS debt security is prospectively recognized as interest income over time.

The new guidance also eliminates the concept of "other-than-temporary" impairment and instead focuses on determining whether the unrealized loss is a result of a credit loss or other factors. As a result, the standard says that management may not use the length of time a security has been in an unrealized loss position as a factor, either by itself or in combination with other factors, to conclude that a credit loss does not exist, as they are permitted to do today.

Entities with AFS debt securities will recognize changes in credit loss estimates through an allowance for credit losses.

The following graphic illustrates the new model.

Illustration 7 — Impairment decision tree for AFS debt securities



How we see it

One of the primary changes is that the new model requires the use of an allowance to recognize credit losses, and entities will need to adjust the allowance in each reporting period when the estimate of credit losses changes. The potential for reversals of previously recognized credit losses in subsequent periods may increase earnings volatility because adjustments will result in immediate increases or decreases to net income.

3.1 Determining whether an AFS debt security is impaired

Excerpt from Accounting Standards Codification

Financial Instruments, Available-for-Sale Debt Securities — Credit Losses

Subsequent Measurement

326-30-35-1

An investment is impaired if the fair value of the investment is less than its amortized cost basis.

326-30-35-4

Impairment shall be assessed at the individual security level (referred to as an investment). Individual security level means the level and method of aggregation used by the reporting entity to measure realized and unrealized gains and losses on its debt securities. (For example, debt securities bearing the same Committee on Uniform Security Identification Procedures [CUSIP] number that were purchased in separate trade lots may be aggregated by a reporting entity on an average cost basis if that corresponds to the basis used to measure realized and unrealized gains and losses for the debt securities.) Providing a general allowance for an unidentified impairment in a portfolio of debt securities is not appropriate.

326-30-35-5

An entity shall not combine separate contracts (a debt security and a guarantee or other credit enhancement) for purposes of determining whether a debt security is impaired or can contractually be prepaid or otherwise settled in such a way that the entity would not recover substantially all of its cost.

An entity will be required to assess whether its AFS debt securities are impaired at every reporting period (i.e., quarterly for public companies). An individual AFS debt security will be considered impaired if the fair value of the investment is less than its amortized cost, which is the amount at which the investment was acquired, adjusted for items such as amortization of any discount or premium and cash collections. This evaluation is unchanged from today's guidance.

Consistent with current guidance, investments in the same instrument may be aggregated for evaluating impairment if the entity aggregates the securities for purposes of measuring realized and unrealized gains and losses. That's the case, even if the securities are purchased on different dates. For example, debt securities with the same CUSIP number that were purchased on separate dates may be aggregated by an entity on an average cost basis if that is the basis the entity uses to measure realized and unrealized gains and losses on the securities.

3.2 Impairment when an entity intends, or is required, to sell an AFS debt security

Excerpt from Accounting Standards Codification

Financial Instruments, Available-for-Sale Debt Securities — Credit Losses

Subsequent Measurement

326-30-35-10

If an entity intends to sell the debt security (that is, it has decided to sell the security), or more likely than not will be required to sell the security before recovery of its amortized cost basis, any allowance for credit losses shall be written off and the amortized cost basis shall be written down to the debt security's fair value at the reporting date with any incremental impairment reported in earnings. If an entity does not intend to sell the debt security, the entity shall consider available evidence to assess whether it more likely than not will be required to sell the security before the recovery of its amortized cost basis (for example, whether its cash or working capital requirements or contractual or regulatory obligations indicate that the security will be required to be sold before the forecasted recovery occurs). In assessing whether the entity more likely than not will be required to sell the security before recovery of its amortized cost basis, the entity shall consider the factors in paragraphs 326-30-55-1 through 55-2.

The guidance for recognizing impairment when an entity intends, or is required, to sell an AFS debt security, will remain consistent with current guidance. That is, an entity must recognize the entire impairment in earnings if the entity has decided to sell the AFS debt security, or it is more likely than not that the entity will be required to sell the AFS debt security.

The phrase "intends to sell the debt security" means a decision has been made to sell the debt security. If no decision has been made to sell the debt security, an entity will need to estimate the period over which the security is expected to recover and whether its cash or working capital requirements and contractual or regulatory obligations may indicate that the security may need to be sold before the forecasted recovery occurs. If it is more likely than not that the entity will be required to sell the security before recovering its cost basis, an impairment loss exists.

Determining whether it is more likely than not that an entity will be required to sell a debt security before recovering its amortized cost basis is a matter of judgment. Entities will need to consider all facts and circumstances including their legal and contractual obligations and operational, regulatory and liquidity needs.

If an entity intends, or is required, to sell the AFS debt security before recovery of its amortized cost basis, an impairment loss must be recognized in earnings in an amount that is equal to the difference between the debt security's amortized cost and fair value. In these circumstances, the entity will not recognize an allowance. Rather, the impairment will be recognized as a reduction in the amortized cost of the debt security.

3.2.1 Accounting after a write-down resulting from a decision or requirement to sell

Excerpt from Accounting Standards Codification

Financial Instruments, Available-for-Sale Debt Securities — Credit Losses

Subsequent Measurement

326-30-35-14

Once an individual debt security has been written down in accordance with paragraph 326-30-35-10, the previous amortized cost basis less writeoffs, including non-credit-related impairment reported in earnings, shall become the new amortized cost basis of the investment. That new amortized cost basis shall not be adjusted for subsequent recoveries in fair value.

326-30-35-15

For debt securities for which impairments were reported in earnings as a writeoff because of an intent to sell or a more-likely-than-not requirement to sell, the difference between the new amortized cost basis and the cash flows expected to be collected shall be accreted in accordance with existing applicable guidance as interest income. An entity shall continue to estimate the present value of cash flows expected to be collected over the life of the debt security. For debt securities accounted for in accordance with Subtopic 325-40, an entity should look to that Subtopic to account for changes in cash flows expected to be collected. For all other debt securities, if upon subsequent evaluation, there is a significant increase in the cash flows expected to be collected or if actual cash flows are significantly greater than cash flows previously expected, those changes shall be accounted for as a prospective adjustment to the yield. Subsequent increases in the fair value of available-for-sale securities after the write-down shall be included in other comprehensive income. (This Section does not address when a holder of a debt security would place a debt security on nonaccrual status or how to subsequently report income on a nonaccrual debt security.)

After writing down an AFS debt security because of a decision to sell or meeting the more likely than not requirement, the holder's new amortized cost basis of the debt security is the previous amortized cost basis less the amount written off. The difference between the new amortized cost basis and the cash flows expected to be collected should be accreted as interest income. As such, an entity should continue to estimate the present value of cash flows expected to be collected over the life of the debt security.

If there is a significant increase in the cash flows expected to be collected or if actual cash flows are significantly greater than cash flows previously expected, such changes must be accounted for as a prospective adjustment to the security's yield, except for securities in the scope of ASC 325-40, which should continue to follow that guidance. An impairment recognized in earnings from a write-down resulting from a decision or requirement to sell should not be reversed.

The accounting for subsequent increases and decreases in fair value (if not determined at that date to be an impairment) remains the same (i.e., they should be included in OCI).

3.3 Assessing whether a credit loss exists

The standard provides guidance on how an entity will assess, either quantitatively or qualitatively, whether a credit loss exists when the fair value of a security is below the security's amortized cost basis at the balance sheet date.

Excerpt from Accounting Standards Codification

Financial Instruments, Available-for-Sale Debt Securities — Credit Losses

Subsequent Measurement

326-30-35-6

In assessing whether a credit loss exists, an entity shall compare the present value of cash flows expected to be collected from the security with the amortized cost basis of the security. If the present value of cash flows expected to be collected is less than the amortized cost basis of the security, a credit loss exists and an allowance for credit losses shall be recorded for the credit loss, limited by the amount that the fair value is less than amortized cost basis. Credit losses on an impaired security shall continue to be measured using the present value of expected future cash flows.

326-30-35-7

In determining whether a credit loss exists, an entity shall consider the factors in paragraphs 326-30-55-1 through 55-4 and use its best estimate of the present value of cash flows expected to be collected from the debt security. One way of estimating that amount would be to consider the methodology described in paragraphs 326-30-35-8 through 35-10. Briefly, the entity would discount the expected cash flows at the effective interest rate implicit in the security at the date of acquisition.

326-30-55-1

There are numerous factors to be considered in determining whether a credit loss exists. The length of time a security has been in an unrealized loss position should not be a factor, by itself or in combination with others, that an entity would use to conclude that a credit loss does not exist. The following list is not meant to be all inclusive. All of the following factors should be considered:

a. The extent to which the fair value is less than the amortized cost basis.

b. Adverse conditions specifically related to the security, an industry, or geographic area; for example, changes in the financial condition of the issuer of the security, or in the case of an asset-backed debt security, changes in the financial condition of the underlying loan obligors. Examples of those changes include any of the following:

   1. Changes in technology

   2. The discontinuance of a segment of the business that may affect the future earnings potential of the issuer or underlying loan obligors of the security

   3. Changes in the quality of the credit enhancement.

c. The payment structure of the debt security (for example, nontraditional loan terms as described in paragraphs 825-10-55-1 through 55-2) and the likelihood of the issuer being able to make payments that increase in the future.

d. Failure of the issuer of the security to make scheduled interest or principal payments.

e. Any changes to the rating of the security by a rating agency.

An entity won't be able to consider the length of time a security has been in an unrealized loss position as a factor in assessing whether a credit loss exists.

The factors in ASC 326-30-55-1 are consistent with the factors in the current guidance (ASC 320-10-35-33F), except that the following factors were removed from the list of factors that are considered today:

- The length of time fair value has been less than the amortized cost basis of the debt security
- The historical and implied volatility of the fair value of the security
- Recoveries or additional declines in fair value after the balance sheet date

How we see it

Although the standard does not specifically preclude an entity from considering volatility of the fair value of the security, as well as recoveries or additional declines in fair value after the balance sheet date, we believe the FASB removed them from the list of factors in ASC 326-30-55-1 because the FASB believes they are not relevant in assessing whether a credit loss exists and should not be considered, given the elimination of the OTTI concept.

The ASU prohibits an entity from considering the length of time a security has been in an unrealized loss position either as a factor by itself, or in combination with others. In making this change, the FASB has shifted the focus from "time" (e.g., how long a debt security's fair value has been below its amortized cost) to a focus on whether the impairment is due to a credit loss. An entity will recognize the impairment relating to credit-related factors through an allowance for credit losses and recognize the impairment relating to non-credit-related factors through other comprehensive income (OCI), net of applicable taxes.

How we see it

Today, many entities use the length of time a debt security's fair value has been below amortized cost as a filter to reduce the number of debt securities requiring a more thorough credit analysis. That is, an entity may have a policy that any debt security that has been in an unrealized loss position for, say 30 days or 60 days, absent other impairment indicators, would not be considered to have a credit loss. Because the ASU will preclude an entity from making this type of conclusion, these entities will need to adjust their process for evaluating whether there is an impairment due to a credit loss when the security has been impaired for a short period of time.

In addition to considering the qualitative factors enumerated in paragraph 55-1, an entity should use its best estimate of the present value of cash flows expected to be collected from the debt security when evaluating whether a credit loss exists. Entities should consider reasonably available data points in that assessment, including industry analyses, credit ratings and other relevant market data. An entity should also consider how other credit enhancements that are not separate contracts affect the expected performance of the debt security, including consideration of the current financial condition of the guarantor of a security and/or whether any subordinated interests are capable of absorbing estimated losses on the financial assets underlying the security

How we see it

Questions have arisen about whether the guidance in paragraphs ASC 326-30-35-6 and 35-7 stating that "an entity shall… use its best estimate of the present value of cash flows expected to be collected from the debt security" in assessing whether a credit loss exists requires an entity to prepare a quantitative DCF analysis for all impaired securities that management does not intend to sell or is not required to sell.

We believe that a calculation of the present value of cash flows generally will not be necessary when assessing whether a credit loss exists, but will be required to measure a credit loss. For example, if after considering the factors in ASC 326-30-55-1, management's best estimate is that all contractual cash flows will be collected timely, our view is that a thorough qualitative analysis supporting the conclusion that there is no credit loss will be sufficient.

3.4 Measuring the credit impairment allowance

For AFS debt securities with unrealized losses, entities will measure credit losses in a manner similar to what they do today, except that the losses will be recognized as allowances rather than reductions in the amortized cost of the securities.

Excerpt from Accounting Standards Codification

Financial Instruments, Available-for-Sale Debt Securities — Credit Losses

Subsequent Measurement

326-30-35-2

For individual debt securities classified as available-for-sale securities, an entity shall determine whether a decline in fair value below the amortized cost basis has resulted from a credit loss or other factors. An entity shall record impairment relating to credit losses through an allowance for credit losses. However, the allowance shall be limited by the amount that the fair value is less than the amortized cost basis. Impairment that has not been recorded through an allowance for credit losses shall be recorded through other comprehensive income, net of applicable taxes. An entity shall consider the guidance in paragraphs 326-30-35-6 and 326-30-55-1 through 55-4 when determining whether a credit loss exists.

326-30-35-3

At each reporting date, an entity shall record an allowance for credit losses that reflects the amount of the impairment related to credit losses, limited by the amount that fair value is less than the amortized cost basis. Changes in the allowance shall be recorded in the period of the change as credit loss expense (or reversal of credit loss expense).

When an entity does not intend to sell an impaired debt security and it is not more likely than not that it will not be required to sell the security prior to recovery, the impairment amount representing the credit loss will be recognized as an allowance for credit losses. This allowance is a contra-account to the amortized cost basis of the AFS debt security. The amount related to all other factors is recognized in OCI. The allowance for credit losses should be re-measured each reporting period and adjusted when necessary.

The requirement to recognize an allowance for credit loss is a significant change from today's approach, which requires an entity to take a direct write-down and reduce the AFS debt security's amortized cost basis. An entity will recognize improvements in estimated credit losses (i.e., expected cash flows) on AFS debt securities immediately in earnings through a reversal to the allowance. Today, a recovery of an AFS debt security impairment loss is recognized as interest income over time.

3.4.1 Measuring the credit loss for an AFS debt security

Using the methodology described in ASC 326-30-35-6 through 35-9 and a single best estimate of expected cash flows, an entity would measure credit losses as the difference between the current amortized cost and the present value of revised cash flows discounted at the original effective interest rate (at the AFS debt security's purchase).

Illustration 8 — Estimating the allowance for credit losses for an AFS debt security

Assume Entity E purchases a five-year, $10,000 par bond with a 5% coupon (a market rate at the time of purchase) on 1 January 20X0. The bond is accounted for under ASC 320 and is classified as an AFS debt security. As of 31 December 20X0, the amortized cost basis of the AFS debt security is $10,000 and Entity E expects to collect less than the contractual cash flows for the years 20X3 and 20X4. Entity E estimates that only $250 of interest will be collected in 20X4 and only $9,000 of the principal balance and no interest will be collected in 20X5.

As of 31 December 20X0, the fair value of the debt security is $6,000, which implies an effective yield or discount rate of approximately 16% based on the new estimate of cash flows expected to be collected. Also, assume that Entity E does not intend to sell the debt security and it is not more likely than not Entity E will be required to sell the debt security before recovery of its amortized cost basis. The table below shows the original and revised cash flows expected to be collected and illustrates how Entity E will estimate the allowance for expected credit losses and the amount attributable to other factors:

	Original cash flows expected to be collected	**Revised cash flows expected to be collected**	**Decrease in cash flows expected to be collected**
20X0	$ 500	(collected)	n/a
20X1	500	$ 500	$ –
20X2	500	500	–
20X3	500	250	250
20X4	10,500	9,000	1,500
Total gross cash flows	$12,500	$ 10,250	$ 1,750
Present value discounted at 5% (original effective rate)	$10,000	$ 8,550	$ 1,450
Fair value as of 31 December 20X0		$ 6,000	
Impairment due to other factors (noncredit)		$ 2,550	
Initial carrying amount		$ 10,000	
Plus: Interest recognized in 20X0		500	
Less: Interest collected in 20X0		(500)	
Impairment amounts as of 31 December 20X0 recognized:			
As an allowance for credit losses	(1,450)		
In OCI for amounts related to other factors	(2,550)		
Total impairment		(4,000)	
Fair value at end of 20X0		$ 6,000	

As illustrated above, applying the guidance in ASC 326-30-35-7 through 35-9, the entity separates the total impairment of $4,000 (the cost basis of $10,000 less the fair value of $6,000 as of 31 December 20X0) into the following two parts:

- The amount representing the decrease in cash flows expected to be collected (i.e., the credit loss) of $1,450, which is discounted at the original effective rate of 5% (rate at the debt security's purchase)
- The amount related to all other factors of $2,550

The entity will recognize an allowance for credit losses with a corresponding credit loss expense in net income of $1,450 for the credit loss and recognize the remaining impairment loss of $2,550 separately in OCI.

Although the method for estimating credit losses for AFS debt securities (e.g., DCF calculation) doesn't change from current practice, the write-down will now be recognized as an allowance instead of a reduction to the amortized costs basis of the debt security. The following illustrates the journal entries required for Illustration 8.

Illustration 9 — Recognizing the allowance estimated in Illustration 8

Entity E would make the following journal entries, which we have simplified to exlcude income taxes and interest:

Dr. Credit loss expense	$	1,450		
Cr. Allowance for credit losses			$	1,450

To recognize the credit loss in earnings through an allowance

Dr. Other comprehensive income	$	2,550		
Cr. Investment in AFS debt security			$	2,550

To recognize the impairment due to other factors

As a result, the carrying value of the investment is calculated as follows:

Amortized cost	$	10,000
Less allowance		(1,450)
Less impairment due to other factors		(2,550)
Net carrying value (i.e., fair value)	$	6,000

At 31 December 2020, Company A's balance sheet would reflect the net $6,000 carrying value (i.e., the fair value) of the investment. The allowance of $1,450 would be presented parenthetically on the face of the balance sheet.

The $1,450 credit loss would be recognized in income and the noncredit impairment of $2,550 would be separately recognized in OCI, net of income taxes. In a change from today's OTTI model, assuming all interest is accrued and collected and assuming Entity E concludes that a write-off is not necessary, the amortized cost basis remains at $10,000 (i.e., under today's OTTI model, the amortized cost basis would have been reduced by the recognized credit loss).

How we see it

Because different impairment models will exist for debt securities that are classified as HTM and AFS, entities will need to consider the guidance in each model when evaluating credit losses for these securities. For example, a security held in an entity's HTM portfolio will have a credit loss recorded even if the fair value is greater than the security's amortized cost basis. However, credit losses will be recognized for AFS debt securities only when the security's fair value is less than its amortized cost basis.

3.4.2 Accounting for an AFS debt security after a credit impairment

Excerpt from Accounting Standards Codification

Financial Instruments, Available-for-Sale Debt Securities — Credit Losses

Subsequent Measurement

326-30-35-12

An entity shall reassess the credit losses each reporting period when there is an allowance for credit losses. An entity shall record subsequent changes in the allowance for credit losses on available-for-sale debt securities with a corresponding adjustment recorded in the credit loss expense on available-for-sale debt securities. An entity shall not reverse a previously recorded allowance for credit losses to an amount below zero.

326-30-35-13

An entity shall recognize writeoffs and recoveries of available-for-sale debt securities in accordance with paragraphs 326-20-35-8 through 35-9.

After the recognition of a credit loss through the allowance, an entity should continue to reassess credit losses and adjust the allowance at each subsequent report date as necessary. This will result in subsequent gains and losses to net income as the measured credit loss changes. However, the allowance should never be reversed to a negative amount.

3.5 Interest income

Entities will continue to apply the interest method outlined in ASC 835-30[10] (including the requirement to impute interest when there is no stated interest rate) and the guidance in ASC 310-20[11] for nonrefundable fees and other costs, premiums and discounts.

As discussed in section 3.2.1, for securities written down resulting from an intent to sell or a requirement to sell, if there is a significant increase in the cash flows expected to be collected or if actual cash flows are significantly greater than cash flows previously expected, such changes must be accounted for as a prospective adjustment to the accretable yield. This is consistent with practice today.

The AFS debt security impairment model does not provide nonaccrual guidance, but does not preclude the application of such policies.

How we see it

Although the standard does not change the interest recognition methods under current US GAAP, the amount of interest income recognized may change. This is because interest income accruals are calculated using the amortized cost basis of the security as the base. Because an entity will now record an allowance for credit losses instead of directly reducing the amortized cost basis of an AFS debt security (when there is no intent to sell and it is not more likely than not the entity will be required to sell the AFS debt security before recovery), there will be a larger amortized cost basis, which will result in higher interest income accruals than under current guidance. However, because the allowance is a discounted amount, the higher interest income will generally be offset in the income statement by the accretion of the discount on the allowance.

---

[10] ASC 835-30, *Imputation of Interest*.

[11] ASC 310-20, *Nonrefundable Fees and Other Costs*.

Entities will have a choice about where to present the accretion of this discount (i.e., the change in present value attributable to the passage of time) as either a credit loss expense or as a reduction of interest income. Further, entities will see a difference in interest recognition when cash flows are expected to improve, since the change in expected cash flows for these securities will no longer be accreted into income over time, but will be recognized as a reversal of the allowance.

3.6 Disclosures

The new standard retains today's disclosure requirements related to AFS debt securities described in ASC 320-10-50 (e.g., details of the difference between fair value and amortized cost, information about the contractual maturities of the securities) but updates them to reflect the use of an allowance for credit losses and the removal of the other-than-temporary concept.

The purpose of the disclosures about impaired AFS debt securities is to help financial statement users understand the credit risk inherent in an entity's AFS debt securities, management's estimate of credit losses and changes in the estimate of credit losses that have taken place during the period.

The ASU requires information to be provided by major security type. Major security types are based on the nature and risks of the security. In determining whether disclosure for a particular security type is necessary and whether it is necessary to further separate a particular security type into greater detail, an entity should consider the following:

- Shared activity or business sector
- Vintage
- Geographic concentration
- Credit quality
- Economic characteristic

Entities will need to determine the appropriate level of disclosure for major security types. The objective is to provide information at a level that provides sufficient detail for a user to understand the portfolio or class without being overwhelmed by insignificant data.

The sections that follow highlight changes and additions to current disclosure requirements.

3.6.1 Rollforward of the allowance for credit losses

Entities will have to disclose a tabular rollfoward of the allowance for credit losses at each balance sheet date. This requirement will change practice for entities with AFS debt securities. The rollforward should be disclosed by major security type and include a minimum of the following:

- The beginning balance of the allowance for credit losses
- Additions to the allowance for credit losses on securities for which credit losses were not previously recorded
- Additions to the allowance for credit losses arising from purchases of AFS debt securities accounted for as PCD assets (including beneficial interests that meet the criteria in paragraph 325-40-30-1A)
- Reductions for securities sold during the period

- Reductions in the allowance for credit losses because the entity intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis
- If the entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis, additional increases or decreases to the allowance for credit losses on securities that had an allowance recorded in a previous period
- Write-offs charged against the allowance
- Recoveries of amounts previously written off
- The ending balance of the allowance for credit losses

3.6.2 Accounting policy for recognizing write-offs

Entities will be required to disclose their accounting policy for recognizing write-offs. This will be a change in practice for investors in AFS debt securities as they did not need policies for determining when to write off a security. Under the current OTTI model, all credit losses result in a direct write-off of the cost basis of the security, thus a write-off policy was not necessary.

3.7 Comparison of impairment models for AFS and HTM debt securities

An entity may record different amounts for credit losses on the same security depending on whether it is classified as HTM or AFS.

The following summarizes key differences between the impairment models for AFS and HTM debt securities.

Topic	AFS debt security impairment model*	HTM current expected credit loss model
Unit of measurement	Individual AFS debt security	Collective (pool) when similar risk characteristics exist; otherwise, individual
Allowance recognition threshold	When a decline in fair value below the amortized cost basis has resulted from a credit loss	None
Measurement of credit losses	Excess of the amortized cost basis over the best estimate of the present value of cash flows expected to be collected, limited by the amount that fair value is less than amortized cost	Expected credit loss that reflects the risk of loss even if that risk is remote
Acceptable methods for measuring credit losses	DCF	Various methods are appropriate, including DCF, loss rate, PD and others that faithfully estimate collectibility by applying the principles in ASC 326-20

*When the entity has decided to sell the debt security or it's more likely than not the entity will be required to sell the security before recovery of the security's amortized cost basis, the security's amortized cost basis should be written down to fair value through earnings at the reporting date.

How we see it

Because the models for AFS and HTM debt securities are different, an entity may record different amounts for credit losses on the same debt security in its AFS and HTM portfolios.

4 The model for certain beneficial interests (ASC 325-40)

Today's ASC 325-40 model for beneficial interests applies to certain interests in securitized financial assets as described in Section 1.3, *Scope: The model for certain beneficial interests (ASC 325-40).* A mortgage-backed security (MBS) made up of subprime loans is an example of a beneficial interest that may fall within the scope of ASC 325-40.

The ASC 325-40 model for beneficial interests provides an integrated approach to recognizing interest income and impairment expense for such investments. Under the model, an entity evaluates both (1) changes in expected cash flows from the beneficial interest and (2) whether the fair value of the beneficial interest exceeds the carrying amount. Based on those two factors, an entity may need to recognize an allowance for credit losses and/or prospectively adjust the yield to be recognized on the beneficial interest.

ASC 325-40 requires an entity to use a DCF approach to estimate expected cash flows from period to period. Changes in expected cash flows can arise from prepayments, credit concerns, changes in interest rates or other factors.

4.1 Initial recognition

As discussed in Section 1.3, ASC 325-40 currently does not apply to a beneficial interest that is in the scope of ASC 310-30 (a so-called purchased credit impaired asset). A beneficial interest in the scope of ASC 310-30 is initially and subsequently measured in accordance with that guidance.

The ASU eliminates the guidance in ASC 310-30 and replaces it with a special day-one accounting for purchased financial assets with credit deterioration (PCD assets), as described more fully in Section 5, *Purchased financial assets*. Under the ASU, an entity that purchases a beneficial interest in the scope of ASC 325-40 will have to determine whether it should apply the PCD asset guidance. An entity will need to apply that guidance to a purchased beneficial interest classified as HTM or AFS that meets either of the criteria described in the following excerpt from the Codification:

Excerpt from Accounting Standards Codification

Investments — Other — Beneficial Interests in Securitized Financial Assets

Initial Measurement

Initial Investment

325-40-30-1A

An entity shall apply the initial measurement guidance for purchased financial assets with credit deterioration in Subtopic 326-20 to a beneficial interest classified as held-to-maturity and in Subtopic 326-30 to a beneficial interest classified as available for sale, if it meets either of the following conditions:

a. There is a significant difference between contractual cash flows and expected cash flows at the date of recognition.

b. The beneficial interests meet the definition of purchased financial assets with credit deterioration.

How we see it

It's unclear what "contractual cash flows" means in the context of a beneficial interest in the scope of ASC 325-40. For example, some believe the contractual cash flows used in this scoping exercise should be based on the contractual terms of the beneficial interest, while others believe they should use the contractual cash flows of the underlying assets within the structure. In certain cases, we believe using either approach could yield a similar result.

The ASU also isn't clear about what prepayment speeds to use when determining the contractual cash flows under either scenario. For example, if prepayments are not assumed when determining the contractual cash flows, an entity will often conclude that there is a significant difference between contractual and expected cash flows because an investor will most likely have some expectation of prepayments when they purchase the beneficial interest. If this is the case, the beneficial interest would meet the threshold to be accounted for as a PCD asset, and the entity would recognize an allowance upon initial recognition by grossing up the beneficial interest's amortized cost. This approach would change the pattern of interest income recognition from what it is today because in subsequent periods, an entity will adjust the allowance for changes in cash flow expectations before prospectively adjusting yield.

On the other hand, if prepayments are assumed for the purposes of determining contractual cash flows, an entity might not conclude that there is a significant difference between contractual cash flows and expected cash flows on the date of recognition.

4.1.1 Accretable yield

Accretable yield is an important concept in the ASC 325-40 model that represents the amount of cash flows that should be accreted as interest income over the remaining life of the beneficial interest using the effective interest method. Entities should consider the following guidance when determining a beneficial interest's accretable yield at purchase:

Excerpt from Accounting Standards Codification

Investments — Other — Beneficial Interests in Securitized Financial Assets

Initial Measurement

Accretable yield

325-40-30-2

For beneficial interests that do not apply the accounting for purchased financial assets with credit deterioration, the holder shall measure accretable yield initially as the excess of all cash flows expected to be collected attributable to the beneficial interest estimated at the acquisition-transaction date (the transaction date) over the initial investment. For beneficial interests that apply the accounting for purchased financial assets with credit deterioration, the holder shall measure accretable yield initially as the excess of all contractual cash flows attributable to the beneficial interest at the acquisition-transaction date (the transaction date) over the amortized cost basis (the purchase price plus the initial allowance for credit losses).

An entity's initial estimate of credit loss will not be accreted to income. This is because for non-PCD assets an entity will only consider expected cash flows in determining the yield on the beneficial interests. For PCD assets, the yield is determined by equating contractual cash flows to the beneficial interests amortized cost, which has been grossed up for the entities initial estimate of credit loss.

4.2 Subsequent measurement

The following chart summarizes the subsequent measurement of beneficial interests under the ASU based on whether the beneficial interest is classified as AFS or HTM and highlights the differences and similarities of the two classifications.

<table>
<tr><th rowspan="2">Topic</th><th colspan="2">Beneficial interests in the scope of ASC 325-40 classified as</th></tr>
<tr><th>AFS</th><th>HTM</th></tr>
<tr><td rowspan="2">If there is a favorable or adverse change in cash flows expected to be collected from the cash flows previously projected*</td><td>Apply the guidance in ASC 326-30 on measuring credit losses on AFS debt securities to account for that favorable or adverse change</td><td>Apply the guidance in ASC 326-20 on financial instruments measured at amortized cost to account for that favorable or adverse change</td></tr>
<tr><td colspan="2">After application of the guidance in either ASC 326-30 or ASC 326-20 (as discussed above), if the amount of the favorable or adverse change in cash flows expected to be collected from the cash flows previously projected is not reflected (either as an increase or as a decrease) in the allowance for credit losses pursuant to ASC 326-30 or ASC 326-20, the investor shall recalculate the amount of accretable yield for the beneficial interest on the date of evaluation as the excess of cash flows expected to be collected over the beneficial interest's reference amount.**</td></tr>
<tr><td>Unit of measurement</td><td>Individual debt security</td><td>Collective (pool) when similar risk characteristics exist; otherwise, individual</td></tr>
<tr><td>Allowance recognition threshold</td><td>When a decline in fair value below the amortized cost basis has resulted from a credit loss</td><td>None</td></tr>
<tr><td>Measurement of credit losses</td><td>Excess of the amortized cost basis over the best estimate of the present value of cash flows expected to be collected, limited by the amount that fair value is less than amortized cost.</td><td>Expected credit loss that reflects the risk of loss even if that risk is remote</td></tr>
<tr><td>Acceptable methods for measuring credit losses</td><td colspan="2">DCF</td></tr>
</table>

* A favorable or an adverse change in cash flows expected to be collected is considered in the context of both timing and amount of the cash flows expected to be collected. If the present value of the estimate at the initial transaction date (or the last date previously revised) of cash flows expected to be collected is less than the present value of the current estimate of cash flows expected to be collected, the change is considered favorable. If the present value of the estimate at the initial transaction date (or the last date previously revised) of cash flows expected to be collected is greater than the present value of the current estimate of cash flows expected to be collected, the change is considered adverse.

** The reference amount is equal to the initial investment (or initial amortized cost basis for beneficial interests that apply the accounting for PCD assets) minus cash received to date minus any write-off of amortized cost basis plus the yield accreted to date.

5 Purchased financial assets

5.1 Purchased financial assets with credit deterioration

The standard eliminates today's separate model in ASC 310-30 (pre-Codification Statement of Position 03-3[12]) for purchased credit impaired (PCI) assets, which include both loans and securities. In its place, the standard provides a special Day 1 accounting for purchased financial asset with credit deterioration (PCD assets). After initial recognition (i.e., Day 1 accounting), the accounting for the instrument will follow one of the credit loss models within the standard, depending on which one applies to the instrument:

- ASC 326-20 CECL model
- ASC 326-30 AFS debt security impairment model
- ASC 325-40 impairment model for certain beneficial interests

An asset is considered a PCD asset if it has experienced more than insignificant credit deterioration since origination. For a PCD asset, the entity will gross up the amortized cost basis for the initial estimate of credit losses under the applicable impairment model. The allowance is established without an income statement effect.

The following illustrates the Day 1 gross-up approach for PCD assets.

For a PCD asset, an entity will gross up the amortized cost basis for the initial estimate of credit losses.

Illustration 10 — PCD asset gross-up

Assume Company A purchases a note receivable with the following characteristics:

- Par amount of $100,000
- Purchase price of $80,000, due to the more than an insignificant deterioration in credit quality the note has experienced since origination
- Expected credit loss embedded in the $20,000 discount to par is determined by Company A to be $15,000

Company A recognizes the $15,000 credit loss through a "gross-up" of the asset's carrying value. The remaining $5,000 (i.e., total discount from par of $20,000 less credit loss of $15,000) relates to other factors and is recorded as a non-credit-related discount in the carrying value of the investment and accreted through income over the life of the instrument.

The following sample journal entries would be recorded at acquisition:

Account	Debit	Credit
Debt instrument	$ 100,000	
Debt instrument (non credit discount)		$ 5,000
Allowance for credit losses		$ 15,000
Cash		$ 80,000

To account for a PCD asset on acquisition

12 Statement of Position 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*.

Illustration 10 — PCD asset gross-up (continued)

Amortized cost and Day 1 carrying value are determined as follows:

Purchase price	$ 80,000
Add: Day 1 allowance	15,000
Amortized cost	95,000
Less: allowance	(15,000)
Day 1 carrying value	(80,000)

As discussed above, the difference between the amortized cost of the debt instrument ($95,000) and its par amount will be accreted through income over the life of the insturment.

As illustrated above, the allowance recorded at acquisition for a PCD asset would not be a charge to income on Day 1. Instead the allowance is created by "grossing up" the purchase price of the instrument at initial recognition.

The FASB's view is that for a PCD asset, if interest were accreted to the amount of contractual cash flows, interest could be accreted to an amount greater than the amount expected to be collected at acquisition, thus inflating the yield. Under this view, it is not appropriate to accrete interest income to the contractual cash flow amount when a purchased financial asset has experienced more than insignificant credit deterioration since origination (i.e., a PCD asset).

Therefore, upon initial recognition of a PCD asset, the discount embedded in the purchase price that is attributable to the purchaser's initial estimate of credit losses at acquisition (i.e., the allowance) is removed from the amount to be accreted as interest income. Thereafter, changes in expected credit losses (i.e., the allowance) are recognized as increases or decreases in credit loss expense, and the non-credit-related discount or premium is accreted /amortized as interest income over the life of the asset.

The accounting treatment for purchased assets that do not meet the scope criteria described in Section 5.1, *Scope*, is discussed in Section 5.2, *Purchased financial assets with no credit deterioration*.

5.1.1 Scope

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses

Glossary

Purchased Financial Assets with Credit Deterioration

Acquired individual financial assets (or acquired groups of financial assets with similar risk characteristics) that as of the date of acquisition have experienced a more-than-insignificant deterioration in credit quality since origination, as determined by an acquirer's assessment. See paragraph 326-20-55-5 for more information on the meaning of similar risk characteristics for assets measured on an amortized cost basis.

For a purchased asset to qualify for the PCD asset gross-up treatment upon initial recognition, the standard states that it must have experienced more-than-insignificant credit deterioration since its origination. Under today's guidance, an asset is considered PCI when there is evidence of deterioration in credit qualify such that it is "probable, at acquisition, that the investor will be unable to collect all contractually required payments." The new standard does not mention a threshold of probable losses or impairment.

As highlighted in the Basis for Conclusions (BC90), the Board did not intend for the gross-up approach to be limited to financial assets that are considered to be impaired. The Board was concerned that stakeholders would misinterpret its intent and incorrectly apply the new PCD asset gross-up approach to the same population of assets as the existing PCI model. As a result, the Board intentionally changed the term from PCI to PCD and revised the definition. The Board believes this new definition applies to a larger population of purchased financial assets than the population of purchased financial assets eligible for the PCI model.

Bank regulatory perspectives

US banking regulators said "the definition of purchased credit-deteriorated assets is broader than the definition of purchased credit-impaired assets in current accounting standards."

How we see it

We believe that the FASB intended to create a very low threshold for applying the new PCD asset guidance. This will result in the Day 1 gross-up being applied to a much larger population of purchased loans than under today's PCI guidance.

The scope of today's PCI guidance excludes certain loan types that are not scoped out of the new PCD asset guidance. For example, the new guidance applies to purchased loans drawn under revolving credit agreements such as credit card and home equity loans that, at the date of acquisition, have experienced a more-than-insignificant deterioration in credit quality since origination. Entities will need to change their processes, systems, reporting and documentation to reflect this change in scope.

5.1.1.1 Pooling assets to determine whether they are PCD assets

Another significant change relates to the treatment of groups of assets (i.e., pools). Under today's guidance, for an acquisition of a pool of loans, an entity individually assesses each loan to determine whether it meets the PCI scope criteria. Under the new guidance, an entity is permitted to assess acquired groups of financial assets with similar risk characteristics and determine whether they meet the scope criteria.

The Board concluded that it would be impossible to individually evaluate each purchased financial asset in an asset acquisition or business combination within the reporting deadlines to determine whether each individual asset qualifies as a PCD asset. As a result, the Board decided that an entity should be able to assess whether individual financial assets or groups of financial assets with similar risk characteristics qualify as having experienced a more-than-insignificant deterioration in credit quality since origination.

Similar risk characteristics may include any one or a combination of the following:

- Internal or external (third-party) credit score or credit ratings
- Risk ratings or classification
- Financial asset type
- Collateral type
- Size
- Effective interest rate
- Term

- Geographical location
- Industry of the borrower
- Vintage
- Historical or expected credit loss patterns
- Reasonable and supportable forecast periods

How we see it

The FASB deliberately removed the guidance in ASC 310-30 that requires pools of loans to be maintained as a single unit of account because of the many practice issues related to pooled units of account. As such, we generally believe an entity could:

- Group loans together for purposes of determining whether the pool of loans has experienced a more-than-insignificant deterioration in credit quality
- Estimate the allowance to be recognized through the Day 1 gross-up
- Allocate any resulting noncredit discount or premium to each individual asset

After the Day 1 recognition, the pool of loans is not considered to be a unit of account. That is, the entity can change the composition of the pool for purposes of measuring the allowance to most faithfully estimate expected credit losses. Unlike today's guidance, the new guidance doesn't restrict an entities ability to remove assets from a pool.

We believe entities will need to establish a consistent accounting policy for deciding how to group financial assets for purposes of determining whether they should be treated as PCD assets.

5.1.1.2 PCD asset scope considerations for assets under the CECL model

For assets that are included in the scope of the CECL model, the standard does not provide specific guidance on when an instrument should be considered PCD asset, other than the basic definition of a PCD asset. However, the guidance includes the example below that illustrates one way an entity might assess, at the individual asset level, which purchased assets qualify as PCD assets.

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Implementation Guidance and Illustrations

Example 11: Identifying Purchased Financial Assets with Credit Deterioration

326-20-55-57

This Example illustrates factors that may be considered when assessing whether the purchased financial assets have more than an insignificant deterioration in credit quality since origination.

326-20-55-58

Entity N purchases a portfolio of financial assets subsequently measured at amortized cost basis with varying levels of credit quality. When determining which assets should be considered to be in the scope of the guidance for purchased financial assets with credit deterioration, Entity N considers the factors in paragraph 326-20-55-4 that are relevant for determining collectibility.

326-20-55-59

Entity N assesses what is more-than-insignificant credit deterioration since origination and considers the purchased assets with the following characteristics to be consistent with the factors that affect collectibility in paragraph 326-20-55-4. Entity N records the allowance for credit losses in accordance with paragraph 326-20-30-13 for the following assets:

a. Financial assets that are delinquent as of the acquisition date

b. Financial assets that have been downgraded since origination

c. Financial assets that have been placed on nonaccrual status

d. Financial assets for which, after origination, credit spreads have widened beyond the threshold specified in its policy.

326-20-55-60

Judgment is required when determining whether purchased financial assets should be recorded as purchased financial assets with credit deterioration. Entity N's considerations represent only a few of the possible considerations. There may be other acceptable considerations and policies applied by an entity to identify purchased financial assets with credit deterioration.

The illustration lists the widening of credit spreads as a qualifying characteristic for a PCD asset. This evidences the lower threshold the FASB intended to be used when applying the new guidance.

Further, the example refers to ASC 326-20-55-4 for the factors relevant to collectibility that should be considered when assessing whether a financial asset has experienced a more than insignificant deterioration in credit quality since origination. The factors, which are discussed earlier in this publication, include:

- The customer's or borrower's financial condition, credit rating, credit score, asset quality or business prospects
- The customer's or borrower's ability to make scheduled interest or principal payments
- The volume and severity of past due financial assets and the volume and severity of adversely classified or rated financial assets
- The value of underlying collateral on financial assets for which the collateral-dependent practical expedient has not been used
- The environmental factors of a customer or borrower and the areas in which the entity's credit is concentrated, such as:
    - Regulatory, legal or technological environment to which the entity has exposure
    - Changes and expected changes in the general market condition of either the geographical area or the industry to which the entity has exposure
    - Changes and expected changes in the international, national, regional and local economic and business environment, including the condition and expected condition of various market segments

5.1.1.3 *PCD asset scope considerations for AFS securities*

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Available-for-Sale Debt Instruments

326-30-30-2

A purchased debt security classified as available-for-sale shall be considered to be a purchased financial asset with credit deterioration when the indicators of a credit loss in paragraph 326-30-55-1 have been met. The allowance for credit losses for purchased financial assets with credit deterioration shall be measured at the individual security level in accordance with paragraphs 326-30-35-3 through 35-10. The amortized cost basis for purchased financial assets with credit deterioration shall be considered to be the purchase price plus any allowance for credit losses. See paragraphs 326-30-55-1 through 55-7 for implementation guidance.

The standard specifies that an AFS debt security should be considered a PCD asset when the relevant indicators of a credit loss in paragraph 326-30-55-1 have been met. Those factors include:

- Any changes to the rating of the security by a rating agency
- The likelihood of the issuer being able to make payments that increase in the future
- Failure of the issuer of the security to make scheduled interest or principal payments
- Adverse conditions specifically related to the security, an industry or geographic area; for example, changes in the financial condition of the issuer of the security, or in the case of an asset-backed debt security, changes in the financial condition of the underlying loan obligors

The threshold for applying PCD asset accounting to a purchased AFS debt security is different from the threshold for an asset subject to the CECL model.

How we see it

We believe an entity would apply different thresholds to determine when to use PCD accounting for an asset subject to the CECL model and one subject to the AFS debt security model.

- For CECL instruments, an entity will apply the Master Glossary definition of PCD assets.
- For AFS debt securities, an entity will apply the guidance in 326-30-30-2 that says the purchased debt security meets the PCD asset definition when the impairment indicators in 326-30-55-1 are met.

As a result, we generally believe the threshold for applying PCD asset accounting to a purchased AFS debt security is higher than that for an asset subject to the CECL model. A higher threshold for AFS securities is consistent with the requirement that a credit loss must exist before recognizing an allowance under the AFS impairment model. The CECL model has no such trigger or threshold that must be reached before an entity recognizes expected credit losses.

Entities will need to consider these differences when establishing their accounting policies for assessing whether to apply Day 1 gross-up accounting.

5.1.2 Applying the PCD asset Day 1 accounting treatment

5.1.2.1 Grossing-up assets subject to the CECL model

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Initial Measurement

326-20-30-13

An entity shall record the allowance for credit losses for purchased financial assets with credit deterioration in accordance with paragraphs 326-20-30-2 through 30-10 and 326-20-30-12. An entity shall add the allowance for credit losses at the date of acquisition to the purchase price to determine the initial amortized cost basis for purchased financial assets with credit deterioration. Any noncredit discount or premium resulting from acquiring a pool of purchased financial assets with credit deterioration shall be allocated to each individual asset. At the acquisition date, the initial allowance for credit losses determined on a collective basis shall be allocated to individual assets to appropriately allocate any noncredit discount or premium.

326-20-30-14

If an entity estimates expected credit losses using a discounted cash flow method, the entity shall discount expected credit losses at the rate that equates the present value of the purchaser's estimate of the asset's future cash flows with the purchase price of the asset. If an entity estimates expected credit losses using a method other than a discounted cash flow method, the entity shall estimate expected credit losses on the basis of the unpaid principal balance (face value) of the financial asset(s). See paragraphs 326-20-55-66 through 55-78 for implementation guidance and examples.

The standard specifies that the effective interest rate for a PCD asset should exclude the discount that was embedded in the purchase price that is attributable to credit losses expected at the purchase date.

Consistent with other aspects of the guidance, the standard does not require a specific method to be used when determining the initial allowance gross-up for a PCD asset. Instead, the standard states that when an entity estimates credit losses using a method that does not project future interest and principal cash flows (i.e., a loss rate approach is used), the PCD asset gross-up should be based on the unpaid principal balance (or par) amount of the asset. However, when an entity estimates credit losses using a DCF approach, the gross-up for expected credit losses should be determined using a discount rate that equates the present value of estimated future cash flows with the purchase price of the financial asset.

The standard provides the following example to show how this would be done under a loss-rate approach for assets in the scope of the CECL model.

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Implementation Guidance and Illustrations

Example 13: Using a Loss-Rate Approach for Determining Expected Credit Losses and the Discount Rate on a Purchased Financial Asset with Credit Deterioration

326-20-55-66

This Example illustrates the application of the guidance to determine the expected credit loss using a loss rate for an individual purchased financial asset with credit deterioration. The method applied to initially measure expected credit losses for purchased financial

assets with credit deterioration generally would be applied consistently over time and should faithfully estimate expected credit losses for financial assets by applying this Subtopic. This does not mean that the application of a loss-rate approach is an irrevocable election.

326-20-55-67

Bank P purchases a $5 million amortizing nonprepayable loan with a 6 percent coupon rate and original contract term of 5 years. All contractual principal and interest payments due of $1,186,982 for each of the first 3 years of the loan's life have been received, and the loan has an unpaid balance of $2,176,204 at the purchase date at the beginning of Year 4 of the loan's life. The original contractual amortization schedule of the loan is as follows.

Period	Beginning Balance	Total Payment	Interest	Principal	Ending Balance
1	$ 5,000,000	$ 1,186,982	$ 300,000	$ 886,982	$ 4,113,018
2	4,113,018	1,186,982	246,781	940,201	3,172,817
3	3,172,817	1,186,982	190,369	996,613	2,176,204
4	2,176,204	1,186,982	130,572	1,056,410	1,119,794
5	1,119,794	1,186,982	67,188	1,119,794	-
Totals		$ 5,934,910	$ 934,910	$ 5,000,000	

326-20-55-68

At the purchase date, the loan is purchased for $1,918,559 because significant credit events have been discovered. The purchaser expects a 10 percent loss rate, based on historical loss information over the contractual term of the loan, adjusted for current conditions and reasonable and supportable forecasts, for groups of similar loans. In accordance with paragraph 326-20-30-14, as a result of the expected credit losses, the allowance is estimated as $217,620 by multiplying the 10 percent loss rate by the unpaid principal balance, or par amount, of the loan (see beginning balance in Year 4 in the table above). The following journal entry is recorded at the acquisition of the loan:

Loan	$ 2,176,204	
Loan—noncredit discount		$ 40,025
Allowance for credit losses		217,620
Cash		1,918,559

326-20-55-69

The contractual interest rate is adjusted for the noncredit discount of $40,025 to determine the discount rate (consistent with paragraph 326-20-30-14) of 7.33 percent, which excludes the purchaser's assessment of expected credit losses at the acquisition date. The 7.33 percent (rounded from 7.3344 percent) is computed as the rate that equates the amortized cost of $2,136,179 (computed by adding the purchase price of $1,918,559 to the gross-up adjustment of $217,620) with the net present value of the remaining contractual cash flows on the purchased asset ($1,186,982 in each of Years 4 and 5).

326-20-55-70

A default occurs in the last year of the loan's life. The amortization of the purchased loan would be recorded as follows for the periods after the purchase date in Years 4 and 5 of the loan's life.

Period	Beginning Balance (a)	Total Payment (b)	Writeoff (c)	Accrued Interest (d)	Reduction (e)	Ending Balance (f)
4	$ 2,136,179	$ 1,186,982		$ 156,67	$ 1,030,306	$ 1,105,873
5	1,105,873	969,362	$ 217,62	81,10	1,105,873	-
Totals		$ 2,156,344	$ 217,62	$ 237,78	$ 2,136,179	

(a) The amortized cost at the purchase date is determined as the sum of the purchase price of $1,918,559 and the allowance for credit losses of $217,620.

(b) The cash received is consistent with the expectations at the purchase date.

(c) The writeoff represents the default in the final year of the loan that is written off.

(d) The interest income recognized is determined by multiplying the beginning amortized cost by the discount rate of 7.33 percent (as determined in accordance with paragraph 326-20-55-69).

(e) The reduction of amortized cost is determined as the sum of the cash received (b) and writeoffs recognized (c) (if any), less the interest income recognized (d). The writeoff in Year 5 represents the difference between the contractual cash flows of $1,186,982 and the actual cash flows of $969,362.

(f) The ending amortized cost is equal to the beginning amortized cost (a), less the amortized cost reduction (e).

326-20-55-71

The rollforward of the allowance would be as follows.

Beginning allowance for credit losses	$	217,620
Plus, credit loss expense		-
Less, writeoffs		(217,620)
Ending allowance for credit losses	$	–

The standard also provides the following example to show how the PCD asset approach would work under a DCF method for assets in the scope of the CECL model.

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Implementation Guidance and Illustrations

Example 14: Using a Discounted Cash Flow Approach for Determining Expected Credit Losses and the Discount Rate on a Purchased Financial Asset with Credit Deterioration

326-20-55-72

This Example illustrates the application of the guidance to determine the expected credit loss using a discounted cash flow approach for an individual purchased financial asset with credit deterioration. The method applied to initially measure expected credit losses for purchased financial assets with credit deterioration generally would be applied consistently over time and should faithfully estimate expected credit losses for financial assets by applying this Subtopic. This does not mean that the application of a discounted cash flow approach is an irrevocable election.

326-20-55-73

This Example uses the same assumptions as in Example 13, as described in paragraphs 326-20-55-66 through 55-71.

326-20-55-74

To determine the discount rate in accordance with paragraph 326-20-30-14, the expected cash flows would be estimated and discounted at a rate that equates the purchase price with the present value of expected cash flows. The expected cash flows, including the considerations for current conditions and reasonable and supportable forecasts, are expected to be $1,186,982 in Year 4 and $969,362 in Year 5. The discount rate that equates the purchase price with the cash flows expected to be collected is 8.46 percent (rounded from 8.455 percent). This also is the same rate that equates the amortized cost basis (purchase price plus the acquisition date allowance for credit losses) with the net present value of the future contractual cash flows.

326-20-55-75

To determine the allowance for credit losses at the purchase date, the expected credit loss (that is, the contractual cash that an entity does not expect to collect) is discounted using the discount rate of 8.46 percent. The expected credit loss is $217,620 in Year 5, as

determined by finding the difference between the contractual cash flows of $1,186,982 and the expected cash flows of $969,362. The present value of the expected loss at the purchase date is $185,012. The journal entry to record the purchase of this loan is as follows:

Loan	$ 2,176,204	
Loan—noncredit discount		$ 72,633
Allowance for credit losses		185,012
Cash		1,918,559

326-20-55-76

The amortization of the loan in the years following the purchase date is as follows.

Period	Beginning Balance (a)	Total Payment (b)	Writeoff (c)	Accrued Interest (d)	Reduction (e)	Ending Balance (f)
4	$ 2,103,571	$ 1,186,982		$ 177,857	$ 1,009,125	$ 1,094,446
5	1,094,446	969,362	$ 217,620	92,536	1,094,446	-
Totals		$ 2,156,344	$ 217,620	$ 270,393	$ 2,103,571	

(a) The amortized cost at the purchase date is determined as the sum of the purchase price of $1,918,559 and the allowance for credit losses of $185,012.

(b) The cash received is consistent with the expectations at the purchase date.

(c) The writeoff represents the default in the final year of the loan that is written off.

(d) The interest income recognized is determined by multiplying the beginning amortized cost by the discount rate of 8.46 percent (as determined in accordance with paragraph 326-20-55-74).

(e) The reduction of amortized cost is determined as the sum of the cash received (b) and writeoffs recognized (c) (if any), less the interest income recognized (d). The writeoff in Year 5 represents the difference between the contractual cash flows of $1,186,982 and the actual cash flows of $969,362.

(f) The ending amortized cost is equal to the beginning amortized cost (a), less the amortized cost reduction (e).

326-20-55-77

The Day 1 allowance established at the purchase date was $185,012. The allowance for credit losses was estimated on a discounted cash flow approach and, therefore, the allowance for credit losses needs to be adjusted for the time value of money. The rollforward of the allowance for credit losses is shown below.

Beginning allowance for credit losses	$ 185,012
Plus, credit loss expense	15,643[a]
Less, writeoffs	-
Ending allowance for credit losses (Year 4)	$ 200,665
Plus, credit loss expense	16,965[a]
Less, writeoffs	(217,620)[b]
Ending allowance for credit losses (Year 5)	$ -

(a) The provision for credit losses in Years 4 and 5 is determined by multiplying the beginning allowance for credit losses by the discount rate of 8.46 percent to adjust for the time value of money

(b) The writeoff represents the default in year 5. The default is the difference between the Year 5 contractual cash flows of $1,186,982 and the actual cash flows received of $969,362

326-20-55-78

The net income effect of a loss-rate approach illustrated in Example 13 and of a discounted cash flow approach illustrated in this Example is the same ($237,785 net income). The difference between the two approaches is that the Day 1 allowance for credit losses under a discounted cash flow approach explicitly reflects the time value of money. Therefore, it needs to be accreted to the future value of the loss that ultimately will occur. The change in the allowance for credit losses associated with the time value of money can be presented either as credit loss expense or as an adjustment to interest income in accordance with paragraph 326-20-45-3. Therefore, the discounted cash flow approach, over the life of the asset, presents interest income as $270,393 but will require $32,608 ($15,643 in Year 4

plus $16,965 in Year 5) of credit loss expense to be recorded for the time value of money, resulting in net interest income after credit loss expense of $237,785. Under a loss-rate approach as illustrated in Example 13, interest income over the life of the asset is $237,785 but does not require credit loss expense to be recognized.

Further, the estimate of CECL for PCD assets should be measured on an aggregate (pool) basis when similar risk characteristics exist. However, even though the "default" is for this estimate to be measured on a pool basis, any noncredit discount or premium must be allocated to each individual asset.

How we see it

The effective interest rate (EIR) that results from the DCF approach may not be the same as the EIR that results from a non-DCF approach, given the different amortized cost amounts that could result from the Day 1 gross-up.

Further, the amount of interest income and credit loss expense recognized in future periods may be affected by which approach is used to estimate credit losses (DCF versus non-DCF). To see the difference, compare illustrations 13 and 14 above. While the gross amount of expected credit losses is the same under both methods, that amount is discounted under the DCF approach to determine the amount of the allowance but it is not discounted under a non-DCF approach.

As a result, the credit-related discount (allowance) is smaller, and the non-credit-related discount is larger, under the DCF approach. Over time, the allowance will increase (i.e., accrete as an increase in credit loss expense or reduction in interest income) under a DCF approach due to the time value of money, and the non-credit-related discount will be accreted (in an equal amount) through an increase in interest income.

Because the guidance does not require a specific method for allocating the allowance and noncredit discount or premium to individual assets, entities will need to exercise judgment to determine an appropriate approach.

5.1.2.2 *Measurement of PCD assets under the CECL model after initial recognition*

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Subsequent Measurement

326-20-35-1

At each reporting date, an entity shall record an allowance for credit losses on financial assets (including purchased financial assets with credit deterioration) within the scope of this Subtopic. An entity shall compare its current estimate of expected credit losses with the estimate of expected credit losses previously recorded. An entity shall report in net income (as a credit loss expense or a reversal of credit loss expense) the amount necessary to adjust the allowance for credit losses for management's current estimate of expected credit losses on financial asset(s). The method applied to initially measure expected credit losses for the assets included in paragraph 326-20-30-14 generally would be applied consistently over time and shall faithfully estimate expected credit losses for financial asset(s).

The guidance indicates that the method (i.e., DCF or non-DCF method) applied to initially measure expected credit losses for PCD assets would generally be applied consistently over time.

ASC 326-20-30-14 says that the initial measurement of expected credit losses under a non-DCF approach should be based on the unpaid principal balance. As mentioned above, ASC 326-20-35-1 says that an entity generally should use a consistent method for measurement over time, but does not address the basis (i.e., unpaid principal balance or amortized cost) on which the loss should be measured. As a result, it's unclear whether the assessment of credit losses after Day 1 for PCD assets under a non-DCF approach should be based on the unpaid principal balance (consistent with the Day 1 accounting) or on the amortized cost basis (consistent with the measurement for non-PCD assets).

How we see it

The ASU says that the PCD asset estimation method should generally be applied consistently over time. Entities that initially use a non-DCF approach to estimate expected credit losses for PCD assets may, in the future, determine that they can apply a DCF approach (e.g., additional information about cash flow expectations). We believe that by saying that the PCD asset estimation method should "generally be applied consistently over time," the standard provides the ability to make such a change.

5.1.2.3 *Grossing up AFS debt securities*

Excerpt from Accounting Standards Codification

Financial Instruments, Available-for-Sale Debt Instruments — Credit Losses

Initial Measurement

326-30-30-3

Estimated credit losses shall be discounted at the rate that equates the present value of the purchaser's estimate of the security's future cash flows with the purchase price of the asset.

326-30-30-4

An entity shall record the holding gain or loss through other comprehensive income, net of applicable taxes.

The standard specifies that the effective interest rate for a PCD asset that is a security classified as AFS should exclude the discount that was embedded in the purchase price that is attributable to expected credit losses at the purchase date. For AFS debt securities, the standard requires that the gross-up amount upon acquisition (and corresponding allowance for credit losses) be measured at the individual security level in accordance with the provisions of the AFS debt security impairment model in ASC 326-30. That is, the gross-up should be measured on a present value basis (i.e., a DCF approach) using the best estimate of the present value of cash flows expected to be collected.

5.1.2.4 *Measurement of PCD assets under the AFS debt security impairment model after initial recognition*

Excerpt from Accounting Standards Codification

Financial Instruments, Available-for-Sale Debt Instruments — Credit Losses

Subsequent Measurement

326-30-35-16

An entity shall measure changes in the allowance for credit losses on a purchased financial asset with credit deterioration in accordance with paragraph 326-30-35-6. The entity shall report changes in the allowance for credit losses in net income as credit loss expense (or reversal of credit loss expense) in each reporting period.

Subsequent to acquisition, the estimate of expected credit losses for PCD assets that are AFS debt securities uses the same "best estimate" model that is used for other AFS debt securities. Post-acquisition changes in the allowance for credit losses for PCD assets that are AFS debt securities will be recorded as credit loss expense (or a reversal in credit loss expense) rather than as an increase in the amortized cost basis of the asset.

5.1.3 *Interest income recognition on PCD assets*

Under the new standard, interest income for a PCD asset should be recognized by accreting the amortized cost basis of the instrument to its contractual cash flows. The discount related to estimated credit losses on acquisition (that is, the allowance recognized at the date of purchase through the gross-up accounting) will not be accreted into interest income, and only the non-credit-related discount will be accreted. Recognition of income requires a reasonable expectation about both the timing and amount of cash flows expected to be collected, and nonaccrual approaches can be applied. It is not yet clear how nonaccrual practices will be applied to PCD assets.

5.1.4 *Disclosures for PCD assets*

The disclosure requirements for PCD assets acquired during the current reporting period apply to all PCD assets, regardless of whether they are measured at amortized cost (as outlined in ASC 326-20-50-19) or are AFS debt securities (as outlined in ASC 326-30-50-10). A reconciliation of the difference between the purchase price and the par amount must be provided. Separate disclosure of the purchase price, the allowance for credit losses at acquisition, the discount (or premium) attributable to other factors and par value must be included in that reconciliation.

Impairment of an originated asset and a purchased financial asset that does not meet the definition of PCD is accounted for in the same way.

5.2 Purchased financial assets that don't qualify as PCD assets

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Initial Measurement

326-20-30-15

An entity shall account for purchased financial assets that do not have a more-than-insignificant deterioration in credit quality since origination in a manner consistent with originated financial assets in accordance with paragraphs 326-20-30-1 through 30-10 and 326-20-30-12. An entity shall not apply the guidance in paragraphs 326-20-30-13 through 30-14 for purchased financial assets that do not have a more-than-insignificant deterioration in credit quality since origination.

Purchased financial assets that do not meet the definition of PCD assets are accounted for in a manner consistent with the same type of originated financial asset (as described in Section 2, 3 or 4 above). There is no "gross-up" of the amortized cost by the amount of the initial allowance for purchased non-PCD assets (i.e., those that have not experienced more than insignificant credit deterioration since origination), and instead, entities will recognize the allowance through earnings on Day 1.

In addition, for non-PCD assets, the discount that is embedded in the purchase price that is attributable to the purchaser's initial estimate of credit losses at acquisition (i.e., the allowance) is not removed from the amount to be accreted as interest income, and the entire discount or premium is recognized as interest income over the life of the asset. This differs from the treatment of the credit-related discount for PCD assets, which is not accreted through interest income. As discussed above, the PCD asset approach is based on the Board's view that it is not appropriate to accrete interest income to the contractual cash flow amount when purchased financial assets have experienced more than insignificant credit deterioration since origination.

The FASB included the following sections in the ASU, which clarify its view that there is no fundamental difference between an originated asset and a non-PCD asset and, as such, the two should be accounted for in the same way. That is, an entity should recognize an allowance through earnings when it originates new assets or purchases assets not deemed to be PCD assets.

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Initial Measurement

326-20-30-5

…In addition, when an entity expects to accrete a discount into interest income, the discount should not offset the entity's expectation of credit losses…

Business Combinations — Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Initial Measurement

805-20-30-4A

For acquired financial assets that are not purchased financial assets with credit deterioration, the acquirer shall record the purchased financial assets at the acquisition-date fair value. Additionally, for these financial assets within the scope of Topic 326, an allowance shall be recorded with a corresponding charge to credit loss expense as of the reporting date.

As a result, the accounting model for PCD assets is very different from that for non-PCD assets.

How we see it

When purchased financial assets in the scope of the CECL model are not considered PCD assets, the purchaser recognizes a Day 1 loss. That is, there is no allowance established on the date of acquisition by grossing up the amortized cost of the asset. Rather, at the first reporting date after the date of acquisition, the purchaser recognizes an allowance (and corresponding expense) for expected credit losses on those assets.

While some constituents, including both preparers and users, expressed concerns that the treatment of assets that aren't PCD assets, and therefore don't receive gross-up treatment, amounted to "uneconomic accounting," the Board ultimately decided not to extend the gross-up approach to all purchased assets. The FASB cites the following reasons for that decision:

- Credit risk may be difficult to reliably isolate from other discounts reflected in the purchase price when the credit risk is insignificant.
- Benefits would not justify the incremental costs associated with a requirement to separate the credit and non-credit-related discounts when the amounts are insignificant.
- Accretion of the discount into income due to credit would be insignificant.

Given the requirements to record Day 1 losses for non-PCD assets, we expect entities that engage in significant business combinations or asset acquisitions to seek to maximize the portion of purchased financial assets considered PCD assets. We note that the Board's reference to the factors in paragraph ASC 326-20-55-4 may make it easier for pools of purchased assets to qualify as PCD assets. For example, this may be the case if a pool of assets has experienced a more than insignificant increase in the volume and severity of past due or adversely classified financial assets even though some items in the pool may not individually meet the definition of PCD assets.

6 Transition

The ASU requires a cumulative effect adjustment to the statement of financial position as of the beginning of the first reporting period in which the guidance is effective. For example, a calendar-year PBE that meets the definition of an SEC filer will apply the cumulative effect adjustment on 1 January 2020 and provide the related transition disclosures in its first quarter 2020 Form 10-Q.

Bank regulatory perspectives

The Joint Statement states that "until institutions implement the new accounting standard, they must continue to calculate their allowances for loan and lease losses using the existing incurred loss methodology. Institutions should not begin increasing their allowance levels beyond those appropriate under existing U.S. GAAP in advance of the new standard's effective date. However, institutions are encouraged to take steps to assess the potential impact on capital."

Additionally, the standard includes the following transition provisions to ease the burden of calculating the cumulative-effect adjustment for certain items.

The ASU includes transition provisions to ease the burden of calculating the cumulative-effect adjustment for certain items.

6.1 Application to purchased financial assets with credit deterioration

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Transition and Open Effective Date Information

326-10-65-1(d)

An entity shall apply prospectively the pending content that links to this paragraph for purchased financial assets with credit deterioration to financial assets for which Subtopic 310-30 was previously applied. The prospective application will result in an adjustment to the amortized cost basis of the financial asset to reflect the addition of the allowance for credit losses at the date of adoption. An entity shall not reassess whether recognized financial assets meet the criteria of a purchased financial asset with credit deterioration as of the date of adoption. An entity may elect to maintain pools of loans accounted for under Subtopic 310-30 at adoption. An entity shall not reassess whether modifications to individual acquired financial assets accounted for in pools are troubled debt restructurings as of the date of adoption. The noncredit discount or premium, after the adjustment for the allowance for credit losses, shall be accreted to interest income using the interest method based on the effective interest rate determined after the adjustment for credit losses at the adoption date. The same transition requirements should be applied to beneficial interests for which Subtopic 310-30 was applied previously or for which there is a significant difference between the contractual cash flows and expected cash flows at the date of recognition.

As previously discussed, the definition of a PCD asset under the new standard differs from that of a PCI asset under ASC 310-30. The Board decided that when calculating the cumulative effect adjustment, an entity should simply apply the new PCD asset gross-up approach to all assets that are accounted for as PCI prior to adoption of the new guidance. In addition, an entity should not reassess whether prior modifications of individual PCI loans accounted for in pools are TDRs at the adoption date.

Upon transition, the effective interest rate of a PCD asset will be determined after the amortized cost basis gross-up adjustment for expected credit losses at adoption. An entity will use the new PCD asset definition for evaluating purchases after the date of adoption.

How we see it

We believe the Board's decision to simplify the transition for PCD assets will significantly reduce the cost and complexity of adopting the standard for entities with these assets. Because of the transition relief, an entity will not need to reassess whether any recognized PCI financial assets as of the date of adoption meet the definition of a PCD asset.

6.2 Application to debt securities with an other-than-temporary impairment

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Transition and Open Effective Date Information

326-10-65-1(e)

An entity shall apply prospectively the pending content that links to this paragraph to debt securities for which an other-than-temporary impairment had been recognized before the date of adoption, such that the amortized cost basis (including previous write-downs) of the debt security is unchanged. In addition, the effective interest rate on a security will remain unchanged as a result of the adoption of the pending content that links to this paragraph. Amounts previously recognized in accumulated other comprehensive income as of the adoption date that relate to improvements in cash flows will continue to be accreted to interest income over the remaining life of the debt security on a level-yield basis. Recoveries of amounts previously written off relating to improvements in cash flows after the date of adoption shall be recorded to income in the period received.

Today's AFS debt security impairment model requires a write-down of the amortized cost basis of a security for the credit-loss portion of an OTTI. The new standard, however, requires the use of an allowance for estimated credit losses on an AFS debt security. For purposes of calculating the cumulative effect adjustment, the Board decided that when transitioning to the new standard, an entity should simply use the pre-transition amortized cost basis (and related yield) and apply the allowance approach on a prospective basis (i.e., to changes in credit impairment subsequent to adoption), except for recoveries of amounts previously written off that occur after the date of adoption, which are recorded in income in the period received instead of the period in which the entity's best estimate has changed.

How we see it

The Board's guidance on recoveries of amounts written off prior to the date of adoption relating to improvements in cash flows that occur after the date of adoption was intended to make sure that entities would not recognize a "negative allowance."

For example, assume a bond was originally purchased at $100 and was later written down to $80 for credit-related reasons. If the amortized cost of the bond upon transition is $80, but after adoption the investor expects to collect all contractual cash flows, the new guidance would require the investor to wait to record the $20 in improved cash flows until it is actually received.

This approach may cause operational challenges for some entities because it will require them to maintain separate records for securities for which an OTTI was recognized before transition compared to securities for which a credit loss is recognized post-transition. Entities will need to track cash flows received on pre-transition OTTI securities to determine whether those cash flows represent the receipt of amounts previously written off through an OTTI.

6.3 Transition disclosures

An entity is required to provide the following transition disclosures in the period of adoption.

Excerpt from Accounting Standards Codification

Financial Instruments — Credit Losses — Measured at Amortized Cost

Transition and Open Effective Date Information

326-10-65-1(f)

An entity shall disclose the following in the period that the entity adopts the pending content that links to this paragraph:

1. The nature of the change in accounting principle, including an explanation of the newly adopted accounting principle.
2. The method of applying the change.
3. The effect of the adoption on any line item in the statement of financial position, if material, as of the beginning of the first period for which the pending content that links to this paragraph is effective. Presentation of the effect on financial statement subtotals is not required.
4. The cumulative effect of the change on retained earnings or other components of equity in the statement of financial position as of the beginning of the first period for which the pending content that links to this paragraph is effective.

An entity that issues interim financial statements is required to provide the above disclosures in each of the interim and the annual financial statements in the year of the change.

6.4 SEC SAB Topic 11.M[13] disclosures

For registration statements and periodic reports filed with the SEC between now and the date of adoption, entities will need to provide disclosures about the effects of the standard. SEC SAB Topic 11.M requires disclosure of the potential effects of recently issued accounting standards, if those effects are known. Companies should consider making the following disclosures within management's discussion and analysis and the financial statements:

- 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
- A discussion of the effect the standard is expected to have on the financial statements or, if the effect isn't known or reasonably estimable, a statement to that effect
- Disclosure of other significant matters that the registrant believes might result from adopting the standard (e.g., planned or intended changes in business practices)

---

[13] SEC 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.*

At the September 2016 Emerging Issues Task Force meeting, the SEC Observer reminded registrants that they need to disclose the effect of adopting new accounting standards in future periods in accordance with SAB Topic 11.M in light of new guidance issued by the FASB, including the guidance on measuring credit losses on financial instruments in the ASU.

Consistent with SAB Topic 11.M, the SEC Observer said that if a registrant does not know or cannot reasonably estimate the effect that the adoption of a new standard will have on its financial statements, it should make a statement to that effect and consider providing qualitative disclosures to help the reader assess the significance of the effect on the registrant's financial statements. These qualitative disclosures should include a description of the new standard's effect on the registrant's accounting policies and provide a comparison to the registrant's current accounting policies. In addition registrants should describe the status of their processes to implement the new standards and the significance of any implementation matters yet to be addressed in those processes.

The SEC Observer said that registrants should consider disclosing this information no later than in their next year-end filing.

Entities should monitor developments as regulators, the TRG and others discuss this new guidance over the coming months.

How we see it

Initially, we anticipate companies may not know, or be able to make a reasonable estimate of, the effect the new standard will have on its financial statements, and will make a statement to that effect.

Consistent with the SEC staff's expectations, an entity's disclosures should evolve over time as more information about the effects of the new standard becomes available.

6.5 Interpretations and further guidance

We expect further discussion about this new guidance over the coming months. The FASB has formed a Transition Resource Group for Credit Losses (TRG). The group held its first public meeting on 1 April 2016, to address implementation issues raised by stakeholders, much like a similar group that the FASB and the IASB created jointly to address implementation issues related to their new revenue standards. In the case of the credit loss standard, however, the FASB convened the TRG before issuing the final standard in an effort to avoid having to amend it and add more implementation guidance.

The purpose of the TRG is to:

- Solicit, analyze and discuss stakeholder issues arising from implementation of the new guidance
- Inform the FASB about those implementation issues, which will help the Board determine what, if any, action will be needed to address those issues
- Provide a forum for stakeholders to learn about the new guidance from others involved with implementation

The TRG will meet periodically to discuss potential issues arising from the implementation of the new guidance. Preparers, auditors and users may submit issues for the TRG to discuss. The FASB staff will evaluate each submission and prioritize the issues for discussion at a TRG meeting. During the meetings, the TRG members will share their views on the issues. The TRG will not issue guidance. Subsequent to each meeting, the FASB will determine what action, if any, it should take on each issue. To date, no other TRG meetings have been scheduled.

In addition, the AICPA has formed two task forces related to the standard: one will address concerns related to the ASU and credit models and the other will address audit matters.

Finally, we expect the bank regulators to continue to provide their views and interpretations prior to the standard's effective date. Guidance from regulators will clearly affect how regulated financial institutions implement the standard and may influence how other entities approach implementation issues.

Bank regulatory perspectives

The Joint Statement indicates that the federal agencies are in the process of "determining the nature and extent of supervisory guidance institutions will need during the implementation period, with a particular focus on the needs of smaller and less complex institutions. If institutions have issues or concerns about implementing the new accounting standard, they should discuss their questions with their primary federal supervisor."

The regulators go on to say that their "goal is to ensure consistent and timely communication, delivery of examiner training, and issuance of supervisory guidance pertaining to the new accounting standard. The agencies will be especially mindful of the needs of smaller and less complex institutions when developing supervisory guidance describing the expectations for an appropriate and comprehensive implementation of this standard. The guidance will not prescribe a single approved method for estimating expected credit losses. Furthermore, because appropriate allowance levels are institution-specific amounts, the guidance will not establish benchmark targets or ranges for the change in institutions' allowance levels upon adoption of CECL or for allowance levels going forward."

The Joint Statement concludes that "the move to an expected credit loss methodology represents a change to current allowance practices for the agencies and institutions. The agencies support an implementation of the FASB's new accounting standard that is both reasonable and practical, taking into consideration the size, complexity, and risk profile of each institution."

As highlighted in this publication, there are various topics that remain unclear and we expect additional discussion about them by various stakeholders over the coming months. Some of these topics are:

- Should a pool of financial assets have certain shared risk characteristics, such as credit quality or remaining contractual life, to be included in a pool for estimation of credit losses?
- Which modeling approaches faithfully estimate expected credit losses for financial assets and which do not?
- Over what period of time should an entity measure expected credit losses for financial assets that do not have a contractual maturity (e.g., credit cards)?
- What does it mean for a forecast to be reasonable and supportable?
- What does it mean to have a reasonable expectation that an entity will execute a TDR?
- What constitutes a more than insignificant deterioration in credit quality?
- How should an entity that uses a non-DCF approach account for interest rate concessions?

6.6 Processes and controls

To implement the ASU, entities may need to change their credit loss estimation practices. Thjs will likely require significant adjustments to processes, systems and controls. How much an entity will be affected will depend on the types of financial assets it holds. While financial institutions will likely see the most significant change, virtually all entities will be affected. For example, entities with accounts receivable will need to change their process to make sure their estimate of bad debts reflects forecasted economic conditions. Additionally, entities that hold AFS or HTM debt securities will need to measure and record credit loss each reporting period through an allowance rather than reduce the carrying value of the asset, as they do today.

One of the potential challenges — and opportunities — related to implementing the ASU is the latitude given to financial statement preparers by the FASB. The ASU is largely principles based and does not provide specific rules on how an entity should measure expected credit losses. For example, even though some might argue that a DCF approach is the "gold standard," the ASU is clear that an entity is not required to reconcile a chosen approach to a DCF approach. In addition, through the Basis for Conclusions and other avenues, including speeches, Board members have made it clear that preparers have latitude in the methods they choose to estimate expected credit losses, acknowledging that different methods could yield very different outcomes. As such, we believe entities will need to focus on (1) developing a systematic methodology that is both disciplined and consistently applied, (2) documenting the methodology, including supporting documentation for policies and procedures as well as key decisions, assumptions and processes, and (3) designing an appropriate mix of internal controls that operate at an acceptable level of precision. Entities should not underestimate the effort that all this may require.

6.7 Next steps

Entities should begin developing detailed implementation plans to address the ASU. The SEC's Mr. Bricker recently said that "it is a good time for companies, their audit committees, and their auditors to assess the quality and status of implementation plans so that the implementation of the standard achieves the financial reporting objectives intended by the standard setters. Without an appropriate allocation of time and resources, companies risk financial reporting failures that can lead to significant, adverse consequences for shareholders."

"Implementation will involve in many cases a fresh look at estimation processes and related policies, procedures, systems and internal controls. Investors expect companies to have internal controls in place to reasonably assure the reliability of the financial information reported by management. Therefore, transition plans for the new standard should include initiatives for identifying and implementing the necessary changes to controls."

The federal bank regulators have also provided guidance on how to plan for a successful transition over the coming months and years before the standard becomes effective. While this guidance was aimed at regulated financial institutions, it is helpful for all entities.

Bank regulatory perspectives

"Although the agencies recognize the impact of CECL will vary from institution to institution, the agencies encourage institutions to start planning and preparing for their transition to the new accounting standard by:

- Becoming familiar with the new accounting standard.
- Discussing with the board of directors, industry peers, external auditors, and supervisory agencies how best to implement the new accounting standard in a manner appropriate to the institutions' size and the nature, scope, and risk of their lending and debt securities investment activities.
- Reviewing existing allowance and credit risk management practices to identify processes that can be leveraged when applying the new accounting standard.
- Identifying data needs and necessary system changes to implement the new accounting standard consistent with its requirements, the allowance estimation method or methods to be used, and supervisory expectations.
- Determining how and when to begin collecting the additional data that may be needed for implementation.
- Planning for the potential impact of the new accounting standard on capital.

Senior management, under the oversight of the board of directors, should work closely with staff in their accounting, lending, credit risk management, internal audit, and information technology functions during the transition period leading up to the effective date of the new accounting standard as well as after its adoption."

EY | Assurance | Tax | Transactions | Advisory

© 2016 Ernst & Young LLP.
All Rights Reserved.

SCORE No. 03320-161US

ey.com/us/accountinglink

About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

Ernst & Young LLP is a client-serving member firm of Ernst & Young Global Limited operating in the US.

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

Appendix: US GAAP vs. IFRS

This table compares key aspects of the US GAAP CECL model in ASC 326-20 with IFRS 9.

Topic	US GAAP's CECL model (ASC 326-20)	IFRS 9
Scope	Applies to financial assets measured at amortized cost, including debt instruments (e.g., loans), held-to-maturity (HTM) debt securities and trade receivables); net investments in leases recognized by a lessor under ASC 842; contract assets under ASC 606; and off-balance-sheet credit exposures that are not accounted for as insurance (e.g., loan commitments, standby letters of credit and financial guarantees), except for instruments in the scope of ASC 815, *Derivatives and Hedging*. Entities will account for credit losses on AFS debt securities pursuant to ASC 326-30 and not the CECL model.	Applies to debt instruments recorded at amortized cost or at fair value through OCI (FV-OCI) such as loans, debt securities and trade receivables; lease receivables under IFRS 16; contract assets under IFRS 15; and loan commitments and financial guarantee contracts that are not measured at fair value through profit or loss.
Unit of measurement	The standard requires a collective (i.e., pool-based) estimate of expected credit losses (ECLs) when similar risk characteristics exist.	The standard allows expected credit losses (ECLs) to be estimated on a collective basis when there are shared risk characteristics. The assessment of significant deterioration in credit risk and the estimate of ECLs are made collectively if they cannot be done at the individual asset level.
Measurement objective	<u>One measurement objective:</u> The allowance for credit losses is the amount that, when deducted from the amortized cost basis of the financial asset, reflects the net amount expected to be collected.	<u>Two measurement objectives:</u> The amount of the allowance depends on the extent of credit deterioration since the initial recognition of the asset. For assets that have experienced a significant increase in credit risk since initial recognition, the allowance reflects lifetime ECLs. For all other assets, the allowance reflects 12 months of ECLs (i.e., the portion of lifetime ECLs that result from default events that are possible within the next 12 months). There is a simplified approach for certain trade & lease receivables as well as contract assets. See below for discussion of originated or purchased credit-impaired assets.

Topic	US GAAP's CECL model (ASC 326-20)	IFRS 9
Elements of an estimate of expected credit losses	Be based on the asset's amortized cost. The ASU does not require a specific approach to determine the allowance and there is no explicit requirement to consider the time value of money. If a discounted cash flow (i.e., future principal and interest cash flows) approach is used, then the discount rate is the financial asset's original effective interest rate (EIR).	A discounted cash flow approach is required. ECLs must be discounted using a rate that approximates the EIR of the asset.
	Reflect losses expected over the remaining contractual life of an asset, recognizing that prepayments reduce loss.	Reflect the present value of all cash shortfalls over the remaining expected life of the financial asset, including consideration of prepayments and expected renewals and extensions.
	Reflect the risk of loss, even when that risk is remote (an estimate based solely on the most likely outcome is not permitted).	ECLs are an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes that is representative of the loss distribution. The number of scenarios is not specified but should consider the possibility of non-linear outcomes with respect to ECLs.
	Consider available information about the collectibility of cash flows, including information about past events, current conditions, and reasonable and supportable forecasts.	Generally consistent with the ASU, but multiple scenarios should be considered.
Recognizing credit losses	An allowance (contra asset) is established through net income for expected credit losses. Changes in the allowance are recognized immediately in net income.	Generally consistent with the ASU; movements between the two measurement objectives are also recognized immediately in net income.
Write-off principle	Financial assets are written off when they are deemed uncollectible.	Financial assets are written off when the entity has no reasonable expectation of recovery.
Interest income recognition and measurement	Interest income is recognized based on the asset's EIR and amortized cost amount. For PCD assets, the purchase price discount attributable to the ECLs at acquisition date is not recognized as interest income. The non-credit-related discount or premium is accreted as interest income.	Interest revenue is based on the asset's EIR and gross carrying amount (without deducting the loss allowance). If a financial asset subsequently becomes credit-impaired, an entity is required to calculate interest revenue by applying the EIR to the amortized cost of the financial asset (i.e., the gross carrying amount net of loss allowance) rather than to the gross carrying amount.
Purchased financial assets with evidence of credit deterioration	Defined as purchased financial assets that have experienced a more-than-insignificant deterioration in credit quality since origination.	Defined as purchased or originated assets for which one or more events that have a detrimental impact on the estimated future cash flows of the asset have occurred.
	Allowance for expected credit losses is recognized at acquisition, but not through net income (the initial amortized cost is the purchase price plus the allowance for credit losses at the acquisition date). Subsequent changes in the allowance for expected credit losses are recognized immediately in the income statement.	No allowance is recorded at initial recognition; lifetime expected credit losses at origination or acquisition are incorporated in determining the effective interest rate. Subsequent changes in lifetime expected credit losses are recognized immediately in the income statement.

No. 2016-23
10 October 2016

Technical Line

A closer look at the SEC staff's scrutiny of non-GAAP financial measures

In this issue:

Overview 1
Staff focus areas and changes companies are making 2
Prominence of non-GAAP measures 2
Appropriateness of adjustments and disclosures 3
Excluding normal recurring cash operating expenses 3
Other considerations 4
Strengthening disclosure controls and procedures 4
Applying the non-GAAP rules and regulations 4
Presenting changes to non-GAAP disclosures 4
What's next? 5

What you need to know

- The SEC staff is continuing to focus on whether companies' use of non-GAAP financial measures in earnings releases complies with the more explicit guidance the staff issued in May 2016.
- The SEC staff is currently reviewing and commenting on companies' use of non-GAAP measures in second-quarter earnings releases, which should provide more information about how the staff will apply the interpretations.
- Companies should challenge their disclosures of non-GAAP measures and monitor developments in SEC staff views and comments.
- Companies should involve the audit committee in discussions about their non-GAAP measures and strengthening disclosure controls and procedures related to those disclosures.

Overview

In the nearly six months since the Securities and Exchange Commission (SEC) staff updated its Compliance and Disclosure Interpretations (C&DIs) on non-GAAP financial measures, the staff has focused on compliance with that guidance in its reviews of earnings releases and SEC filings. The staff is currently performing reviews of second-quarter earnings releases, and the related SEC staff comment letters should provide more information about how the staff will apply the updated C&DIs.

In some cases, the staff is looking at earnings releases of companies that it had already reviewed this year and is challenging measures and presentations that it didn't previously question.

EY
Building a better working world

As we previously reported,[1] the updated C&DIs describe in detail non-GAAP financial measures that the staff believes would be misleading and would therefore violate applicable SEC rules. The clear message is that companies need to reevaluate their use and presentation of non-GAAP financial measures. In response to the updated C&DIs and comments from SEC officials, many companies changed the format of their earnings releases and filings in the second quarter to present GAAP figures more prominently than non-GAAP measures, and a number of them began developing and implementing more robust disclosure controls and procedures.

The Financial Accounting Standards Advisory Council, which advises the Financial Accounting Standards Board, and the Standing Advisory Group, which advises the Public Company Accounting Oversight Board, have also been discussing whether additional standard setting and auditor involvement is needed with respect to non-GAAP measures.

This publication discusses the SEC staff's main areas of focus in comment letters seeking compliance with the updated C&DIs, changes companies have made to their disclosures and challenges companies are encountering with their non-GAAP disclosures.

Staff focus areas and changes companies are making

Prominence of non-GAAP measures

The SEC staff's views on prominence were clarified in the C&DIs. As a result, many companies revised their non-GAAP disclosures in recent earnings releases and SEC filings to comply with the C&DIs. Based on our review, the most common request from the staff has been that companies reorganize their disclosures so that non-GAAP measures are not shown with greater prominence than the corresponding GAAP measures.

Example comment: Prominence
We note that you present non-GAAP measures in the headline of your press release without also presenting GAAP with equal or greater prominence, as required by Item 10(e)(1)(i)(A) of Regulation S-K. Your presentations appear to give greater prominence to the non-GAAP measures than to the comparable GAAP measures, which is inconsistent with the updated Compliance and Disclosure Interpretations. Please review this guidance when preparing your next earnings release.

While this may seem like a straightforward rule to follow, some companies with extensive non-GAAP disclosures have struggled to comply. For example, in addition to presenting non-GAAP measures in bulleted highlights in earnings releases, those companies often disclosed non-GAAP measures before GAAP measures, used a bold font for non-GAAP measures and put more emphasis on non-GAAP measures throughout the release. These practices have required some companies to substantially overhaul their earnings releases to comply with the updated C&DIs. In some cases, companies have chosen to discontinue disclosure of some non-GAAP measures.

Some companies also struggled with the requirement to reconcile any forward-looking non-GAAP disclosures with GAAP measures. While the reconciliation of forecasted guidance is clearly required by Item 10(e) of Regulation S-K, the rule provides an exception that allows companies to omit a reconciliation if it would require "unreasonable efforts" to prepare. The C&DIs challenge how frequently companies can rely on that exception, which applies in limited cases such as when a significant reconciling item is difficult to predict. One example might be the change in the fair value of a derivative that is not a designated hedge. If a company does not provide the reconciliation in reliance on the exception, it must disclose that fact and explain what information is unavailable and how it might affect the GAAP measure.

Example comment: Non-GAAP forecasts
In future filings, when presenting a forecasted non-GAAP financial measure, please provide a reconciliation of that measure to the most directly comparable GAAP financial measure. If you omit the information due to unreasonable efforts, please provide the required disclosures.

Appropriateness of adjustments and disclosures

The updated C&DIs also provide guidance on measures the staff would consider misleading or inappropriate under Regulation G. These include applying "individually tailored" accounting principles or adjusting performance measures to remove normal cash operating expenses.

Example comments: Tailored accounting principles
It appears you adjust a GAAP measure to accelerate the recognition of revenue in your presentation of gross operating margin, which may be inconsistent with the updated non-GAAP Compliance and Disclosure Interpretations. Please review this guidance and explain to us whether and how it will impact your disclosures in future filings.

The updated C&DIs clearly state that non-GAAP performance measures that accelerate revenue recognition are unacceptable, and many companies changed their measures to comply. However, the C&DIs don't explain what other types of adjustments the staff would consider to be "tailored" accounting principles.

The reconciliation of forecasted guidance is clearly required by Item 10(e) of Regulation S-K.

The SEC staff recently said that it will object to non-GAAP measures calculated based on proportionate consolidation when those measures don't follow the applicable GAAP consolidation principles. The staff has objected to non-GAAP measures that combine unconsolidated and consolidated interests (or removing the non-controlling interest holders' share of consolidated amounts) on the basis that such presentations can be misleading. Such measures are common in the real estate industry, among others.

The SEC staff has said it will not object to companies disclosing the various components of measures that otherwise are prohibited because they use tailored accounting principles. That is, a company could disclose the components of such measures as key performance indicators (i.e., operating statistics) or GAAP financial measures. For example, to help investors calculate a revenue metric that removes the effect of deferred revenue and rebates, a company could provide information about bookings and disclose components of GAAP revenue such as rebates, discounts and the change in deferred revenue, among others.

The SEC staff has said that it would not object if companies that have been presenting non-GAAP measures calculated using proportionate consolidation separately present financial statement line item information applicable to each type of interest (i.e., controlling and non-controlling). Analysts could then calculate alternative measures that are relevant to them (e.g., deduct the non-controlling interest share from the consolidated balances and add the proportionate share of any unconsolidated interests).

Excluding normal recurring cash operating expenses

The staff is issuing more comments on non-GAAP performance measures that exclude recurring cash operating expenses (e.g., those that add back restructuring charges, acquisition costs, litigation expenses, store opening expenses and elements of pension costs). The updated C&DIs state that excluding recurring expenses could be considered misleading because these items are routine and related to activities that drive profitability. Companies should consider why they are making such adjustments to their non-GAAP performance measures and whether those measures reflect the company's operating performance. To date, we have not seen the SEC staff challenge adjustments to non-GAAP performance measures that eliminate stock-based compensation, because such amounts are noncash.

Example comment: Excluding recurring cash operating expenses
You disclosed a non-GAAP financial measure, Adjusted Operating Income, which excludes various compensation, restructuring and acquisition charges from net income. Please explain, in greater detail, the nature of the excluded charges in the calculation of the non-GAAP financial measure and tell us whether these charges are recurring and/or cash expenses and how they are in line with the updated Compliance and Disclosure Interpretations.

Other considerations

Strengthening disclosure controls and procedures

SEC Chair Mary Jo White has said that companies should implement controls over their preparation and disclosure of non-GAAP measures. When disclosed in SEC filings, non-GAAP measures and the related reconciliations and disclosures fall under a company's disclosure controls and procedures that require certification by the Chief Executive Officer and Chief Financial Officer. Common types of disclosure controls implemented by companies include establishing policies that clearly describe the adjustments made to calculate a non-GAAP measure, establishing a process for changing how a non-GAAP financial measure is calculated (including reviewing non-GAAP adjustments for compliance with the SEC rules and staff interpretations) and enhancing audit committee oversight of the company's disclosure of non-GAAP financial measures.

Applying the non-GAAP rules and regulations

One of the common challenges companies encounter involves which rules apply to which forms of communication (i.e., earnings releases, filings required by the Securities Act or the Securities Exchange Act, earnings calls, investor presentations and other forms of communication with investors).

For example, the rules on the prominence of non-GAAP measures appear in Item 10(e) of Regulation S-K, which applies to all documents filed with the SEC and earnings releases furnished under Item 2.02 of Form 8-K (including supplemental information included or incorporated into such filings). The prominence rules do not apply to other communications such as investor presentations or information a company posts on its website or presents in an earnings call. Therefore, the prominence rules technically do not apply to these other forms of communication. Nevertheless, companies should still consider whether the nature of non-GAAP measures, or the manner of their presentation, is misleading. We encourage companies to consult with their securities counsel on such questions.

Regulation G prohibits misleading uses of non-GAAP measures in all communications by registrants. Regulation G also requires a reconciliation to the most comparable GAAP measure for non-GAAP measures used in all communications.

Presenting changes to non-GAAP disclosures

The SEC staff has said that changing a non-GAAP measure from period to period could be misleading. Companies that are changing their measures to comply with the updated staff interpretations should provide clear and transparent communication to explain the change, why it was made and how the new measure provides useful information. For example, a company might reconcile a revised measure to the one it previously presented in addition to recasting the previously presented measure to reflect the new calculation.

If a company changes how it calculates a non-GAAP measure to comply with the staff guidance, the staff has said it won't object if the company presents the inappropriate measure for one additional period to explain the change to investors.

What's next?

In the coming months, we expect the SEC staff to continue its focus on non-GAAP disclosures through its comment letter process. We also expect senior officials to continue to discuss the topic. Chair White said in a recent speech that enforcement actions and rulemaking were also possible.[2]

Endnotes:

[1] Our publication To the Point, *SEC staff updates guidance on non-GAAP financial measures* discusses the staff's updated interpretations issued in May 2016. For additional information on non-GAAP rules also refer to our Technical Line, *Spotlight on non-GAAP financial measures*.

[2] Keynote Address, International Corporate Governance Network Annual Conference: Focusing the Lens of Disclosure to Set the Path Forward on Board Diversity, Non-GAAP, and Sustainability https://www.sec.gov/news/speech/chair-white-icgn-speech.html.

EY | Assurance | Tax | Transactions | Advisory

© 2016 Ernst & Young LLP.
All Rights Reserved.

SCORE No. 03290-161US

ey.com/us/accountinglink

About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

Ernst & Young LLP is a client-serving member firm of Ernst & Young Global Limited operating in the US.

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

No. 2016-29
19 May 2016

To the Point

SEC staff updates guidance on non-GAAP financial measures

The SEC staff provided more explicit guidance on when the use of non-GAAP measures may violate SEC rules.

What you need to know

- The SEC staff updated its interpretations of the rules on non-GAAP financial measures and added new guidance to address its concerns about some types of non-GAAP financial measures and the manner of presentation of all such measures in earnings releases and SEC filings.
- Companies that present non-GAAP financial measures need to consider the new staff guidance, especially the examples of presentation of non-GAAP measures that the staff will consider misleading or too prominent.

Overview

The Securities and Exchange Commission (SEC) staff updated its Compliance and Disclosure Interpretations (C&DIs) on the use of non-GAAP financial measures to provide more explicit guidance on when such measures may violate SEC rules.

The updates reflect concerns that SEC officials have been discussing publicly in recent speeches about how non-GAAP measures are being used in SEC filings and earnings releases. Among other things, SEC officials are concerned that companies may be violating the SEC rules that prohibit the use of these measures in ways that are misleading or give them undue prominence.

In its comment letter process, the staff in the Division of Corporation Finance has stepped up its scrutiny of the use of non-GAAP measures, and staff members have said they will "crack down" on inappropriate uses of these measures.

EY

Building a better working world

Our recent Technical Line, *Spotlight on non-GAAP financial measures*, discusses the SEC rules and regulations on non-GAAP measures and recommends that companies reconsider their use of these measures in light of the heightened focus.

Guidance on when non-GAAP measures may be misleading

The updated C&DIs clarify that a non-GAAP measure could be considered misleading if it:

- Excludes normal, recurring cash operating expenses necessary to operate the registrant's business
- Is presented inconsistently between periods without adequate disclosure of the change and explanation of the reasons for the change
- Excludes non-recurring charges but does not exclude non-recurring gains

The C&DIs also state that, depending on the significance of a change in how the non-GAAP measure is calculated, it may be necessary to recast the prior period measures to conform to the current presentation, in addition to disclosing that a change has been made and the reasons for the change.

How we see it

These interpretations are consistent with our understanding of the SEC staff's views historically but appear to indicate the areas in which the staff is most concerned about abuse.

Guidance on tailoring recognition and measurement principles

One of the new C&DIs clarifies that non-GAAP performance measures that accelerate the recognition of revenue to the time of sale or customer billing that under GAAP would be recognized ratably over the performance period are unacceptable under Regulation G and may not be presented publicly, including in SEC filings, earning releases or company websites. Further, other measures that use "individually tailored" recognition and measurement methods for other financial statement items also may be unacceptable. Wesley Bricker, the SEC's Deputy Chief Accountant, and Mark Kronforst, Chief Accountant in the SEC's Division of Corporation Finance, recently expressed similar concerns at a financial reporting conference.

How we see it

While companies may use non-GAAP recognition and measurement methods to calculate segment profit reported under Accounting Standards Codification 280, *Segment Reporting*, we expect that the SEC staff would object to the presentation or discussion of such measures on a consolidated basis.

Guidance on the prominence of non-GAAP measures

The new C&DIs list the following examples of presentations of non-GAAP measures that the SEC staff would consider inappropriate in SEC filings and earnings release because they are presented more prominently than the comparable GAAP measure:

- Omitting comparable GAAP measures from an earnings release headline or caption that includes non-GAAP measures
- Presenting a non-GAAP measure using a style of presentation (e.g., bold, larger font) that emphasizes the non-GAAP measure over the comparable GAAP measure

- Presenting a non-GAAP measure before the most directly comparable GAAP measure (including in an earnings release headline or caption)
- Describing a non-GAAP measure as, for example, "record performance" or "exceptional" without an equally prominent descriptive characterization of the comparable GAAP measure
- Providing tabular disclosure of non-GAAP financial measures without preceding it with an equally prominent tabular disclosure of the comparable GAAP measures or including the comparable GAAP measures in the same table
- Excluding a quantitative reconciliation with respect to a forward-looking non-GAAP measure in reliance on the "unreasonable efforts" exception in Item 10(e)(1)(i)(B) without disclosing that fact and identifying the information that is unavailable and its probable significance in a location of equal or greater prominence
- Providing discussion and analysis of a non-GAAP measure without a similar discussion and analysis of the comparable GAAP measure in a location with equal or greater prominence

In addition, the C&DIs clarify that the staff considers the presentation of a full income statement of non-GAAP measures, or a full non-GAAP income statement when reconciling non-GAAP measures to the most directly comparable GAAP measures, to violate the prohibition on greater prominence.

The new guidance could alter the way companies present non-GAAP measure in earnings releases.

How we see it

Companies may need to reconsider how they present non-GAAP measures, especially in earnings releases. We note that this list of examples is not all inclusive.

Other updates

The C&DIs also address non-GAAP disclosures related to liquidity measures and tax effects.

Presenting liquidity measures on a per-share basis has long been prohibited by the SEC, but the SEC staff has historically not questioned per share measures when a company defined them as performance measures. In recent speeches, the SEC staff has expressed concerns that companies may be characterizing liquidity measures as performance measures to support presentation on a per-share basis, such as measures of adjusted earnings before interest, taxes, depreciation and amortization that appear to function as a liquidity measure.

The C&DIs clarify that the staff will focus on the substance of the non-GAAP per-share measure rather than management's characterization of the measure as a performance measure. Therefore, the SEC staff would object to a per-share measure described as performance measure that in substance is a per-share liquidity measure. Moreover, while free cash flow (FCF) is a commonly used non-GAAP liquidity measure, the C&DIs clarify that FCF measures cannot be presented on a per-share basis because they are liquidity measures.

The presentation of income tax effects related to non-GAAP adjustments has not historically been a focus area for the SEC staff. Following up on recent comments made by SEC officials, the C&DIs clarify that a registrant should appropriately reflect the income tax effects of adjustments made in calculating its non-GAAP measures. This includes potentially adjusting non-GAAP liquidity measures to show taxes paid in cash or reflecting the appropriate tax rate that would apply to adjustments made to calculate the non-GAAP measure of profitability, considering both the applicable current and deferred tax expense. This could differ from the company's GAAP effective tax rate. In a change from the staff's previous interpretations, the new C&DIs say that adjustments to arrive at a non-GAAP measure should not be presented net of tax in the reconciliation to the most comparable GAAP measure. Instead the tax effect of adjustments should be presented as a separate reconciling item.

How we see it

Companies presenting non-GAAP after tax performance measures should consider whether the effective tax rate would change based upon the level of non-GAAP profitability and whether other items in the tax provision (e.g., changes in valuation allowances) should be adjusted.

EY | Assurance | Tax | Transactions | Advisory

© 2016 Ernst & Young LLP.
All Rights Reserved.

SCORE No. 01108-161US

ey.com/us/accountinglink

About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

Ernst & Young LLP is a client-serving member firm of Ernst & Young Global Limited operating in the US.

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

NAREIT Alert (May 19, 2016)

NAREIT Alert Important Industry Updates from NAREIT

May 19, 2016

SEC Issues Compliance and Disclosure Interpretations on the Use of Non-GAAP Financial Measures

On May 17, the Securities and Exchange Commission issued a Compliance and Disclosure Interpretations (the Interpretations) of the rules and regulations on the use of non-GAAP financial measures. Among many topics discussed, the Interpretations focused a number of comments on reporting “funds from operations” (FFO). Of note, the Interpretations include a definitive statement that “The staff accepts NAREIT’s definition of FFO in effect as of May 17, 2016 as a performance measure and does not object to its presentation on a per share basis.” Given recent criticisms and public statements by regulators surrounding non-GAAP measures, NAREIT views this statement as a positive development for REITs. Additionally, the Interpretations provide a reminder that when a registrant presents a non-GAAP measure, it must present the most directly comparable GAAP measure *with equal or greater prominence*.

Questions and Answers referencing FFO

Question 102.01: “What measure was contemplated by ‘funds from operations’ in footnote 50 to Exchange Act Release 47226, *Conditions for the Use of Non-GAAP Measures,* which indicates that ‘companies may use ‘funds from operations per share’ in earnings releases and materials that are filed or furnished to the Commission, subject to the requirements of Regulation G and Item 10(e) of Regulation S-K?”’

Answer: “The reference to ‘funds from operations’ in footnote 50, or ‘FFO’, refers to the measure defined as of January 1, 2000, by the National Association of Real Estate Investment Trusts (NAREIT). NAREIT has revised and clarified the definition since 2000. The staff accepts NAREIT’s definition of FFO in effect as of May 17, 2016 as a performance measure and does not object to its presentation on a per share basis.”

Question 102.02: “May a registrant present FFO on a basis other than as defined by NAREIT as of May 17, 2016?”

Answer: “Yes, provided that any adjustments made to FFO comply with Item 10(e) of Regulation S-K and the measure does not violate Rule 100(b) of Regulation G. Any adjustment made to FFO must comply with the requirements of Item 10(e) of Regulation S-K for a performance measure or liquidity measure, depending on the nature of the adjustments, some of which may trigger the prohibition on presenting this measure on a per share basis.”

Question 102.03: “Item 10(e) of Regulation S-K prohibits adjusting a non-GAAP financial performance measure to eliminate or smooth items identified as non-recurring, infrequent or unusual when the nature of the charge or gain is such that it is reasonably likely to recur within two years or there was a similar charge or gain within the prior two years. Is this prohibition based on the description of the charge or gain, or is it based on the nature of the charge or gain?”

Answer: “The prohibition is based on the description of the charge or gain that is being adjusted. It would not be appropriate to state that a charge or gain is non-recurring, infrequent or unusual unless it meets the specified criteria. The fact that a registrant cannot describe a charge or gain as non-recurring, infrequent or unusual, however, does not mean that the registrant cannot adjust for that charge or gain. Registrants can make adjustments they believe are appropriate, subject to Regulation G and the other requirements of Item 10(e) of Regulation S-K. See Question 100.01.”

Question and Answer referencing Prominence of Non-GAAP Measures

Question 102.10: “Item 10(e)(1)(i)(A) of Regulation S-K requires that when a registrant presents a non-GAAP measure it must present the most directly comparable GAAP measure *with equal or greater prominence*. This requirement applies to non-GAAP measures presented in documents filed with the Commission and also

earnings releases furnished under Item 2.02 of Form 8-K. Are there examples of disclosures that would cause a non-GAAP measure to be more prominent?"

Answer: "Yes. Although whether a non-GAAP measure is more prominent than the comparable GAAP measure generally depends on the facts and circumstances in which the disclosure is made, the staff would consider the following examples of disclosure of non-GAAP measures as more prominent:

- Presenting a full income statement of non-GAAP measures or presenting a full non-GAAP income statement when reconciling non-GAAP measures to the most directly comparable GAAP measures;
- Omitting comparable GAAP measures from an earnings release headline or caption that includes non-GAAP measures;
- Presenting a non-GAAP measure using a style of presentation (e.g., bold, larger font) that emphasizes the non-GAAP measure over the comparable GAAP measure;
- A non-GAAP measure that precedes the most directly comparable GAAP measure (including in an earnings release headline or caption);
- Describing a non-GAAP measure as, for example, "record performance" or "exceptional" without at least an equally prominent descriptive characterization of the comparable GAAP measure;
- Providing tabular disclosure of non-GAAP financial measures without preceding it with an equally prominent tabular disclosure of the comparable GAAP measures or including the comparable GAAP measures in the same table;
- Excluding a quantitative reconciliation with respect to a forward-looking non-GAAP measure in reliance on the "unreasonable efforts" exception in Item 10(e)(1)(i)(B) without disclosing that fact and identifying the information that is unavailable and its probable significance in a location of equal or greater prominence; and
- Providing discussion and analysis of a non-GAAP measure without a similar discussion and analysis of the comparable GAAP measure in a location with equal or greater prominence."

Contact: George Yungmann at gyungmann@nareit.com or Christopher Drula at cdrula@nareit.com.

NAREIT Alert (June 23, 2016)

NAREIT Alert Important Industry Updates from NAREIT

June 23, 2016

On June 16, the Financial Accounting Standards Board (FASB or Board) issued a final Financial Instruments – Credit Losses Standard (the Standard). The Standard will require more timely recognition of credit losses associated with financial assets. The scope of the Standard is not limited to financial institutions; rather, its scope is asset-based. The Standard will be of particular interest to Mortgage REITs that invest in loans and debt securities.

Consistent with some of NAREIT's recommendations in its submission, the Standard:

- Is not applicable to operating leases;
- Will allow the credit loss allowance to be based on management's "best estimate";
- Defines the time horizon for developing an expected credit loss based on the expected life of an asset; and,
- Permits the reversal of previously recorded credit losses.

Scope

The Standard will apply to financial assets, which include:

- Loans;
- Loan commitments;
- Held-to-maturity debt securities;
- Financial guarantees;
- Finance-type leases;
- Reinsurance receivables; and,
- Trade receivables.

Overview of the Current Expected Credit Loss (CECL) Model

The Standard requires that entities measure all current expected credit losses for financial assets held at the reporting date based on historical experience, current market conditions, and reasonable and supportable forecasts. The Standard does not prescribe a specific credit loss methodology, which will allow for management judgement in determining the estimation method that is best suited for its financial assets.

The recognition of a credit loss will be required at *inception* of the loan or finance-type lease receivable. The credit loss will be based on management's estimate of the full amount of credit losses that are expected to be incurred. Generally, the initial estimate of the credit loss and subsequent changes to the estimate will be recognized in net income. The credit losses will be recorded through an allowance for loan and lease losses in the balance sheet.

The CECL methodology represents a fundamental change from current U.S. GAAP. Current U.S. GAAP requires recognition of credit losses based on an "incurred loss" methodology that delays recognition until it is probable that a loss has been incurred. This model was highly criticized after the financial crisis as requiring companies to recognize an insufficient and untimely amount of credit losses.

Available-for-Sale Debt Securities

The Standard does not change the current guidance related to measurement of credit losses for available-for-sale debt securities. However, the Standard will require that credit losses be recorded through an

allowance for credit losses and will allow subsequent reversals in credit loss estimates to be recognized in current income. The allowance will be limited by the amount that fair value is less than the amortized cost.

Transition

The Standard requires entities to apply the amendments through a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is effective. Thus, the Board chose a modified-retrospective approach by not requiring entities to restate prior periods presented upon the adoption of the Standard.

Effective Date

For public companies, the Standard is effective for fiscal years beginning after Dec. 15, 2019, and for interim periods within those fiscal years. Thus, the Standard will be effective beginning on Jan. 1, 2020 for publicly traded REITs.

The FASB will permit early adoption for all entities for fiscal years, and interim periods within those years, beginning after Dec. 15, 2018.

Contact: Christopher Drula at cdrula@nareit.com or George Yungmann at gyungmann@nareit.com.

NAREIT Alert (August 12, 2016)

NAREIT Alert Important Industry Updates from NAREIT

On Aug. 4, the Securities and Exchange Commission (SEC or Commission) issued a proposal (the Proposal) that would amend certain disclosure requirements that it believes have become redundant, duplicative, outdated, or superseded by other SEC disclosure requirements, US Generally Accepted Accounting Principles (GAAP), International Financial Reporting Standards (IFRS) or changes in the business environment. The SEC is also seeking constituent input on SEC disclosure requirements that overlap with, or are incremental to, existing GAAP to determine whether the SEC should retain, modify or eliminate the disclosure requirements. Alternatively, the SEC questions whether the Commission should simply refer the disclosure requirements to the Financial Accounting Standards Board (FASB) for potential incorporation into GAAP.

The Proposal may be of interest to REITs, as it specifically cites REIT examples when current SEC guidance would be amended and duplicative disclosure would be eliminated. If you are interested in participating in a task force that will evaluate the Proposal and consider whether NAREIT should develop a comment letter, please contact Christopher Drula at cdrula@nareit.com by close of business on Aug. 22. Comments are due to the Commission by Oct. 3.

Reporting Gains or Losses on Sales of Properties by REITs

The Proposal seeks to align current SEC and FASB guidance for reporting gains or losses on sales of properties by real estate companies such as REITs. Current SEC requirements in Regulation S-X mandate that REITs present separately all gains and losses on the sale of properties outside of continuing operations in the income statement. This guidance is in conflict with current GAAP, which restricts that presentation to gains and losses on disposals that meet the definition of discontinued operations. In July 2014, NAREIT alerted its members of the inconsistency, the SEC staff's acknowledgement of the inconsistency, and our understanding that the SEC staff would not comment on issuers' filings so long as either GAAP or SEC guidance was consistently applied.

Prior to 2014, application of Regulation S-X often resulted in the same presentation as GAAP because most REIT dispositions met the definition of discontinued operations. Thus, any gains or losses were presented outside of continuing operations in compliance with both SEC and GAAP requirements. In 2014, consistent with NAREIT's recommendation, the FASB narrowed the definition of discontinued operations in GAAP, such that the reporting now more frequently results in a presentation that differs from that under Regulation S-X. The Proposal would eliminate the inconsistency by amending Regulation S-X to conform to GAAP.

Disclosure of Issuer's REIT Status

The Proposal would eliminate disclosures about an issuer's status as a REIT in the audited notes to the financial statements, in reliance on disclosures within the same filing, but outside the audited financial statements (*e.g.*,management's discussion and analysis).

Contact: George Yungmann at gyungmann@nareit.com or Christopher Drula at cdrula@nareit.com.

NAREIT Alert (August 15, 2016)

NAREIT Alert Important Industry Updates from NAREIT

On Aug. 4, the Financial Accounting Standards Board (FASB or Board) issued an Invitation to Comment, *Agenda Consultation* (the Invitation to Comment). The Invitation to Comment seeks constituent feedback about the Board's future standard-setting agenda. NAREIT members may be particularly interested in providing the Board with input on how aspects of the financial statements could be improved particularly with respect to the income statement, including segment reporting, other comprehensive income, and the statement of cash flows. Previously, NAREIT submitted a letter in support of the Board's Financial Performance Research Project, requesting that it be added to the Board's formal standard setting agenda. If you are interested in participating in a task force that will evaluate the Invitation to Comment and develop a response to the Board, please contact Christopher Drula at cdrula@nareit.com by close of business on August 22. Comments are due to the Board by Oct. 17.

In addition to requesting feedback on possible improvements to the financial statements, the Invitation to Comment also explores potential issues and possible solutions about the following areas:

- Intangible assets, including research and development;
- Pensions and other postretirement benefit plans; and,
- Distinguishing liabilities from equity.

The Board plans to hold a public roundtable to discuss the Invitation to Comment in Q4 2016. The FASB plans to seek participants for the meeting that represent a wide spectrum of stakeholders, including financial statement users, preparers, auditors, and academics. In order to be eligible to participate, constituents are required to send an e-mail to director@fasb.org expressing their interest, as well as submit a written comment letter by the comment letter deadline (Oct. 17, 2016).

Contact: George Yungmann at gyungmann@nareit.com or Christopher Drula at cdrula@nareit.com.

NAREIT Alert (September 30, 2016)

NAREIT Alert Important Industry Updates from NAREIT

September 30, 2016

Reporting Pro-Rata Information

On September 27 at NAREIT's Senior Financial Officer Workshop, a representative of the Securities and Exchange Commission's (SEC) Division of Corporation Finance indicated that certain pro-rata financial information, which is provided by most REITs that invest in joint ventures, does not comply with the SEC's May 17, 2016 Compliance and Disclosure Interpretations (the C&DI) of the rules and regulations on the use of non-GAAP financial measures.

Subsequently, NAREIT discussed this matter with SEC staff. NAREIT understands that SEC staff would not object to the following presentation of elements of pro-rata financial statements:

Elements of Pro-Rata Statement of Operations	**Noncontrolling Interest Share of Consolidated Ventures**	**Company Share of Unconsolidated Ventures**
Minimum rent	-	-
Overage rent	-	-
Tenant reimbursements	-	-
Other income	-	-
Property operating expenses	-	-
Depreciation and amortization	-	-
Real estate taxes	-	-
Repairs and maintenance	-	-
Advertising and promotion	-	-
Provision for credit losses	-	-
Other	-	-
Interest Expense	-	-

Elements of Pro-Rata Balance Sheet	**Noncontrolling Interest Share of Consolidated Ventures**	**Company Share of Unconsolidated Ventures**
Investment properties, at cost	-	-
Less - accumulated depreciation	-	-
Cash and cash equivalents	-	-
Tenant receivables and accrued revenue, net	-	-
Investment in unconsolidated entities, at equity	-	-
Deferred costs and other assets	-	-
Mortgage and unsecured indebtedness	-	-
Accounts payable and accrued expenses	-	-
Other liabilities	-	-
Commitments and contingencies	-	-
Limited partners' preferred interest in the Operating Partnership	-	-

Important notes:

- *The consolidated GAAP financial statements may not be reported on the same table with the pro-rata information.*
- *The elements shown in this illustration of reporting pro-rata information may be different for each company's facts and circumstances.*
- *No totals or subtotals should be presented.*
- *Analysts could deduct the non-controlling interest share of consolidated ventures from the consolidated amounts.*
- *Analysts could add the company share of unconsolidated ventures to the consolidated amounts.*

Contact: George Yungmann at gyumgmann@nareit.com or Christopher Drula at cdrula@nareit.com.

NAREIT Alert (October 18, 2016)

NAREIT Alert Important Industry Updates from NAREIT

October 18, 2016

Further Guidance on Pro-Rata Reporting of Non-GAAP Financial Measures and Metrics

On Oct. 17, NAREIT held further discussions on pro-rata reporting with the Securities and Exchange Commission (SEC or Commission) staff in the Division of Corporation Finance.

NAREIT understands that the SEC staff will object to the use of the full presentation of non-GAAP pro-rata financial statements. The staff believes that this presentation is inconsistent with the Commission's rules for reporting non-GAAP financial measures and recent staff guidance for prominence and tailored accounting principles.

NAREIT understands that the SEC staff will not object to a presentation of proportional investee amounts, which may include a column of adjustments that would have been made to arrive at the full pro-rata financial statements. For further information, refer to the NAREIT Alert: Reporting Pro-Rata Information dated Sept. 30. Further, NAREIT understands that the SEC staff will not object to including subtotals and totals in the table of adjustments originally included in the Alert.

Currently, NAREIT understands that the SEC staff will also not object to the limited use of other measures and metrics that incorporate pro-rata financial information. Any disclosure of pro-rata financial information should be transparent. Registrants should include disclosure clearly explaining the nature and limits of the pro-rata results, such as:

- Registrants should provide clear disclosure of the relationship to the consolidated and unconsolidated investees and explain how the pro-rata information was derived.
- Registrants should explicitly disclose that they do not control the unconsolidated investees.
- Registrants should clearly explain any limitations of the proportional data. For example, registrants should caution investors that multiplying each of the investees' financial statement line items by the registrant's percentage ownership and adding those amounts to the registrant's totals may not accurately depict the legal and economic implications of holding a non-controlling interest in the investee.

Contact: George Yungmann at gyumgmann@nareit.com or Christopher Drula at cdrula@nareit.com.

NATIONAL
ASSOCIATION
OF
REAL ESTATE
INVESTMENT
TRUSTS®

♦ ♦ ♦

REITS:
BUILDING
DIVIDENDS

October 14, 2016

Ms. Susan Cosper
Technical Director
File Reference No. 2016-290
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, Connecticut 06856-5116
director@fasb.org

Delivered Electronically

Re: File Reference No. 2016-290, FASB *Invitation to Comment - Agenda Consultation*

Dear Ms. Cosper:

This letter is submitted by the National Association of Real Estate Investment Trusts® (NAREIT) to provide support and input to the Board's *Invitation to Comment - Agenda Consultation* (ITC).

NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other real estate businesses throughout the world that own, operate and finance commercial and residential real estate. NAREIT's members play an important role in providing diversification, dividends, liquidity and transparency to investors through their businesses that operate in all facets of the real estate economy.

REITs are generally deemed to operate as either Equity REITs or Mortgage REITs. Our members that operate as Equity REITs acquire, develop, lease and operate income-producing real estate. Our members that operate as Mortgage REITs finance housing and commercial real estate, by originating mortgages or by purchasing whole loans or mortgage backed securities in the secondary market.

A useful way to look at the REIT industry is to consider an index of stock exchange-listed companies like the FTSE NAREIT All REITs Index, which covers both Equity REITs and Mortgage REITs. This Index contained 221 companies representing an equity market capitalization of $1.052 trillion at September 30, 2016. Of these companies, 181 were Equity REITs representing 94.5% of total U.S. listed REIT equity market capitalization (amounting to $994

♦ ♦ ♦

1875 I Street, NW, Suite 600, Washington, DC 20006-5413
Phone 202-739-9400 Fax 202-739-9401 REIT.com

billion)[1]. The remainder, as of September 30, 2016, was 40 publicly traded Mortgage REITs with a combined equity market capitalization of $58 billion.

Overarching View

While NAREIT agrees that each of the areas covered by the ITC could be improved, we do not believe that intangible assets (including research and development), pensions and other postretirement benefit plans, and distinguishing liabilities from equity represent major reporting issues. Further, in the event that the Financial Accounting Standards Board (FASB or Board) follows our recommendation to add the income statement and cash flows statement to the formal standard setting agenda, we believe that the Board should target these two areas, and make no changes to segment reporting or other comprehensive income at this time. In our view, tackling all of the aspects cited in the ITC of the reporting performance and cash flows is too expansive of a project to undertake at one time.

In its letter dated April 30, 2015 NAREIT urged the Board to formally add the *Financial Performance Reporting* project to its standards setting agenda and to pursue a management approach to developing an income statement that more effectively communicates the economic results of a company's operations. NAREIT continues to support the Board's efforts to examine reporting performance and cash flows under U.S. Generally Accepted Accounting Principles (GAAP). The use of non-GAAP measures continues to expand exponentially. We believe that one of the reasons for this expansion is that the current GAAP income statement does not provide companies the flexibility to report performance in a way that communicates the relevant economics of its operations and profitability. Further, investors clamor for more useful cash flow information. Therefore, we are pleased that the Board has included *Reporting Performance and Cash Flow* in its *Agenda Consultation.* As was the case with the joint FASB/International Accounting Standards Board *Financial Statement Presentation* project, NAREIT is committed to support this project, bringing to the table industry executives and leading investors and analysts.

Income Statement

As indicated above, NAREIT believes that income statement presentation is a major financial reporting issue and urges the Board to consider evaluating modifications to the structure of the income statement (and corresponding changes to the statement of cash flows) to significantly enhance its relevance to users of financial statements. NAREIT does not believe that the Board should attempt to develop a standardized definition of operating income. It seems to us impossible for the Board to define an operating income measure that would be relevant for all types of business; rather we believe the Board should provide principles to guide a management approach to defining operating income.

Exhibit I to this letter provides an abstract of the income statement model developed by the Real Estate Equity Securitization Alliance (REESA); a global coalition of organizations representing

[1] https://www.reit.com/sites/default/files/returns/FNUSIC2016.pdf.

public real estate companies from Australia, Japan, Asia, Canada, United Kingdom, the European Union and the United States. The complete model is available at https://www.reit.com/sites/default/files/portals/0/PDF/Comment-Letter-on-FASB-Paper-041409.pdf. This model, which was developed in response to the joint FASB/IASB *Financial Statement Presentation* project, is being provided to simply illustrate how a company or industry can, with flexibility, develop an income statement that is most relevant to investors. The model statement reports subtotals that investors and other financial statement users employ in evaluating the operating performance of REITs and other companies that own and operate portfolios of investment property. To emphasize, NAREIT is not proposing that the income statement model in the Exhibit is a model under current GAAP. This model was prepared in 2007 and generally reflects U.S. GAAP and IFRS in place at that time. At the same time, NAREIT strongly believes that achieving highly relevant performance reporting requires that any new standard provide a management approach to structuring the income statement.

Statement of Cash Flows

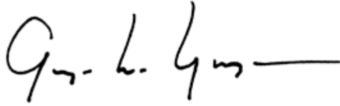
While NAREIT has not completed extensive research into the effectiveness of cash flow statements, it seems clear that investors and other financial statement users continue to demand more useful cash flow information. In connection with the work that REESA did in developing the income statement model discussed above, the organization also considered how the usefulness of the cash flow statement could be enhanced. We concluded, at that time, that the use of the direct method of reporting operating cash flow and a greater line-by-line interrelationship with the income statement would enhance the usefulness of the statement. At the same time, many companies believed that such a dramatic modification to the cash flow statement would not be cost effective and, therefore, NAREIT does not advocate such a dramatic modification to cash flow reporting at this time.

NAREIT encourages the Board to initiate a project that would consider possibilities for improving cash flow reporting. We would particularly support the standard-setting alternative to develop targeted improvements to provide greater disaggregation of specific cash flows. NAREIT agrees that reporting capital expenditures should be a specific focus of the Board's effort to improve cash flow reporting.

***

We thank the FASB for the opportunity to comment on the *Invitation to Comment- Agenda Consultation*. If you would like to discuss our views in greater detail, please contact George Yungmann, NAREIT's Senior Vice President, Financial Standards, at gyungmann@nareit.com or 202-739-9432, or Christopher Drula, NAREIT's Vice President, Financial Standards, at cdrula@nareit.com or 202-739- 9442.

Respectfully submitted,



George L. Yungmann
Senior Vice President, Financial Standards
NAREIT

Christopher T. Drula
Vice President, Financial Standards
NAREIT

cc: Wesley R. Bricker, Interim Chief Accountant, Office of the Chief Accountant, Securities and Exchange Commission
Rick A. Fleming, Investor Advocate, Securities and Exchange Commission
Karen Garnett, Esq., Associate Director, Division of Corporation Finance, Securities and Exchange Commission
Sonia Barros, Esq., Assistant Director, Division of Corporation Finance, Securities and Exchange Commission
Daniel Gordon, Senior Assistant Chief Accountant, Division of Corporation Finance, Securities and Exchange Commission

Exhibit

Global Real Estate Financial Reporting Model
Statement of Net Income
Abstract of August 2007 Model

Property Operations Income and Expense:	
Gross rental revenue	$
Interest on finance leases	
Service cost reimbursements from tenants	
Reimbursible service costs	
Property operating expenses	
Ground rent expense	
Share of net property income from unconsolidated affiliates	
Net Property Income (NPI)	$
Other Operating Income and Expense (OOIE):	
Gains/losses on sales of properties developed/acquired for sale	
Other operating revenue, including third party fees	
Other operating expenses	
G&A	
Dividend income	
Share of OOIE of unconsolidated affiliates	
Total Other Operating Income and Expense	$
Income From Operations before Finance Costs and Taxes	$
Finance costs:	
Interest expense, net	
Share of finance costs of unconsolidated affiliates	
Gains/losses on debt extinguishment	
Total finance costs	$
Income From Operations before Taxes, including deferred taxes	$
Taxes attributable to Net Operating Income	
Share of taxes of unconsolidated affiliates	
Total Taxes Attributable to IFO	$
Income from Operations (FFO/EPRA EPS)	$
Other Income and Expense:	
Gains/losses on sale of investment property	
Increase/decrease in unrealized value of investment property	
Increase/decrease in unrealized value of financial instruments	
Depreciation of real estate not reported at fair value	
Share of other income and expenses of unconsolidated affiliates	
Other	
Income tax on other income/expense, including deferred taxes	
Total Other Income and Expense	$
Net Income	$

Officers

Chair
W. Edward Walter
Host Hotels & Resorts, Inc.

President and CEO
Steven A. Wechsler

First Vice Chair
Ronald L. Havner, Jr.
Public Storage, Inc.

Second Vice Chair
David J. Neithercut
Equity Residential

Treasurer
David B. Henry
Kimco Realty Corporation

2013 NAREIT Executive Board
Jon E. Bortz
Pebblebrook Hotel Trust
Richard J. Campo
Camden Property Trust
Edward J. Fritsch
Highwoods Properties, Inc.
Rick R. Holley
Plum Creek Timber Company, Inc.
Andrew F. Jacobs
Capstead Mortgage Corporation
Dennis D. Oklak
Duke Realty Corporation
Steven B. Tanger
Tanger Factory Outlet Centers, Inc.
Robert S. Taubman
Taubman Centers, Inc.
Thomas W. Toomey
UDR, Inc.
Donald C. Wood
Federal Realty Investment Trust

2013 NAREIT Board of Governors
Thomas J. Baltimore, Jr.
RLJ Lodging Trust
Michael D. Barnello
LaSalle Hotel Properties
William C. Bayless, Jr.
American Campus Communities, Inc.
Kenneth F. Bernstein
Acadia Realty Trust
George L. Chapman
Health Care REIT, Inc.
Wellington Denahan-Norris
Annaly Capital Management, Inc.
Bruce W. Duncan
First Industrial Realty Trust
James F. Flaherty, III
HCP, Inc.
Dennis H. Friedrich
Brookfield Office Properties
Daniel S. Fulton
Weyerhaeuser
Lawrence L. Gellerstedt, III
Cousins Properties Incorporated
Michael P. Glimcher
Glimcher Realty Trust
William P. Hankowsky
Liberty Property Trust
Philip L. Hawkins
DCT Industrial Trust, Inc.
Daniel B. Hurwitz
DDR Corp.
David J. LaRue
Forest City Enterprises, Inc.
Stephen D. Lebovitz
CBL & Associates Properties, Inc.
Thomas H. Lowder
Colonial Properties Trust
Peter S. Lowy
The Westfield Group
Craig Macnab
National Retail Properties Inc.
Joel S. Marcus
Alexandria Real Estate Equities, Inc.
Sandeep Mathrani
General Growth Properties
George F. McKenzie
Washington REIT
Donald A. Miller
Piedmont Office Realty Trust, Inc.
Marguerite Nader
Equity Lifestyle Properties, Inc.
Timothy J. Naughton
AvalonBay Communities, Inc.
Jeffrey S. Olson
Equity One, Inc.
Adam D. Portnoy
CommonWealth REIT
Joseph D. Russell, Jr.
PS Business Parks, Inc.
Richard B. Saltzman
Colony Financial, Inc.
Michael J. Schall
Essex Property Trust, Inc.
David P. Stockert
Post Properties, Inc.
Amy L. Tait
Broadstone Net Lease, Inc.
Mark E. Zalatoris
Inland Real Estate Corporation
Mortimer B. Zuckerman
Boston Properties, Inc.

NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

May 31, 2013

Ms. Susan Cosper
Technical Director
File Reference No. 2012-260
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, Connecticut 06856-5116
director@fasb.org

Delivered Electronically

Re: File Reference No. 2012-260, *Financial Instruments – Credit Losses (Subtopic 825-15)*

Dear Ms. Cosper:

This letter is submitted by the National Association of Real Estate Investment Trusts® (NAREIT) in response to the Proposed Accounting Standards Update from the Financial Accounting Standards Board (FASB or the Board) on *Financial Instruments – Credit Losses (Subtopic 825-15)* (the Proposal).

NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate, and finance income-producing real estate, as well as those firms and individuals who advise, study, and service those businesses.

REITs are generally deemed to operate as either Equity REITs or Mortgage REITs. Our members that operate as Equity REITs acquire, develop, lease, and operate income-producing real estate. Our members that operate as Mortgage REITs finance housing and commercial real estate by originating mortgages or by purchasing whole loans or mortgage backed securities in the secondary market.

A useful way to look at the REIT industry is to consider an index of stock exchange-listed companies like the FTSE NAREIT U.S. Real Estate Index, which covers both Equity REITs and Mortgage REITs. This Index contained 172 companies representing an equity market capitalization of $603.4 billion at 2012 year end. Of these companies, 139 were Equity REITs representing 90.2% of total U.S. listed

REIT equity market capitalization (amounting to $544.4 billion)[1]. The remainder, as of December 31, 2012, was 33 publicly traded Mortgage REITs with a combined equity market capitalization of $59 billion.

NAREIT's Recommendation

NAREIT concurs with the FASB's goal of developing a financial reporting model that more accurately reflects the timing and degree to which companies sustain credit losses on financial assets. However, with respect to the FASB's proposed current expected credit loss model (CECL), we believe that there are a number of areas that need improvement for the model to become operational for preparers and understandable for users, regulators, and auditors alike. Therefore, NAREIT proposes the following enhancements with regard to the CECL model:

- **Allow the credit loss allowance to be based on management's "best estimate" of expected credit losses – so, for example, an investor in an AA-rated bond or U.S. Treasury bond or Agency security would expect a best estimate of zero**

- **Clarify that the time horizon for the CECL model is based on the expected life (as opposed to the contractual life) of the financial asset**

- **Allow preparers to reverse previously recorded credit losses and require preparers to adjust the effective yield over the remaining life of the financial instrument to the extent that the expected cash flows exceeds the originally anticipated amount**

- **Exclude trade receivables and lease receivables from the scope of the Proposal**

- **Ensure that interim disclosures are not a mere repeat of the annual disclosures unless there is a material change**

Allow the credit loss allowance to be based on management's "best estimate" of expected credit losses – so, for example, an investor in an AA-rated bond or U.S. Treasury bond or Agency security would expect a best estimate of zero

NAREIT understands that the Proposal would require companies to book a credit loss upon execution of the transaction based on multiple possible outcomes. The estimate would be neither a worst-case scenario nor a best-case scenario, but rather would be based on an entity's assessment of current conditions and reasonable and supportable forecasts about the future. As such, the Proposal would expressly prohibit companies from utilizing a "best estimate" or "most likely outcome" approach that may result in recognizing zero credit losses.

NAREIT does not believe that the Proposal, as written, would faithfully present the underlying economics of certain transactions. NAREIT questions the Proposal's outcome when the model is applied to securities that are measured at fair value with changes in value recognized in other comprehensive income. For example, preparers would be required to record an allowance for credit losses immediately upon purchasing an AA-rated bond, a U.S. Treasury bond, or an Agency

[1] http://returns.reit.com/reitwatch/rw1301.pdf at page 20.

mortgage-backed security and thus "expect" credit losses of something other than zero. The vast majority of companies have never incurred a credit loss with respect to these particular investments. Therefore, NAREIT questions why the Board would require management to book an allowance for credit losses for these types of financial instruments, regardless of how small, when management's long-standing history indicates that there has never been a credit loss incurred historically. Further, the purchase price already inherently reflects what little credit risk exists.

The results of the CECL model become further perplexing when considering the fact that a company would record ***no allowance for credit losses*** at the date of purchase if these financial instruments are measured at fair value, with changes in value recognized in net income.

In NAREIT's view, the Board could easily address this accounting anomaly in the Proposal by permitting management to utilize a "best estimate" of expected credit losses. The concept of "best estimates" has conceptual merits in current U.S. GAAP. For example, FASB Concepts Statement No.7, *Using Cash Flow Information and Present Value in Accounting Measures*, defines the term *best estimate* as follows:

> The single most-likely amount in a range of possible estimated amounts; in statistics, the estimated mode. In the past, accounting pronouncements have used the term *best estimate* in a variety of contexts that range in meaning from "unbiased" to "most likely[2]."

NAREIT believes that providing management with the ability to use a "best estimate" approach within the CECL model would more accurately report management's view of the financial position of a company to users of financial statements.

Clarify that the time horizon for the CECL model is based on the expected life (as opposed to the contractual life) of the financial asset

A literal reading of the Proposal suggests that the allowance for credit losses estimate would be based on the cash flows that management does not expect to collect over the *contractual* life of the financial instrument. NAREIT questions whether it was the Board's intention for management to use the entire contractual life in all instances. For example, based on information obtained from the Federal Housing Finance Agency, the historical assumption for the average life of a 30-year residential mortgage loan is approximately 10 years[3]. The shorter life is due to prepayments that result when homeowners either sell their homes to move, decide to refinance due to decreasing interest rates, or default on the mortgage loan. NAREIT does not believe that an allowance for credit losses that is based on the entire 30-year life of the mortgage loan would be an accurate estimate.

NAREIT recommends that the Board discontinue use of the phrase "contractual cash flows" and utilize the term "expected cash flows" in its place. This would permit management to take

[2] http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175820900214&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs at page CON7-5.

[3] http://www.fhfa.gov/webfiles/25006/MIRS_Feb_2013_final.pdf at page 2.

prepayments into consideration when estimating the expected life of a loan. NAREIT believes that making this change would dispel the confusion regarding whether the Board's intention was for preparers to estimate credit losses over the life-time contractual term of financial instruments that surfaced after the Proposal was issued. Subsequently, the Board attempted to address its intention in question 8 of the Proposed Accounting Standards Update, *Financial Instruments—Credit Losses (Subtopic 825-15)* Frequently Asked Questions document.

Allow preparers to reverse previously recorded credit losses and require preparers to adjust the effective yield over the remaining life of the financial instrument to the extent that the expected cash flows exceeds the originally anticipated amount

While we understand the impetus for the development of an expected credit loss model, we are concerned about any model that would only allow preparers to record downward adjustments and not reverse those credit losses in situations where the fair value of investments (*e.g.,* estimates of future cash flows) subsequently increases. With the benefit of hindsight, a preparer could observe whether market downturns later reverse. To the extent that market conditions stabilize, we believe that an accounting model that allows for reversals of previously recorded credit losses would more accurately reflect the financial position of a company. Thus, in that regard, we agree with the Proposal as an improvement over current practices for debt securities.

However, NAREIT believes that preparers should be able to adjust the effective yield over the remaining life of the financial instrument to the extent that the expected cash flows exceed the *originally* anticipated amount, unlike the Proposal that would record an immediate gain. In our view, the accounting model that we recommend would provide the best information to users of financial statements as well as address the uncertainty of estimates in a prudent manner.

Exclude trade receivables and lease receivables from the scope of the Proposal

NAREIT fails to see the benefit of including trade receivable and lease receivables within the scope of the Proposal. NAREIT observes that the Board is inconsistent when it comes to defining whether a lease is a financial asset. For example, lease receivables are excluded from the scope of the project that deals with financial assets (*e.g.,* the Proposed Accounting Standards Update on *Financial Instruments: Recognition and Measurement*), while in projects such as this, the FASB includes lease receivables as financial assets within the scope of the Proposal. Further, we note that trade receivables are generally short term and present few accounting issues under current U.S. GAAP.

To avoid confusion and complexity, NAREIT recommends that the Board exclude these assets from the scope of the Proposal. NAREIT believes that the accounting treatment for credit losses with respect to these asset types is best suited for the chapters in the codification that address these asset types. For example, credit losses for leases should be included within the codification section that is dedicated to leases. In order to ensure that convergence is achieved, the FASB and IASB should include the accounting for credit losses for leases within the scope of the *Leases* Project.

In the event that the Board does not decide to follow our recommendation, NAREIT requests that the Board clearly articulate the types of leases that would be in scope of the Proposal (*e.g.,* both operating and finance lease receivables?). Depending on the Board's anticipated timing for the

effective date, this scoping decision should contemplate both leases under current U.S. GAAP and leases that would exist under the proposed *Leases* standard.

Ensure that interim disclosures are not a mere repeat of the annual disclosures unless there is a material change

As NAREIT indicated in its November 30, 2012 submission[4] on the FASB's *Disclosure Framework* discussion paper and in its May 15, 2013 submission[5] on the FASB's *Financial Instruments: Recognition and Measurement* Proposal, NAREIT has observed a growing trend in accounting pronouncements that requires companies to prepare the same types of disclosures at both interim and annual reporting dates. NAREIT questions whether detailed information can continue to be disclosed at interim periods given shorter quarterly SEC financial reporting deadlines (*i.e.,* 40 days for both large accelerated filers and accelerated filers, and 45 days for non-accelerated filers[6]) when compared with annual SEC financial reporting deadlines (*i.e.,* 60 days for large accelerated filers, 75 days for accelerated filers, and 90 days for non-accelerated filers[7]). According to APB 28: *Interim Financial Reporting* (Accounting Standards Codification Topic 270), each interim period is an integral part (as opposed to a discrete part) of the annual reporting period.

NAREIT suggests that the Board consider the approach that the SEC utilizes for changes in financial condition and quantitative and qualitative disclosures of market risks. The SEC requires these disclosures in annual reports. To the extent that there has been a material change since the date of the most recent annual report, the SEC requires disclosures in quarterly filings as well. By taking this approach, the SEC has effectively reduced unnecessary disclosure duplication. NAREIT believes that the FASB would achieve its objective by taking a similar approach.

We urge the FASB and the IASB to work toward a converged solution. As the Boards near the completion of the convergence projects, we implore the FASB and IASB to work together to reduce differences in their respective Financial Instruments models. This will benefit preparers, users, auditors, and regulators alike.

We thank the FASB for the opportunity to comment on the Proposal. If you would like to discuss our views in greater detail, please contact George Yungmann, NAREIT's Senior Vice President, Financial Standards, at gyungmann@nareit.com or 1-202-739-9432, or Christopher Drula, NAREIT's Vice President, Financial Standards, at cdrula@nareit.com or 1-202-739-9442.

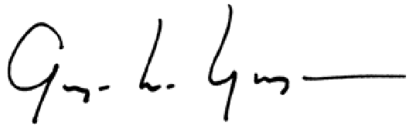
Respectfully submitted,

[4] http://www.reit.com/~/media/Files/Policy/Letter-to-FASB-on-Disclosure-Framework-11-30-12.ashx

[5] http://www.reit.com/~/media/2013/NAREIT%20Comment%20Letter%20on%20FASB%20Recognition%20and%20Measurement%20Proposal.ashx

[6] http://www.sec.gov/answers/form10q.htm

[7] http://www.sec.gov/answers/form10k.htm



George Yungmann
Senior Vice President, Financial Standards
NAREIT

Christopher T. Drula
Vice President, Financial Standards
NAREIT

cc: Mr. Hans Hoogervorst, Chairman, International Accounting Standards Board

Ms. Sue Lloyd, Senior Director, Technical Activities, International Accounting Standards Board

Mr. Alan Teixeira, Senior Director, Technical Activities, International Accounting Standards Board

Officers

Chair
Edward J. Fritsch
Highwoods Properties, Inc.

President and CEO
Steven A. Wechsler

First Vice Chair
Timothy J. Naughton
AvalonBay Communities, Inc.

Second Vice Chair
Thomas J. Baltimore, Jr.
RLJ Lodging Trust

Treasurer
Sandeep Mathrani
General Growth Properties, Inc.

2016 NAREIT Executive Board
Michael P. Glimcher
WP Glimcher
Ronald L. Havner, Jr.
Public Storage
Philip L. Hawkins
DCT Industrial Trus, Inc.
Lauralee E. Martin
HCP, Inc.
W. Benjamin Moreland
Crown Castle International Corp.
David J. Neithercut
Equity Residential
Dennis D. Oklak
Duke Realty Corporation
Doyle R. Simons
Weyerhaeuser
A William Stein
Digital Realty
Robert S. Taubman
Taubman Centers, Inc.
Owen D. Thomas
Boston Properties, Inc.

2016 NAREIT Advisory Board of Governors
Andrew M. Alexander
Weingarten Realty Investors
Michael D. Barnello
LaSalle Hotel Properties
H. Eric Bolton, Jr.
MAA
Trevor P. Bond
W. P. Carey Inc.
Jon E. Bortz
Pebblebrook Hotel Trust
Richard J. Campo
Camden Property Trust
John P. Case
Realty Income Corporation
Randall L. Churchey
EdR
Michael J. Covey
Potlatch Corporation
Bruce W. Duncan
First Industrial Realty Trust, Inc.
Conor C. Flynn
Kimco Realty Corporation
Lawrence L. Gellerstedt, III
Cousins Properties, Inc.
William S. Gorin
MFA Financial, Inc.
Steven P. Grimes
RPAI
Andrew F. Jacobs
Capstead Mortgage Corporation
Kevin G. Keyes
Annaly Capital Management
John B. Kilroy, Jr.
Kilroy Realty Corporation
Spencer F. Kirk
Extra Space Storage, Inc.
Eugene W. Landy
Monmouth Real Estate Investment Corporation
David J. LaRue
Forest City Enterprises, Inc.
Stephen D. Lebovitz
CBL & Associates Properties, Inc.
Joel S. Marcus
Alexandria Real Estate Equities, Inc.
Christopher P. Marr
CubeSmart L.P.
Richard K. Matros
Sabra Health Care REIT, Inc.
Marguerite M. Nader
Equity Lifestyle Properties, Inc.
Jeffrey S. Olson
Urban Edge Properties
Colin V. Reed
Ryman Hospitality Properties, Inc.
Sean E. Reilly
Lamar Advertising Company
Michael J. Schall
Essex Property Trust, Inc.
Bruce J. Schanzer
Cedar Realty Trust, Inc.
Wendy L. Simpson
LTC Properties, Inc.
David P. Singelyn
American Homes 4 Rent
Richard A. Smith
FelCor Lodging Trust Inc.
Stephen M. Smith
Equinix, Inc.
David P. Stockert
Post Properties, Inc.
Gerard H. Sweeney
Brandywine Realty Trust
James D. Taiclet, Jr.
American Tower Corporation
Amy L. Tait
Chairman, President & CEO
Broadstone Net Lease, Inc.
Steven B. Tanger
Tanger Factory Outlet Centers, Inc.
John T. Thomas
Physicians Realty Trust
Thomas W. Toomey
UDR, Inc.
Roger A. Waesche, Jr.
Office Properties Trust
Chad L. Williams
QTS Realty Trust, Inc.

NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

December 8, 2015

Ms. Susan M. Cosper
Technical Director
File Reference No. 2015-310
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116
director@fasb.org

Delivered electronically

RE: Proposed Accounting Standards Update – *Notes to Financial Statements (Topic 235) – Assessing Whether Disclosures Are Material*

Dear Ms. Cosper:

This letter is submitted by the National Association of Real Estate Investment Trusts® (NAREIT) to provide input on the Proposed Accounting Standards Update – *Notes to Financial Statements (Topic 235) – Assessing Whether Disclosures Are Material* (the Proposal).

NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other real estate businesses throughout the world that own, operate and finance commercial and residential real estate. NAREIT's members play an important role in providing diversification, dividends, liquidity and transparency to investors through their businesses that operate in all facets of the real estate economy.

REITs are generally deemed to operate as either Equity REITs or Mortgage REITs. Our members that operate as Equity REITs acquire, develop, lease and operate income-producing real estate. Our members that operate as Mortgage REITs finance housing and commercial real estate, by originating mortgages or by purchasing whole loans or mortgage backed securities in the secondary market.

1875 I Street, NW, Suite 600, Washington, DC 20006-5413
Phone 202-739-9400 Fax 202-739-9401 REIT.com

A useful way to look at the REIT industry is to consider an index of stock exchange-listed companies like the FTSE NAREIT All REITs Index which covers both Equity REITs and Mortgage REITs. This Index contained 224 companies representing an equity market capitalization of $890 billion at September 30, 2015. Of these companies, 183 were Equity REITs representing 93.8% of total U.S. stock exchange-listed REIT equity market capitalization (amounting to $835 billion)[1]. The remainder, as of September 30, 2015, is represented by 41 stock exchange-listed Mortgage REITs with a combined equity market capitalization of $55 billion.

This letter has been developed by a task force of NAREIT members, including members of NAREIT's Best Financial Practices Council (the Council). Members of the task force include financial executives of both Equity and Mortgage REITs, representatives of major accounting firms, institutional investors and industry analysts.

NAREIT supports the Proposal's Objective

NAREIT supports the FASB's objective to improve the effectiveness of disclosures in notes to financial statements. NAREIT appreciates the FASB's efforts as part of the Disclosure Framework to revisit existing requirements to ensure that the financial statements clearly and concisely communicate the information that is most relevant to users of financial statements. NAREIT further welcomes the potential benefit of reducing costs and complexity as a consequence of a sharper focus on what users of financial statements value most in evaluating the prospects of future cash flows of public companies.

NAREIT strongly supports the following aspects of the Proposal:

- The elimination of phrases like "an entity shall at a minimum provide" and other wording that could appear to limit an entity's discretion to omit immaterial disclosure;

- The explicit statement that the omission of an immaterial required disclosure is not an accounting error; and,

- The proposed amendments should be effective upon issuance.

[1] https://www.reit.com/sites/default/files/reitwatch/RW1510.pdf at page 21.

NAREIT recommendations

- **Work in a concerted way with other regulators (*i.e.,* the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB)) to ensure the success of the FASB's Disclosure Framework and SEC's Disclosure Effectiveness Initiative; and,**

- **Expand the scope of the project to apply materiality to the financial statements taken as a whole.**

Following is the rationale in making these recommendations.

Work in a concerted way with other regulators (*i.e.,* the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB)) to ensure the success of the FASB's Disclosure Framework and SEC's Disclosure Effectiveness Initiative

NAREIT observes that the tension surrounding the definition of materiality is not limited to the FASB. In order to ensure successful application of the Proposal in practice, NAREIT recommends that the FASB work with other regulators like the SEC and PCAOB to ensure that there is a collaborative and consistent approach taken once the Proposal is finalized. There would be a natural hesitation on the part of preparers to reduce or eliminate immaterial disclosure at the expense of being second-guessed by auditors or regulators after financial statements have been filed with the SEC. Standard setting and public statements by officials at the SEC and PCAOB would alleviate these concerns and provide preparers with peace of mind.

Expand the scope of the project to apply materiality to the financial statements taken as a whole

NAREIT observes that the scope of the project is limited to the notes to the financial statements. In our view, there would be additional benefit in expanding the scope of the project to include the financial statements as well. NAREIT believes that it would be beneficial to have explicit statements in U.S. GAAP that acknowledge that not following U.S. GAAP for immaterial items would not be considered an error.

NAREIT continues to support the FASB's Disclosure Framework Project. If there are questions regarding this comment letter, please contact either George Yungmann at 202-739-9432 or gyungmann@nareit.com or Christopher Drula at 202-739-9442 or cdrula@nareit.com.

Respectfully submitted,

George L. Yungmann
Senior Vice President, Financial Standards

Christopher T. Drula
Vice President, Financial Standards

NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

Officers

Chair
Edward J. Fritsch
Highwoods Properties, Inc.

President and CEO
Steven A. Wechsler

First Vice Chair
Timothy J. Naughton
AvalonBay Communities, Inc.

Second Vice Chair
Thomas J. Baltimore, Jr.
RLJ Lodging Trust

Treasurer
Sandeep Mathrani
General Growth Properties, Inc.

2016 NAREIT Executive Board

Michael P. Glimcher
WP Glimcher

Ronald L. Havner, Jr.
Public Storage

Philip L. Hawkins
DCT Industrial Trus, Inc.

Lauralee E. Martin
HCP, Inc.

W. Benjamin Moreland
Crown Castle International Corp.

David J. Neithercut
Equity Residential

Dennis D. Oklak
Duke Realty Corporation

Doyle R. Simons
Weyerhaeuser

A William Stein
Digital Realty

Robert S. Taubman
Taubman Centers, Inc.

Owen D. Thomas
Boston Properties, Inc.

2016 NAREIT Advisory Board of Governors

Andrew M. Alexander
Weingarten Realty Investors

Michael D. Barnello
LaSalle Hotel Properties

H. Eric Bolton, Jr.
MAA

Trevor P. Bond
W. P. Carey Inc.

Jon E. Bortz
Pebblebrook Hotel Trust

Richard J. Campo
Camden Property Trust

John P. Case
Realty Income Corporation

Randall L. Churchey
EdR

Michael J. Covey
Potlatch Corporation

Bruce W. Duncan
First Industrial Realty Trust, Inc.

Conor C. Flynn
Kimco Realty Corporation

Lawrence L. Gellerstedt, III
Cousins Properties, Inc.

William S. Gorin
MFA Financial, Inc.

Steven P. Grimes
RPAI

Andrew F. Jacobs
Capstead Mortgage Corporation

Kevin G. Keyes
Annaly Capital Management

John B. Kilroy, Jr.
Kilroy Realty Corporation

Spencer F. Kirk
Extra Space Storage, Inc.

Eugene W. Landy
Monmouth Real Estate Investment Corporation

David J. LaRue
Forest City Enterprises, Inc.

Stephen D. Lebovitz
CBL & Associates Properties, Inc.

Joel S. Marcus
Alexandria Real Estate Equities, Inc.

Christopher P. Marr
CubeSmart L.P.

Richard K. Matros
Sabra Health Care REIT, Inc.

Marguerite M. Nader
Equity Lifestyle Properties, Inc.

Jeffrey S. Olson
Urban Edge Properties

Colin V. Reed
Ryman Hospitality Properties, Inc.

Sean E. Reilly
Lamar Advertising Company

Michael J. Schall
Essex Property Trust, Inc.

Bruce J. Schanzer
Cedar Realty Trust, Inc.

Wendy L. Simpson
LTC Properties, Inc.

David P. Singelyn
American Homes 4 Rent

Richard A. Smith
FelCor Lodging Trust Inc.

Stephen M. Smith
Equinix, Inc.

David P. Stockert
Post Properties, Inc.

Gerard H. Sweeney
Brandywine Realty Trust

James D. Taiclet, Jr.
American Tower Corporation

Amy L. Tait
Chairman, President & CEO
Broadstone Net Lease, Inc.

Steven B. Tanger
Tanger Factory Outlet Centers, Inc.

John T. Thomas
Physicians Realty Trust

Thomas W. Toomey
UDR, Inc.

Roger A. Waesche, Jr.
Office Properties Trust

Chad L. Williams
QTS Realty Trust, Inc.

November 30, 2015

Mr. Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

RE: Request for Public Comment on the Effectiveness of Financial Disclosures about Entities other than the Registrant

Dear Commissioners:

This letter is submitted by the National Association of Real Estate Investment Trusts® (NAREIT) to provide input on the Request for Public Comment on the Effectiveness of Financial Disclosures about Entities other than the Registrant (the Proposal).

NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other real estate businesses throughout the world that own, operate and finance commercial and residential real estate. NAREIT's members play an important role in providing diversification, dividends, liquidity and transparency to investors through their businesses that operate in all facets of the real estate economy.

REITs are generally deemed to operate as either Equity REITs or Mortgage REITs. Our members that operate as Equity REITs acquire, develop, lease and operate income-producing real estate. Our members that operate as Mortgage REITs finance housing and commercial real estate, by originating mortgages or by purchasing whole loans or mortgage backed securities in the secondary market.

A useful way to look at the REIT industry is to consider an index of stock exchange-listed companies like the FTSE NAREIT All REITs Index which covers both Equity REITs and Mortgage REITs. This Index contained 224 companies representing an equity market capitalization of $890 billion at October 31, 2015. Of these companies, 183 were Equity REITs representing 93.8% of total U.S. stock exchange-listed REIT equity market capitalization (amounting to $835 billion). The remainder, as of October 31, 2015, is represented by 41 stock exchange-listed Mortgage REITs with a combined equity market capitalization of $55 billion.

1875 I Street, NW, Suite 600, Washington, DC 20006-5413
Phone 202-739-9400 Fax 202-739-9401 REIT.com

This letter has been developed by a task force of NAREIT members, including members of NAREIT's Best Financial Practices Council (the Council). Members of the task force include financial executives of both Equity and Mortgage REITs, representatives of major accounting firms, institutional investors and industry analysts.

NAREIT Recommendations

NAREIT supports the SEC's objective to improve the effectiveness of disclosure requirements in Regulation S-X for certain entities other than the registrant. NAREIT appreciates the SEC's efforts as part of the Disclosure Effectiveness Initiative to revisit existing regulations to ensure that the financial statements clearly and concisely communicate the information that is most relevant to users of financial statements. NAREIT further welcomes the potential benefit of reducing costs and complexity as a consequence of a sharper focus on what users of financial statements value most in evaluating the prospects of future cash flows of public companies.

After evaluating the Proposal, NAREIT recommends that the SEC:

- Increase and align the significance percentage thresholds utilized in S-X Rules 3-05, 3-09 and 3-14;
- Define another measure as a performance metric for the income test (*i.e.,* Earnings Before Income Taxes, Depreciation and Amortization (EBITDA) or Funds from Operations (FFO)) that more faithfully represents the underlying economics of acquired interests in other entities in transactions involving investment property (*e.g.,* shopping mall, office buildings and apartments); and,
- Establish a single year requirement for stand-alone financial statements for acquired interests in other entities.

Following is the rationale in making these recommendations:

Increase and align the significance percentage thresholds utilized in S-X Rules 3-05, 3-09, and 3-14

In the context of real estate transactions, the consensus amongst our task force is that far more transactions meet the requirements under S-X regulations than was originally intended for mandatory disclosure. One possible solution for this phenomenon is to raise the threshold to focus the users of financial statements on transactions that are truly material to the acquirer. Discussions with industry investors indicated that, while audited pre-acquisition financial statements of the acquired interest are useful, this usefulness is marginal. One investor indicated that he uses these financial statements "when time permits". Therefore, NAREIT does not believe that the effort and costs to meet the current S-X requirements meet any reasonable cost/benefit test. Raising and aligning the significance threshold and reducing the required periods to one year (see below) would balance the cost and benefit of the S-X requirements.

Define another measure as a performance metric for the income test (*i.e.*, Earnings Before Income Taxes, Depreciation and Amortization (EBITDA) or Funds from Operations (FFO)) that more faithfully represents the underlying economics of acquired interests in other entities in transactions involving investment property (*e.g.*, shopping mall, office buildings and apartments)

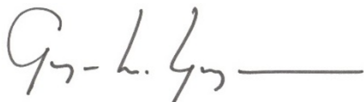
Another possible solution would be to consider replacing the income test with a different performance metric. Because of the unique significance of depreciation related to investment property, net income from operating these properties is very low relative to the other economics of owning and operating portfolios of investment property. Therefore, another possibility to achieve a reasonable cost/benefit result would be to use a metric such as EBITDA or FFO, to evaluate the significance of an acquisition. This could solve two issues: (1) the challenge with consistently meeting the income test requirements when net income is near break-even, and (2) requiring management to disclose information that they would have used as the basis for their own investment decision. When making the investment decision, REITs will often consider whether the investment is accretive to their current portfolio of investment properties. The measures used to evaluate accretion cited by the task force include EBITDA and FFO.

Establish a single year requirement for stand-alone financial statements for acquired interests in other entities

Preparers cite audit fees and time constraints as examples of the costs and complexities associated with the current S-X regulations. Further compounding these challenges are situations where the acquired investment is in a private entity. One possible way to reduce audit fees and the time spent by accounting personal would be to establish a single year requirement for stand-alone financial statements.

NAREIT continues to support the Commission's Disclosure Effectiveness Initiative and would welcome an opportunity to discuss our views on the Proposal with the Commission. If there are questions regarding this comment letter, please contact either George Yungmann at 202-739-9432 or gyungmann@nareit.com or Christopher Drula at 202-739-9442 or cdrula@nareit.com.

Respectfully submitted,



George L. Yungmann
Senior Vice President, Financial Standards

Christopher T. Drula
Vice President, Financial Standards

Officers
Chair
David J. Neithercut
Equity Residential
President and CEO
Steven A. Wechsler
First Vice Chair
David B. Henry
Kimco Realty Corporation
Second Vice Chair
Edward J. Fritsch
Highwoods Properties, Inc.
Treasurer
Timothy J. Naughton
AvalonBay Communities, Inc.

2015 NAREIT Executive Board
Thomas J. Baltimore, Jr.
RLJ Lodging Trust
Wellington J. Denahan
Annaly Capital Management, Inc.
Ronald L. Havner, Jr.
Public Storage
Lauralee E. Martin
HCP, Inc.
Sandeep Mathrani
General Growth Properties, Inc.
W. Benjamin Moreland
Crown Castle International Corp.
Dennis D. Oklak
Duke Realty Corporation
Doyle R. Simons
Weyerhaeuser
Robert S. Taubman
Taubman Centers, Inc.
Owen D. Thomas
Boston Properties, Inc.
W. Edward Walter
Host Hotels & Resorts, Inc.

2015 NAREIT Board of Governors
Andrew M. Alexander
Weingarten Realty Investors
Michael D. Barnello
LaSalle Hotel Properties
William C. Bayless, Jr.
American Campus Communities, Inc.
H. Eric Bolton, Jr.
MAA
Trevor P. Bond
W. P. Carey Inc.
Jon E. Bortz
Pebblebrook Hotel Trust
Richard J. Campo
Camden Property Trust
John P. Case
Realty Income Corporation
Randall L. Churchey
EdR
Douglas J. Donatelli
First Potomac Realty Trust
Bruce W. Duncan
First Industrial Realty Trust, Inc.
Lawrence L. Gellerstedt, III
Cousins Properties Inc.
Michael P. Glimcher
Glimcher Realty Trust
William S. Gorin
MFA Financial, Inc.
Steven P. Grimes
RPAI
Philip L. Hawkins
DCT Industrial Trust Inc.
Rick R. Holley
Plum Creek Timber Company, Inc.
Andrew F. Jacobs
Capstead Mortgage Corporation
John B. Kilroy, Jr.
Kilroy Realty Corporation
Spencer F. Kirk
Extra Space Storage, Inc.
David J. LaRue
Forest City Enterprises, Inc.
Stephen D. Lebovitz
CBL & Associates Properties, Inc.
Peter S. Lowy
Westfield Corporation
Craig Macnab
National Retail Properties, Inc.
Christopher P. Marr
CubeSmart L.P.
Richard K. Matros
Sabra Health Care REIT, Inc.
Donald A. Miller
Piedmont Office Realty Trust, Inc.
Marguerite M. Nader
Equity Lifestyle Properties, Inc.
Edward J. Pettinella
Home Properties, Inc.
Colin V. Reed
Ryman Hospitality Properties, Inc.
Joseph D. Russell, Jr.
PS Business Parks, Inc.
Michael J. Schall
Essex Property Trust, Inc.
Bruce J. Schanzer
Cedar Realty Trust, Inc.
Nicholas S. Schorsch
American Realty Capital
Thomas E. Siering
Two Harbors Investment Corp.
Wendy L. Simpson
LTC Properties, Inc.
Richard A. Smith
FelCor Lodging Trust Inc.
David P. Stockert
Post Properties, Inc.
Gerard H. Sweeney
Brandywine Realty Trust
James D. Taiclet, Jr.
American Tower Corporation
Amy L. Tait
Chairman, President & CEO
Broadstone Net Lease, Inc.
Steven B. Tanger
Tanger Factory Outlet Centers, Inc.
John T. Thomas
Physicians Realty Trust
Thomas W. Toomey
UDR, Inc.
Roger A. Waesche, Jr.
Office Properties Trust
Chad L. Williams
QTS Realty Trust, Inc.

NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

April 30, 2015

Ms. Susan Cosper
Technical Director
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, Connecticut 06856-5116
director@fasb.org

Delivered Electronically

Re: Financial Performance Reporting Project

Dear Ms. Cosper:

This letter is submitted by the National Association of Real Estate Investment Trusts® (NAREIT) to provide support and input to the Board's *Financial Performance Reporting Research* project. For reasons discussed further below, NAREIT urges the Board to formally add the *Financial Performance Reporting* project to its standard setting agenda and to pursue a management approach to developing an income statement that more effectively communicates the economic results of a company's operations.

NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other real estate businesses throughout the world that own, operate and finance commercial and residential real estate. NAREIT's members play an important role in providing diversification, dividends, liquidity and transparency to investors through their businesses that operate in all facets of the real estate economy.

REITs are generally deemed to operate as either Equity REITs or Mortgage REITs. Our members that operate as Equity REITs acquire, develop, lease and operate income-producing real estate. Our members that operate as Mortgage REITs finance housing and commercial real estate, by originating mortgages or by purchasing whole loans or mortgage backed securities in the secondary market.

A useful way to look at the REIT industry is to consider an index of stock exchange-listed companies like the FTSE NAREIT U.S. All REITs Index, which covers both Equity REITs and Mortgage REITs. This Index contained 220 companies

representing an equity market capitalization of $953 billion at February 28, 2015 Of these companies 180 were equity REITs representing 93.5% of total U.S. stock exchange-listed REIT equity market capitalization (amounting to $891 billion)[1]. The remainder, as of February 28, 2015, is represented by 40 stock exchange-listed mortgage REITs with a combined equity market capitalization of $62 billion.

Most industry investors and analysts we have talked to believe that the current income statement prepared in accordance with Generally Accepted Accounting Principles (GAAP) does not provide sufficiently adequate relevant information for investors in companies that own and operate portfolios of investment property, *i.e.,* real estate investment trusts and other similar stock exchange-listed real estate companies. At a recent industry conference, the Chief Financial Officer of a major REIT and a prominent industry analyst each shared their view that the GAAP income statement is generally not relevant to evaluating the operating performance of a company that owns and operates a portfolio of investment property. Given the limits placed on financial reporting in the GAAP statement of financial performance, NAREIT defined the non-GAAP metric, Funds from Operations (FFO) in 1991 to provide investors a supplemental performance metric that more effectively communicates the economic operating performance of REITs. Since 2003 FFO has been recognized by the SEC as a non-GAAP metric that may be reported on a per share basis, so long as the issuer uses the NAREIT definition and reconciles it to net income. See question 7 in the SEC's *Frequently Asked Questions Regarding the Use of Non-GAAP Financial Measures* at http://www.sec.gov/divisions/corpfin/faqs/nongaapfaq.htm. Additionally, if the issuer calculates an FFO measure that is not consistent with the NAREIT definition, the SEC staff has required that the metric be reconciled to FFO as defined by NAREIT. Attached as Exhibit A is the latest FFO White Paper issued by NAREIT.

In addition to FFO, industry investors and analysts focus heavily on Net Operating Income (NOI). This non-GAAP metric is generally defined as direct revenues generated by the property, primarily revenue under tenant leases, less direct property operating costs. This metric is significant since it provides the principal basis for valuing investment property. The valuation is developed by either discounting projected NOI or capitalizing a single year's NOI using current required investor yields in the real estate capital markets.

While investors and other industry financial analysts that regularly focus on the REIT industry are familiar with the FFO and NOI metrics and their use in evaluating the investment quality of REITs, the use of non-GAAP/unaudited metrics as primary factors in valuing REIT shares by the REIT-dedicated investment community may be considered a complication and, therefore a negative factor, to those investors in the broader capital market outside of real estate.

Many industry participants from both the financial statement preparer and user communities believe that the real estate industry is primed to be even more accepted by the broader capital markets. As evidence of this movement, in November of last year, MSCI, Inc. and S&P Dow Jones announced that stock exchange-listed equity REITs and other exchange-listed real estate

[1] https://www.reit.com/sites/default/files/reitwatch/RW1503.pdf at page 21

companies will be reclassified from the Financials Sector and elevated to a new 11th headline sector, the Real Estate Sector, of the Global Industry Classification Standard (GICS) in 2016.

Both preparers and users of the industry's financial statements believe that the movement of REITs into wider acceptance would be aided greatly by companies being able to report in the audited GAAP income statement operating performance metrics that better communicate the economic operating results generated by portfolios of investment property. In response to the FASB/IASB joint *Financial Statement Presentation* (FSP) project, a global coalition of real estate organizations developed the Statement of Comprehensive Income attached as Exhibit B that reports these important metrics. In this model statement, NOI is labeled Net Property Income and FFO is labeled Income from Operations. The development of this statement is further discussed below.

Background on NAREIT's Involvement in the Financial Statement Presentation Project

In the context of the FASB/IASB efforts to develop global financial reporting standards, the Boards initiated a project in 2005 that began to examine the structure of the primary financial statements – the FSP project. At its initial meeting, the Joint International Working Group that was focused on this project virtually unanimously agreed that new financial statement formats should be based on a management approach. This approach would allow more meaningful disaggregation and groupings of income and expense items that would allow management to create an operating performance statement that would communicate the economic operating results of the company. Real estate industry representatives around the globe saw this as an opportunity to develop financial statements that would more faithfully report the economics of owning and operating investment property to investors and other financial statement users.

In response to this FASB/IASB initiative, a global industry coalition was established that developed a real estate industry financial statement model[2]. This model included an example of an income statement that would report a number of metrics relevant to communicating the economic operating performance of companies that own and operate investment property. After issuing a preliminary views document and receiving significant input from constituents, the Boards deferred further work on this project due to resource constraints.

NAREIT is pleased that the FASB is once again considering the relevance of operating performance reporting in its current research project.

Conclusion

As indicated in the Board's Project Update, the primary objective of this research project is to evaluate ways to improve the relevance of information presented in the operating statement. A significant factor in considering the need for this project is the widespread use of non-GAAP measurements developed by companies to more effectively communicate the economics of their operating performance. This condition calls for all of us to rethink whether the current GAAP

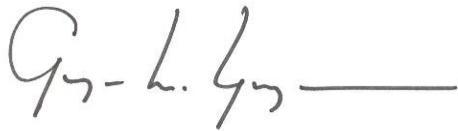
[2] https://www.reit.com/sites/default/files/portals/0/PDF/NAREITCommentLetterPreliminaryViewsFSP041409.pdf

NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS®
1875 I Street, NW, Suite 600, Washington, DC 20006-5413
Phone 202-739-9400 Fax 202-739-9401 REIT.com

operating statement can be improved. We think it can be improved and we urge the FASB to move this project to its formal standard setting agenda. As was the case with the joint FASB/IASB FSP project, NAREIT is committed to support this project, bringing to the table industry executives and leading investors and analysts.

We thank the FASB for the opportunity to comment on the *Financial Performance Reporting Research* project. If you would like to discuss our views in greater detail, please contact George Yungmann, NAREIT's Senior Vice President, Financial Standards, at gyungmann@nareit.com or 202-739-9432, or Christopher Drula, NAREIT's Vice President, Financial Standards, at cdrula@nareit.com or 202-739-9442.

Respectfully submitted,



George L. Yungmann
Senior Vice President, Financial Standards
NAREIT

Christopher T. Drula
Vice President, Financial Standards
NAREIT

CC: Mr. Hugh Shields
Executive Technical Director
International Accounting Standards Board

Exhibit A

White Paper on Funds From Operations

April 2002

TABLE OF CONTENTS

I. Introduction

II. History and Intended Use of FFO Definition

III. Discussion of FFO Definition

- A. Amortization and Depreciation
- B. Treatment of Non-recurring and Extraordinary items
- C. Entities Addressed by the FFO Definition
- D. Disclosure of FFO
- E. Gains and Losses on Property Sales

IV. Supplemental Disclosure

- A. Capital Expenditures
- B. Straight-Line Rents
- C. Results of Discontinued Operations

V. Implementation

I. INTRODUCTION

In 1991, NAREIT adopted a definition of Funds From Operations (FFO) in order to promote a supplemental industry-wide standard measure of REIT operating performance that would not have certain drawbacks associated with net income under generally accepted accounting principles ("GAAP"). The definition was clarified in 1995, 1999 and 2002. The current definition follows:

FUNDS FROM OPERATIONS means net income (computed in accordance with generally accepted accounting principles), excluding gains (or losses) from sales of property, plus depreciation and amortization, and after adjustments for unconsolidated partnerships and joint ventures. Adjustments for unconsolidated partnerships and joint ventures will be calculated to reflect funds from operations on the same basis.

Historical cost accounting for real estate assets implicitly assumes that the value of real estate assets diminishes predictably over time. Since real estate values instead have historically risen or fallen with market conditions, many industry investors have considered presentations of operating results for real estate companies that use historical cost accounting to be insufficient by themselves.

The term Funds From Operations was created to address this problem. It was intended to be a standard supplemental measure of REIT operating performance that excluded historical cost depreciation from — or "added it back" to — GAAP net income.

Since the introduction of the definition, the term has come to be widely used by REITs. In the view of NAREIT, this use (combined with the primary GAAP presentations required by the Securities and Exchange Commission) has been fundamentally beneficial, improving the understanding of operating results of REITs among the investing public and making it easier than before to compare the results of one REIT with another.

Nevertheless, issues have arisen that suggest that greater guidance on its intent and interpretation is useful, both to reporting companies and investors. This White Paper addresses these issues.

II. HISTORY AND INTENDED USE OF FFO DEFINITION

NAREIT recognizes that the management of each of its member companies has the responsibility and authority to publish financial information that it regards as useful to the financial community, within the limits prescribed by law and regulation. Nevertheless, NAREIT has been and remains convinced that the industry benefits from having a supplement to net income as a measure of operating performance, and is aware that the SEC's Accounting Series Release (ASR) No. 142 encourages the development of such "industry standard" accounting terms.

In particular, GAAP historical cost depreciation of real estate assets is generally not correlated with changes in the value of those assets, whose value does not diminish predictably over time,

as historical cost depreciation implies. For this reason, comparisons of the operating results of REITs that rely solely on net income have been less than satisfactory. Some analysts have also concluded that comparing or measuring prices of REIT stocks solely in terms of conventional P/E multiples is not as useful as also using a supplemental metric.

In an effort to overcome this problem, NAREIT adopted the term Funds From Operations in the belief that it would be useful if consolidated after-tax income plus depreciation and amortization were used as a supplemental measure of operating performance. In particular, it was hoped that prices of various REIT stocks could be compared with each other and in terms of the relationship between REIT stock prices and FFO. Thus, the original intent was that FFO be used for the sake of determining a supplemental capitalization multiple similar to a P/E ratio.

However, the underlying premise of the definition of FFO was not to sanction deviations from GAAP in the name of calculating Funds From Operations. In fact, the definition specifically refers to GAAP net income as the starting point in the calculation of FFO.

Importantly, FFO was also not intended to be used as a measure of the cash generated by a REIT nor of its dividend paying capacity. NAREIT feels that the statements of cash flows provided for by GAAP financial statements are adequate for analysts to assess the cash generated and used by REITs.

Similarly, NAREIT continues to believe that the dividend paying capacity of a REIT results from the economic characteristics of its assets, the degree of risk in matters of capital structure decided upon by individual companies, and other financial policy matters that are properly the province of management. While dividends can be analyzed in comparison to FFO, much as they are analyzed in comparison to net income in other industries, it was and is not NAREIT's intent to imply that FFO is a measure of the sustainable level of dividends payable by a REIT.

The following sections address the most important of the interpretive issues under the definition of FFO, along with NAREIT's views on them.

III. DISCUSSION OF FFO DEFINITION

A. Amortization and Depreciation.

The 1991 definition of FFO specified that depreciation and amortization were to be added back to consolidated net income, without specifying what amortized items are to be included. As a result, different capitalization policies among reporting REITs led to widely varying lists of items being "added back" in the calculation.

In addition, some analysts questioned the propriety of adding back any depreciation other than depreciation of real estate, since the original justification for the add back was that historical cost depreciation is inappropriate for real estate assets. Their argument has been that depreciation of assets other than real estate is no less real when they are owned by a REIT than when

they are owned by a company in another industry, and that there is therefore no reason to add back their depreciation in measuring the operating performance of a REIT.

NAREIT agrees that the logic underlying the concept of FFO is inconsistent with the add back of depreciation or amortization of assets other than those uniquely significant to the real estate industry. It urges all member companies reporting FFO to add back only those items that meet this standard.

Examples of items that should be added back include real property depreciation, amortization of capitalized leasing expenses, tenant allowances or improvements, and the like. Specifically excluded are the add back of items such as the amortization of deferred financing costs, depreciation of computer software, company office improvements, and other items commonly found in other industries and required to be recognized as expenses in the calculation of net income.

B. Treatment of Non-recurring and Extraordinary Items

NAREIT's intent in the creation of FFO was to try to produce a measure of consolidated operating performance that is recurring in nature. Accordingly, in NAREIT's 1995 White Paper, the definition of FFO excluded items classified by GAAP as extraordinary or unusual, along with significant non-recurring events that materially distort the comparative measurement of company performance over time.

Given the diversity in practice that developed with respect to non-recurring events, in 1999 NAREIT clarified the definition of FFO to include non-recurring events, except for those that are defined as "extraordinary items" under GAAP. This clarification was effective January 1, 2000, and calculation of FFO based on this clarification should be shown for all periods presented in financial statements or tables. NAREIT also reiterated in 1999 that FFO would continue to exclude the earnings impacts of cumulative effects of accounting changes and results of discontinued operations — both as defined by GAAP. In 2002, NAREIT clarified that FFO related to assets held for sale, sold or otherwise transferred and included in results of discontinued operations should continue to be included in consolidated FFO. This clarification is effective January 1, 2002, and calculation of FFO based on this clarification should be shown for all periods presented in financial statements or tables.

C. Entities Addressed by the FFO Definition.

The 1991 definition of FFO addressed the treatment of unconsolidated partnerships and joint ventures. Specifically, REITs were instructed to reflect the contributions of unconsolidated partnerships and joint ventures to the REIT's consolidated FFO on the same basis as the REIT's own operations. It appears that the original drafters intended that the term joint ventures include both unincorporated associations or corporations in which a REIT holds an active interest.

Nevertheless, REITs increasingly use corporations, the operations of which are not reported on a consolidated basis with those of the REITs. NAREIT believes that the use of a corporate

form instead of a partnership should not affect the determination of whether an entity is to be treated as a joint venture for purposes of the definition.

D. Disclosure of FFO

Many companies have reported FFO without providing sufficient disclosure to allow analysts to determine how it is being calculated. In turn, this has made it more difficult to evaluate the degree to which reported FFO results are inconsistent with the definition.

NAREIT believes that an important benefit to all REITs has arisen from the increased use of FFO as a supplement to net income in the measurement of REIT operating performance. In order to continue that benefit, NAREIT encourages its member companies to report their FFO on a quarterly basis, and in all SEC filings, including 10-Ks, 10-Qs, and registration statements, along with a statement showing how FFO is calculated.

The format for the statement of FFO should reconcile to net income from the statement of operations and include a line-item breakdown of each of the adjustments being used in the calculation of FFO. The reconciliation should be sufficiently detailed to provide readers with a clear understanding of the material differences between net income and FFO.

In addition to depreciation of real estate, examples of important items that should be considered for inclusion in the reconciliation, itemized both for wholly owned entities and partially owned entities, when applicable, include the following:

— separate itemized listing of each of the following: amortization or depreciation of tenant allowances, tenant improvements, or capitalized leasing costs;

— adjustments for extraordinary items, results of discontinued operations and cumulative effects of accounting changes — all as defined by GAAP;

— FFO from discontinued operations;

— gains or losses on asset dispositions, to the extent not included in both net income and FFO; and

— distributions to minority interests, if applicable.

E. Gains and Losses on Property Sales

A number of REITs sell undepreciated property incidental to their main business, most often sales of securities or parcels of land peripheral to operating properties. The prohibition against the inclusion of gains or losses on property sales in FFO was not meant to address this kind of activity, but rather the gain or loss on previously depreciated operating properties.

Those REITs that choose to include such gains or losses on sales of securities or undepreciated land in their FFO should disclose the amount of such gains or losses for each applicable reporting period. Those that do not should address the amount of such gains or losses in their reconciliation of net income to FFO.

IV. SUPPLEMENTAL DISCLOSURE

A. Capital Expenditures

Thanks in some measure to a desire to use anticipated rather than historical results of operations in order to explain dividend policies, especially in initial public offerings, companies used their estimates of future FFO to justify anticipated dividend payouts in the descriptions of dividend policy contained in registration statements, and specifically in the so-called “magic page.”

Given that FFO is not intended to be a measure of cash generated or of dividend paying capacity, this practice has led to understandable confusion and criticism by users of these prospectuses that the FFO numbers do not represent an appropriate means for evaluating dividend policy. Some critics have gone further and suggested a variety of adjustments to FFO, with the desire to adjust it so that it would be a better measure of cash generated or dividend capacity. The result of these calculations generally are referred to by their authors as Funds Available for Distribution, Cash Available for Distribution or Adjusted FFO (AFFO).

Although there is some considerable overlap among analysts as to what might be appropriate adjustments to Funds From Operations that would make it a better measure of dividend paying capacity, NAREIT believes that there is not adequate consensus among preparers and users of the REIT financial statements to allow agreement on a single definition of Funds (Cash) Available for Distribution or AFFO. Further, NAREIT does not believe that there is a single measure of distributable cash that is consistently applicable to all REITs.

More detailed disclosures regarding capital spending and certain other items would allow REIT financial statement users who wish to estimate Funds (Cash) Available for Distribution or AFFO to make the adjustments to reported FFO that they consider useful to investors for that purpose. When applicable, this disclosure should reflect the pro rata share of such expenditures by consolidated and unconsolidated entities in which the REIT holds a direct or indirect interest.

NAREIT encourages member firms to provide supplemental disclosure that provides useful insights into material capital expenditures. The total of capital expenditures should be broken down between amounts being spent on corporate items, existing properties, development of new properties, and acquisitions. The nature of the expenditures should be characterized as thoroughly as is practical. Aggregate, rather than property-by-property, totals should be provided, but REITs owning more than one property type should disclose the following information separately for each type of property.

Items that are known to be of particular interest to readers include the following that generally apply to retail, office, and industrial properties:

— separate itemized listing of expenditures on tenant improvements or allowances, both in the aggregate and per square foot, separated into expenditures on new and renewal tenants;

— expenditures on other capitalized leasing costs, including leasing commissions, both in the aggregate and per square foot, and separated by new and renewal tenants; and

— expenditures on expansions and major renovations.

Items generally considered to be of particular interest with respect to apartment properties include the following, to the extent that they are capitalized:

— Expenditures on floor covering, both in the aggregate and per unit owned during the period, and per unit improved;

— expenditures on appliances, both in the aggregate and per unit owned during the period, and per unit improved; and

— expenditures on exterior preparation and painting, both in the aggregate and per unit owned during the period, and per unit improved.

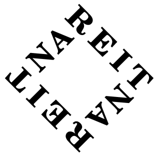
On April 26, 2001, NAREIT issued a National Policy Bulletin that more fully describes these "FFO White Paper Disclosures."

B. Straight-Line Rents

Depending on individual circumstances, GAAP reporting may or may not require "straight lining" of rents in the calculation of net income. In order to provide an opportunity for consistent analysis of operating results among REITs, NAREIT encourages those reporting FFO to make supplemental disclosure of the non-cash effect of straight line rents, if any, affecting their results for each period.

C. Results of Discontinued Operations

NAREIT encourages full disclosure of amounts reported in "results of discontinued operations." These disclosures should identify FFO, gains/losses and other items included in discontinued operations. In addition, disclosures should include specific information about discontinued operations that represent sales of significant business segments.



V. IMPLEMENTATION

NAREIT believes that implementation of the recommendations contained in this White Paper is up to the business judgment of the management of each company. The recommendations are intended to be guidelines for management, rather than a mandatory set of inflexible rules; they are not an indication that NAREIT or any of its members or advisors believe that any of the information is material to REIT investors. Nothing contained herein is intended or shall be construed to impose any legal obligation to follow these guidelines or any liability under the securities laws or otherwise for any failure to do so.

NAREIT recognizes that in some situations it may be difficult to reconstruct comparable information for prior periods. Nevertheless, NAREIT encourages all companies to calculate and present FFO consistently for all periods presented in financial statements or tables.

NAREIT believes that public confidence in the quality of reported results, and the adequacy of disclosures as to the method of calculation of those results, is of paramount importance to the REIT industry as a whole.

Statement of Comprehensive Income
August 2007 Model

Property Operations Income and Expense:	
Gross rental revenue	$
Interest on finance leases	
Service cost reimbursements from tenants	
Reimbursible service costs	
Property operating expenses	
Ground rent expense	
Share of net property income from unconsolidated affiliates, Note A	
Net Property Income (NPI), Note B	$
Other Operating Income and Expense (OOIE):	
Gains/losses on sales of properties developed/acquired for sale, Note C	
Other operating revenue, including third party fees, Note D	
Other operating expenses, Note E	
G&A	
Dividend income	
Share of OOIE of unconsolidated affiliates, Note A	
Total Other Operating Income and Expense	$
Income From Operations before Finance Costs and Taxes	$
Finance costs:	
Interest expense, net	
Share of finance costs of unconsolidated affiliates	
Gains/losses on debt extinguishment	
Total finance costs	$
Income From Operations before Taxes, including deferred taxes	$
Taxes attributable to Net Operating Income	
Share of taxes of unconsolidated affiliates	
Total Taxes Attributable to IFO	$
Income from Operations (FFO/EPRA EPS)	$
Other Income and Expense:	
Gains/losses on sale of investment property	
Increase/decrease in unrealized value of investment property	
Increase/decrease in unrealized value of financial instruments including derivatives	
Depreciation of real estate not reported at fair value	
Share of other income and expenses of unconsolidated affiliates	
Other	
Income tax on other income/expense, including deferred taxes	
Total Other Income and Expense	$
Income from Continuing Operations	$
Discontinued Operations, Note F:	
Operating earnings/loss from discontinued operations	$
Gains/losses on property sales from discontinued operations	
Taxes, current and deferred, attributable to discontinued operations	
Income/loss From Discontinued Operations	$
Net Income	$
Other Comprehensive Income:	
Gains and losses from currency translation of foreign operations	
Actuarial gains/losses on defined benefit plans	
Unrealized gains/losses on effective hedges	
Total Other Comprehensive Income	$
Comprehensive Income	$

Earnings Per Share:

	IFO	Cont. Ops.	Disc. Ops.	Net Income
Basic	$	$	$	$
Diluted	$	$	$	$

Governance **Insights** Center

December 2016

Approaching the 2016 year-end financial reporting season

Five things for audit committees to think about

The 2016 calendar year-end financial reporting season is approaching and audit committees are preparing for their year-end meetings. Here, we highlight some of the financial reporting issues, SEC trends and other developments that audit committees should be thinking about.

pwc.com/us/governanceinsightscenter

1. Are we on course to adopt the new revenue recognition standard?

In May 2014, the FASB issued its new standard on revenue recognition. The standard, which largely removed industry-specific guidance, is meant to allow investors to better compare financial statements across companies and industries. It is also intended to simplify today's revenue recognition guidance by making it principles-based. But, depending on the company or industry, the new standard could greatly change the timing of, recognition of, and, in some cases, the amount of, revenue compared to the current rules. These changes could have ripple effects on key performance measures and debt covenant ratios, and could ultimately affect contract negotiations, budgets, and even business models.

What should the audit committee be thinking about?

The 2018 effective date may seem far away, but audit committees need to be thinking about the new standard now. Many companies have experienced or anticipate difficulties implementing the new standard—with a potentially time-consuming review of customer contracts topping the list of implementation challenges. Yet our research finds that three-fourths of public companies are still assessing the impact, and only 17% say they have taken the next step toward implementation.[1] The SEC has been closely watching and has expressed some concern over company readiness.[2]

When is it effective?

For calendar year companies, the new FASB standards will take effect in the first quarter of 2018. Non-calendar year companies must comply during the first interim period within annual reporting periods beginning after December 15, 2017. Nonpublic entities have an additional year. A company can apply the new revenue standard retrospectively, including using certain practical expedients. Or, the cumulative effect of applying the new standard to existing contracts can be reflected in the opening balance of retained earnings on the effective date—with proper disclosures.

1 PwC/FERF, *2016 Revenue recognition survey*, 2016.

2 SEC Chief Accountant Wesley R. Bricker, Remarks before the 2016 AICPA Conference on Current SEC and PCAOB Developments, December 5, 2016.

In light of this, audit committees should review their companies' proposed implementation timeline. Does it align with the effective date? Is it realistic given the complexity of the company's operations, business model and attendant revenue streams as well as the policy, system, process and control updates required?

Audit committees will want to understand:

- How management has interpreted the new standard and its assessment of the impact on the company's revenue model
- Management's project plan for implementation, including when key milestones will be met
- How new decision points and required disclosure will affect IT systems, processes, and internal controls, and how management is evaluating existing contracts, revenue models, and business practices
- Whether current filings properly disclose the potential impact of the new standard, if known
- The expected impact on pay programs and any related changes to company policies and practices
- The impact on current business activities, contract negotiations, budgeting, and key metrics

Where to go for more information:

CFOdirect resources on revenue recognition

Accounting advisory resources on revenue recognition

2. Are we comfortable with the company's use of non-GAAP measures?

Use of non-GAAP measures in company filings has grown over the past several years, as companies seek to give investors what they see as a fuller picture of company performance. SEC regulations allow the use of these measures, but there are strings attached (such as needing to present the most comparable GAAP figure first and including a reconciliation of the non-GAAP amount to the GAAP figure). In recent years the SEC has targeted the use of non-GAAP measures that it believes could be potentially misleading to investors. And in May 2016, the SEC staff issued clarifying guidance on the use of these measures. The update calls out potentially problematic practices, including:

- Performance measures that exclude normal, recurring cash operating expenses necessary to operate a company's business
- Use of non-GAAP measures inconsistently between periods without disclosing the change and the reasons for change
- Non-GAAP measures that exclude non-recurring charges but do not exclude non-recurring gains
- Individually-tailored accounting principles used to calculate non-GAAP earnings—for example, a non-GAAP revenue metric that accelerates revenue recognition
- Disclosures that cause a non-GAAP measure to be more prominent than the closest comparable GAAP measure

Recent SEC comment letters on the topic have focused on a few key areas. The most common issue identified is the failure to include the most directly comparable GAAP financial measure with equal or greater prominence. The SEC is also frequently asking companies to explain how the non-GAAP measures help investors understand the company's operations and financial results. Additionally, the SEC has targeted improper labeling of non-GAAP measures that sound too similar to a GAAP measure.

What should the audit committee be thinking about?

Audit committees will want to understand what non-GAAP measures are being used in filings, and why. They should ask management how they will ensure that when the measures are used, it is done in line with the new SEC guidance. Audit committees will also want to:

- Read the disclosure that includes non-GAAP measures (and other key metrics communicated to analysts) and decide whether it is fair, balanced, and transparent
- Understand how management ensures that the calculation of the non-GAAP measures and other key metrics are accurate and consistent with those of prior periods considering that the information is not typically covered by a company's internal control over financial reporting and is not audited
- Look to peers to evaluate whether use of non-GAAP measures is commonly accepted and measures used are similar
- Understand how non-GAAP measures could affect executive compensation
- Evaluate whether the use of these measures complies with SEC regulations and updated guidance

Where to go for more information:

Audit Committee Excellence Series: To GAAP or non-GAAP? The SEC is watching

3. How will we be impacted by the new lease accounting standard ?

In February 2016, the FASB issued a new standard on lease accounting. The new standard could impact almost all companies to some extent, but lessees will likely see the biggest changes. Lessees will now need to recognize virtually all of their leases on the balance sheet (i.e., a liability for the future lease payments and a corresponding right-of-use asset), even if the lease is embedded in another arrangement, such as a long-term contract. Each lease also needs to be classified as an operating or finance lease. Operating leases will have straight line rent expense. Finance leases will follow a traditional interest-amortization model.

When is it effective?

For most calendar year entities, the new FASB standards will take effect in the first quarter of 2019. Private companies have an additional year to comply. Companies are required to adopt the standard using a modified retrospective transition approach, which requires application of the new guidance at the beginning of the earliest comparative period presented in the year of adoption. Early adoption is permitted. Lessors may want to consider interactions with the revenue standard and adopt at the same time.

Although this is an accounting change, systems and data issues will likely present challenges for companies. In preparation, management will need to identify and review all existing leases and other contracts that may contain embedded leases. Once the leases are identified, all lease terms will need to be analyzed to measure the amounts that will go on the balance sheet. This could be a time-consuming and difficult effort, depending on the number of leases, their variety and complexity, the availability of records, and the sophistication of current systems.

What should the audit committee be thinking about?

Management will need to discuss with the audit committee how it is analyzing the impact of this new standard on the company. Audit committees will also want to understand:

- The effort required to get the information necessary, and the planned timeline to ensure adoption by the required date
- Management's process for creating a complete and accurate inventory of leases
- How management has evaluated the impacts beyond financial reporting (e.g., debt covenants, apportionment of income for state taxes, and determining whether to lease or buy in the future)

Where to go for more information:

Accounting advisory resources on lease accounting standards

10Minutes on the new US lease standard

4. Should we enhance our audit committee proxy disclosures?

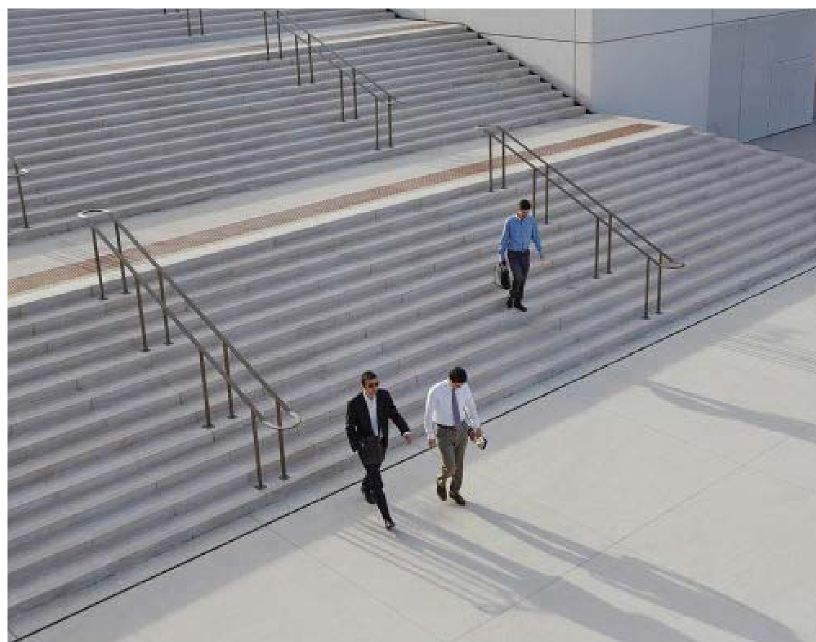
Over the last several years, there has been a growing interest by investors, regulators, and other stakeholders in better understanding the audit committee's role in oversight of the external auditor. In response, a growing number of audit committees have chosen to voluntarily provide more relevant and useful information to investors and other stakeholders about how they perform their role. And recent research affirms the continued rise in such voluntary proxy disclosures by S&P 500 companies.[3] In particular:

- *Audit partner selection*—43% now state that the audit committee is involved in audit partner selection, compared to 13% in 2014
- *Audit firm evaluation/supervision*—34% now discuss criteria considered when evaluating the audit firm, up from 8% in 2014
- *Audit firm selection/ratification*—31% now disclose the audit committee's considerations in recommending the audit firm's appointment, up from 13% in 2014
- *Audit firm compensation*—17% now explicitly state the role the audit committee plays in negotiating audit fees, up from 8% in 2014

What should the audit committee be thinking about?

Audit committees considering changes should re-read their previous disclosure with an eye to how they can better explain the work that they do to investors and other stakeholders. Audit committees will also want to consider:

- Asking management to propose sample disclosure covering the categories to the left, and others tracked in the Center for Audit Quality's *2016 Audit Committee Transparency Barometer*
- Benchmarking proxy disclosures of peers and competitors
- Reviewing the proxies of companies that have already embraced enhanced disclosure



3 Center for Audit Quality/Audit Analytics, *2016 Audit Committee Transparency Barometer,* November 2016.

5. Do we have our arms around recent developments in the income tax space?

As audit committees think about where to spend more time, the income tax area may be moving up the list. A number of issues are converging in this area, including a continued emphasis by the SEC staff on income tax disclosures as noted in comment letters, and a new FASB standard related to tax accounting for intercompany transactions.

In addition, there are developments in the way governments—including the US—are looking at changing tax laws or furthering enforcement. For example, governments around the world facing budget shortfalls are questioning whether multinational companies are paying their "fair share" of taxes. The OECD's[4] base erosion and profit shifting (BEPS) project is likely to spur significant changes in the taxation of international businesses in the future, and may trigger the need for changes to companies' tax structures.

There have been several recent developments in the tax area that audit committees should be aware of:

- **FASB standard update on intra-entity transfers.** In October 2016, the FASB issued new guidance that will require the immediate recognition of the current and deferred tax consequences from an intra-entity asset transfer of an asset other than inventory. One such example would be the sale of intellectual property. This guidance is effective in 2018 but can be adopted in 2017, but only during the first quarter. When adopted, this new guidance could have a significant impact on the company's effective tax rate.
- **Internal Revenue Code (IRC) Section 385 regulations.** Also in October 2016, the US Treasury Department and Internal Revenue Service finalized new regulations under Section 385, which relates to intercompany borrowings. The new rules are intended to minimize the ability of US entities to deduct interest on certain borrowings from foreign related parties by treating them as equity instead of debt for US federal tax purposes. Depending on a company's global structure, this change in tax law could have an impact going forward. Generally, there is no impact until 2017 but the rules may apply to arrangements already in place. The new regulations also impose significant new documentation requirements.

4 The Organization for Economic Co-operation and Development (OECD) is an intergovernmental economic organization with 35 member countries.

Looking forward, tax reform is certainly top of mind in Washington and around the world. President-elect Trump's call for action on comprehensive tax reform, including significantly lowering business income tax rates, is expected to receive strong support from Republicans in Congress. House Republicans have been drafting language for the tax reform "blueprint" that they released earlier this year, which differs in some respects from Trump's tax proposals. House Speaker Paul Ryan (R-WI) has said a Republican-controlled Congress could quickly adopt tax reform in 2017 by using "budget reconciliation" procedures that allow legislation to be approved in the Senate with a simple 51-vote majority, instead of the 60 votes generally needed to advance legislation.

What should the audit committee be thinking about?

Audit committees will want to understand the impact of recent developments in tax policy on a global basis and stay updated on the potential impact of US tax reform efforts under the new administration. Audit committees will also want to:

- Understand the potential impact of the OECD's BEPS project on the global tax picture
- Discuss with management their assessment of the impact of the new FASB guidance on intra-entity asset transfers and IRC Section 385 regulations
- Stay updated on recent trends in SEC comment letters related to income taxes to assess the adequacy of current disclosures and other areas of focus

Where to go for more information:

10Minutes on the OECD's BEPS project

In brief: FASB simplifies tax accounting for intra-entity asset transfers

How PwC can help

To have a deeper discussion about how this topic might impact your business, please contact your engagement partner or a member of PwC's Governance Insights Center.

Paula Loop
Leader, Governance Insights Center
(646) 471 1881
paula.loop@pwc.com

Catherine Bromilow
Partner, Governance Insights Center
(973) 236 4120
catherine.bromilow@pwc.com

Terry Ward
Partner, Governance Insights Center
(612) 326 2066
terrence.j.ward@pwc.com

Paul DeNicola
Managing Director, Governance Insights Center
(646) 471 8897
paul.denicola@pwc.com

pwc.com

This content is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.

© 2016 PricewaterhouseCoopers LLP. All rights reserved. PwC refers to the United States member firm, and may sometimes refer to the PwC network. Each member firm is a separate legal entity. Please see www.pwc.com/structure for further details. 265745-2016. AW.

No. US2016-25
June 16, 2016

Allowance for loan and lease losses - FASB issues final impairment standard

At a glance

New impairment guidance for certain financial instruments will replace the current "incurred loss" model for estimating credit losses with a forward-looking "expected loss" model.

What happened?

On June 16, 2016, the FASB issued Accounting Standards Update 2016-13, *Financial Instruments – Credit Losses (Topic 326)* (the "ASU"), which introduces new guidance for the accounting for credit losses on instruments within its scope. Given the breadth of that scope, the new ASU will impact both financial services and non-financial services entities.

Key provisions

The new guidance introduces an approach based on expected losses to estimate credit losses on certain types of financial instruments. It also modifies the impairment model for available-for-sale (AFS) debt securities and provides for a simplified accounting model for purchased financial assets with credit deterioration since their origination.

Current expected credit losses

The new model, referred to as the current expected credit losses (CECL) model, will apply to: (1) financial assets subject to credit losses and measured at amortized cost, and (2) certain off-balance sheet credit exposures. This includes loans, held-to-maturity debt securities, loan commitments, financial guarantees, and net investments in leases, as well as reinsurance and trade receivables. Upon initial recognition of the exposure, the CECL model requires an entity to estimate the credit losses expected over the life of an exposure (or pool of exposures). The estimate of expected credit losses (ECL) should consider historical information, current information, and reasonable and supportable forecasts, including estimates of prepayments. Financial instruments with similar risk characteristics should be grouped together when estimating ECL. The ASU does not prescribe a specific method to make the estimate so its application will require significant judgment.

Generally, the initial estimate of the ECL and subsequent changes in the estimate will be reported in current earnings. The ECL will be recorded through an allowance for loan and lease losses (ALLL) in the statement of financial position. See below for different accounting that may apply for purchased financial assets.

Available-for-sale debt securities

The ASU amends the current AFS security other-than-temporary impairment (OTTI) model for debt securities. The new model will require an estimate of ECL only when the fair value is below the amortized cost of the asset. The length of time the fair value of an AFS debt security has been below the amortized cost will no longer impact the determination of whether a credit loss exists. As such, it is no longer an other-than-temporary model. In addition, credit losses on AFS debt securities will now be limited to the difference between the security's amortized cost basis and its fair value. The AFS debt security model will also require the use of an allowance to record estimated credit losses (and subsequent recoveries). This is a significant change from the current model.

Purchased financial assets with credit deterioration

The purchased financial assets with credit deterioration (PCD) model applies to purchased financial assets (measured at amortized cost or AFS) that have experienced more than insignificant credit deterioration since origination. This represents a change from the scope of what are considered purchased credit-impaired assets under today's model. Different than the accounting for originated or purchased assets that do not qualify as PCD, the initial estimate of expected credit losses for a PCD would be recognized through an ALLL with an offset to the cost basis of the related financial asset at acquisition (i.e., there is no impact to net income at initial recognition). Subsequently, the accounting will follow the applicable CECL or AFS debt security impairment model with all adjustments of the ALLL recognized through earnings. Beneficial interests classified as held-to-maturity or AFS will need to apply the PCD model if the beneficial interest meets the definition of PCD or if there is a significant difference between contractual and expected cash flows at initial recognition.

Disclosure

ASU 2016-13 also expands the disclosure requirements regarding an entity's assumptions, models, and methods for estimating the ALLL. In addition, public business entities (PBEs) will need to disclose the amortized cost balance for each class of financial asset by credit quality indicator, disaggregated by the year of origination (i.e., by vintage year). This disclosure will not be required for other reporting entities.

Why is this important?

Financial service entities will be heavily affected. However, given its broad scope, which includes trade and lease receivables, all entities will need to evaluate the ASU's impact. The ASU's requirement to estimate ECL will likely result in an increase in credit reserves for those who currently apply the "incurred loss" approach. Changes to systems, processes, and controls will likely be required to apply the new guidance and may require a considerable amount of time to implement.

What's next?

The ASU will be effective for PBEs that are SEC filers in fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. All other entities will have one additional year. Non-public business entities will not be required to apply the provisions to interim periods until fiscal years beginning after December 15, 2021. Early application of the guidance will be permitted for all entities for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

We will be discussing the new impairment standard in a webcast on July 25, 2016 at 1:00 EDT. To register, please click here: PwC Impairment Webcast.

Questions?

PwC clients who have questions about this *In brief* should contact their engagement partner. Engagement teams who have questions should contact the Financial Instruments team in the National Professional Services Group (973-236-7803).

Authored by:

Chip Currie
Partner
Phone: (973) 236-5331
Email: frederick.currie@pwc.com

John Althoff
Partner
Phone: (973) 236-7021
Email: john.althoff@pwc.com

Edward Lee
Director
Phone: (973) 236-4478
Email: edward.x.lee@pwc.com

© 2016 PricewaterhouseCoopers LLP, a Delaware limited liability partnership. All rights reserved. PwC refers to the United States member firm, and may sometimes refer to the PwC network. Each member firm is a separate legal entity. Please see www.pwc.com/structure for further details. This content is for general information purposes only, and should not be used as a substitute for consultation with professional advisors. To access additional content on financial reporting issues, visit www.pwc.com/cfodirect, PwC's online resource for financial executives.

pwc

No. US2016-30
July 15, 2016

At a glance

SEC proposal could eliminate, modify, and in limited situations, add disclosure requirements. The proposal also addresses the location of information, which could impact both public and private companies.

SEC proposes amendments to update and simplify disclosure requirements

What happened?

On July 13, 2016, the SEC voted to propose amendments to eliminate, modify, or integrate into other SEC requirements certain disclosure rules. Many of the disclosure requirements in Regulations S-K and S-X have not changed since they were adopted as far back as the 1930's. Many of the proposed amendments are in response to the subsequent changes in other SEC disclosures, US GAAP, and IFRS, and to reflect advances in technology.

The proposed changes are part of the SEC's overall project to improve disclosure effectiveness and are intended to simplify compliance without significantly altering the total mix of information provided to investors.

Key provisions

The proposed amendments include:

- the elimination of redundant or duplicative requirements that provide substantially the same disclosures as US GAAP;
- the elimination of overlapping disclosures that convey reasonably similar disclosures or disclosures that may no longer be useful to investors;
- the integration of certain disclosures that overlap with, but require information incremental to, other SEC disclosure requirements; and
- the modification or deletion of outdated or superseded provisions, which in some cases may mean adding new reporting requirements.

In addition to soliciting input on the proposed changes, the SEC is also seeking comments on how to address requirements that overlap with, but require information incremental to, US GAAP. The SEC is considering whether such disclosures could be eliminated, modified, or referred to the FASB for potential incorporation into US GAAP, which could impact private as well as public companies.

Why is this important?

The proposal will potentially impact the following types of reporting entities.

All registrants

- Some of the proposed changes would move disclosures between the financial statements and other sections of periodic reports. Information moved into the

financial statements would have audit, review, ICFR, and XBRL implications. It would also no longer qualify for safe harbor protection.

- Some of the proposed changes would eliminate existing quantitative disclosure thresholds, which could reduce the amount of required disclosures and increase the judgment required to determine what disclosures are meaningful to investors.

Smaller reporting companies

- Smaller reporting companies are eligible for relief from some of the disclosures required by larger public entities. If those disclosure requirements are made part of US GAAP, they will become applicable to smaller reporting companies in the same manner as any other public company.

Private companies

- Disclosures incorporated into US GAAP could potentially impact private companies, unless specifically exempted by the FASB.

What's next?

Comments are due 60 days after the proposed rule is published in the *Federal Register*.

Questions?

PwC clients who have questions about this *In brief* should contact their engagement partner. Engagement teams who have questions should contact the National Professional Services Group.

Authored by:

Wayne Carnall
Partner
Phone: 1-973-236-4233
Email: wayne.carnall@pwc.com

Diane Howell
Partner
Phone: 1-973-236-5819
Email: diane.howell@pwc.com

© 2016 PricewaterhouseCoopers LLP, a Delaware limited liability partnership. All rights reserved. PwC refers to the United States member firm, and may sometimes refer to the PwC network. Each member firm is a separate legal entity. Please see www.pwc.com/structure for further details. This content is for general information purposes only, and should not be used as a substitute for consultation with professional advisors. To access additional content on financial reporting issues, visit www.pwc.com/cfodirect, PwC's online resource for financial executives.

In depth

A look at current financial reporting issues

No. US 2016-07
July 11, 2016

What's inside:

At a glance 1
Background 1
Key provisions 2
The CECL model 2
Available-for-sale debt securities 8
Purchased financial assets with credit deterioration...... 9
Beneficial interests 11
Interest income.................... 11
Disclosure 12
Transition 12
What's next 12

The FASB's new financial instruments impairment model

Accounting and disclosure considerations

At a glance

The FASB issued Accounting Standards Update 2016-13, *Financial Instruments – Credit Losses (Topic 326),* (the "ASU") on June 16, 2016. The ASU introduces a new model for recognizing credit losses on financial instruments based on an estimate of current expected credit losses. The ASU will apply to: (1) loans, accounts receivable, trade receivables, and other financial assets measured at amortized cost, (2) loan commitments and certain other off-balance sheet credit exposures, (3) debt securities and other financial assets measured at fair value through other comprehensive income, and (4) beneficial interests in securitized financial assets.

Given the broad scope of the new guidance, both financial services and non-financial service entities will be affected. The ASU will be effective for public business entities (PBEs) that are SEC filers in fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. All other entities will have one additional year. Non-PBEs (including certain not-for-profit entities and employee benefit plans) are not required to adopt the guidance for interim periods until fiscal years beginning after December 15, 2021. Early application of the guidance will be permitted for all entities for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

Background

.1 Accounting Standards Update 2016-13, *Financial Instruments – Credit Losses (Topic 326)*, represents the completion of a major component of the FASB's financial instruments project. The other major components are (1) recognition and measurement guidance for financial instruments, which was finalized in January 2016[1] as ASU 2016-01, *Financial Instruments – Overall*, and (2) targeted amendments to the hedge accounting guidance, which are expected to be exposed for public comment in the third quarter of 2016.

.2 Following the financial crisis of 2008-2009, the FASB was tasked with revisiting the accounting models for the impairment of financial assets to address stakeholder concerns regarding the delayed recognition of credit losses under the current incurred loss model. The FASB began the initiative working jointly with the IASB with the hopes of developing a converged standard. The initial converged model proposed that the recognition of the full expected credit loss be delayed until there was a significant deterioration in credit

[1] See PwC In depth US2016-01, *New guidance on recognition and measurement to impact financial instruments*

risk. However, based on US constituent feedback, the FASB decided to adopt the current expected credit losses (CECL) model, which generally calls for the immediate recognition of all expected credit losses. As a result, the impairment models for financial assets under US GAAP and IFRS will not be converged.

Key provisions

.3 The ASU introduces new accounting models for expected credit losses on financial instruments and applies to: (1) loans, accounts receivable, trade receivables and other financial assets measured at amortized cost, (2) loan commitments and certain other off-balance sheet credit exposures, (3) debt securities and other financial assets measured at fair value through OCI, and (4) beneficial interests in securitized financial assets.

The CECL model

Scope

.4 The CECL model will apply to: (1) financial assets measured at amortized cost, and (2) certain off-balance sheet credit exposures. Examples of instruments subject to the CECL model include loans, held-to-maturity (HTM) debt securities (including corporate bonds, mortgage backed securities, municipal bonds and other fixed income instruments), loan commitments (including lines of credit), financial guarantees accounted for under ASC 460, *Guarantees*, and net investments in leases, as well as reinsurance and trade receivables.

PwC observation:

The scope of the new guidance is broad; while financial service entities will be significantly impacted, all entities will need to assess the impact of the CECL model. For example, application of the model to trade and lease receivables will likely impact most non-financial service entities.

Incurred versus expected credit losses

.5 The CECL model is designed to capture expected credit losses through the establishment of an allowance account, which will be presented as an offset to the amortized cost basis of the related financial asset or as a separate liability, in the case of off-balance sheet exposures. The resulting allowance for loan and lease losses (ALLL) is designed to be a valuation account that is deducted from the amortized cost basis of an instrument to present the net amount expected to be collected.

.6 The CECL model requires an estimate of the credit losses expected over the life of an exposure (or pool of exposures). The estimate of expected credit losses (ECL) should consider historical information, current information, and the reasonable and supportable forecasts of future events and circumstances, as well as estimates of prepayments. Financial instruments with similar risk characteristics should be grouped together when estimating ECL. The ASU does not prescribe a specific method to estimate credit losses, so its application will require significant judgment.

PwC observation:

The CECL model is designed to improve the current impairment model. It removes the current threshold that delayed the recognition of a credit loss until it was "probable" a loss event was "incurred." Under the new model, there is no trigger event before booking ECL. By requiring the consideration of reasonable and supportable forecasts of future events, the CECL model accelerates the recognition of credit losses as compared to current GAAP. Reporting entities will now need to record credit losses they "see coming" but are not yet incurred. These changes will likely require significant effort to develop new processes and controls for estimating expected credit losses, and their application will require considerable judgment.

Initial recognition of life-time expected credit losses

.7 The CECL model requires the recognition of ECL upon initial recognition of a financial asset. With the exception of certain purchased assets with credit deterioration (PCD), this day-one recognition of the ALLL will be recorded with an offset to current earnings. Subsequently, the ECL will need to be assessed each period, and both negative and positive changes to the estimate will be recognized through an adjustment to the ALLL and earnings.

PwC observation:

The day-one recognition of expected credit losses in current earnings for most instruments is one of the most controversial provisions of the new guidance. The FASB understands that financial assets that are originated or purchased will include compensation for credit risk in the yield or investment return of the assets. The recognition of the effective yield of the instrument (including compensation for credit risk) will occur over time through the application of the interest income models under US GAAP. As day-one estimated credit losses will be recognized in earnings, this creates a mismatch in the timing of the recognition of ECL and the recognition of the compensation for credit risk.

.8 The guidance requires that the ALLL be determined based on the amortized cost of the financial asset, which includes all premiums, discounts, deferred origination costs/fees, foreign exchange adjustments, and fair value hedge accounting adjustments. The use of some approaches to estimating the ECL already require consideration of amortized cost. For example, the discounted cash flow (DCF) approach compares the amortized cost of the financial asset and the present value of the expected cash flows. However, other approaches, such as a loss rate approach, which may be based on an analysis of historical losses as compared to the par value of the instrument, will not meet this requirement. In situations where the estimate of the ECL is not based on the amortized cost of the financial asset, an adjustment will need to be made to incorporate premiums and discounts, etc.

PwC observation:

The FASB's outreach to stakeholders on how loss rates are currently derived indicated diversity in practice. Some entities determine loss rates by dividing amounts charged off by the amortized cost basis of the instrument. Others calculate loss rates based on the amount of principal/par amount of an instrument that was charged off. One of the FASB's goals was to permit entities to leverage existing processes and data to the extent possible when adopting the CECL model. As a result, the FASB decided to permit entities to continue to applying loss rates to the unpaid principal balance and then adjust the credit losses for the impact of the other elements of the amortized cost basis (e.g., premiums or discounts) separately.

The ASU provides limited guidance regarding how an entity should incorporate premiums/discounts into the allowance estimate and therefore, doing so may be challenging and will require judgment. It would generally not be appropriate to just assume there is no expected credit loss or partial reduction of expected credit loss for a financial asset that was purchased at a discount (i.e., the ALLL cannot be reduced by the amount of the discount), and a premium may have different credit risks than the unpaid principal value. Given the complexity of the guidance, judgment will be needed to determine the ALLL when an entity is using an approach other than one based on discounted cash flows.

Pooling of financial assets with similar risk characteristics

.9 When estimating CECL, reporting entities will be required to calculate the ECL on a "pooled" approach when instruments have similar risk characteristics. If a financial instrument does not share similar risk characteristics with other financial instruments, the ECL would be calculated on an individual basis. An entity will reassess whether financial instruments share similar risk characteristics at each reporting date. If a financial instrument no longer shares similar risk characteristics with the pool in which it is grouped, it should be removed from the pool for the purposes of calculating ECL. Such an instrument may then be grouped with another pool of instruments with shared risk characteristics or if there are none, the ECL will be calculated on an individual basis, but may be based on expected loss assumptions from groups of similar assets.

.10 Risk characteristics used as a basis for pooling may include past due status, collateral type, borrower's FICO score, internal and external credit ratings, maturity (term), industry of the borrower, subordination, origination vintage, geographical location of the borrower, or other factors. Reporting entities should carefully consider the attributes utilized to create pools of similar risk characteristics and consider what inputs drive the credit risk measurement used in credit loss modelling.

Measurement of expected credit losses

.11 The CECL model requires an entity to estimate the credit losses expected over the life of an exposure (or pool of exposures). The estimate of ECL should consider historical information, current conditions, and reasonable and supportable forecasts, as well as estimates of prepayments. Adjusting historical information to reflect current conditions and expectations about the future will require significant judgment, as the ASU does not prescribe a specific method to make the estimate.

.12 For periods beyond which an entity can develop a reasonable and supportable forecast, an entity should revert to historical loss information that reflects the contractual term of the financial instrument (or group of financial instruments). The reversion to historical loss information may be immediate, on a straight-line basis, or on another rational and systematic basis. For example, if an entity can only reasonably forecast ECL for the first 4 years of a 10-year loan, it should consider historic loss information

reflective of the contractual term of the loan to determine the expected credit losses relating to the period beyond the 4 years it can forecast.

PwC observation:

The CECL model does not provide prescriptive guidance regarding how to develop an estimate of expected credit losses. Although the ASU acknowledges that a DCF model may be used, it does not require its use. There is a high degree of judgment involved in estimating ECL and different methodologies may result in a range of acceptable outcomes. The selection of a modelling methodology is therefore one of the key decisions in adopting the CECL model.

Because the ASU does not provide a definition, different institutions may have different views on what constitutes a reasonable and supportable forecast.

.13 The estimate of expected credit loss should consider the contractual term of the financial asset and a borrower's prepayment behavior. Renewals, modifications, or extensions should generally not be considered.

.14 In making the estimate, credit risk mitigation strategies that may be pursued in the event of a default should be considered, not only as it relates to the amount of the ultimate credit loss, but also as to how it may impact the term of the instrument. For example, when there is a reasonable expectation that the reporting entity will execute a troubled debt restructuring (TDR) with the borrower, the estimate of ECL should consider if the TDR will result in an extension of the term of the financial asset. The FASB concluded that similar to today's guidance, the completion of a TDR does not create a new instrument, rather it is the continuation of the original instrument.

.15 Credit enhancements, such as guarantees or insurance contracts, should also be considered in the estimate of expected credit losses unless they are freestanding contracts. A credit enhancement deemed to be a freestanding contract should not be considered in the estimate of ECL. For example, if a bank originates a loan and then separately enters into a credit default swap (CDS) agreement with another entity as a credit enhancement for the loan, the CDS agreement should be accounted for separately and not considered in the estimate of expected credit losses.

.16 Although credit enhancements are good credit risk mitigation tools, the ASU does not permit an entity to consider them in the estimate of credit loss if the credit enhancement is not embedded in the asset origination or purchase of the financial asset.

.17 If financial assets are secured by collateral, the ECL should consider the impact the collateral will have in reducing credit losses. The estimate of ECL should not only consider current collateral value, but also consider the nature of the collateral, potential future changes in its value, and historical loss information for financial assets secured with similar collateral. A reporting entity generally cannot assume that no credit loss exists simply because the instrument is collateralized. The ASU provides a number of specific provisions and practical expedients relating to collateralized instruments, including:

- An entity should estimate the ECL based on the fair value of the collateral when an entity determines foreclosure is probable (consistent with current US GAAP).

- If the borrower is experiencing significant financial difficulty and repayment of the loan is expected to be provided substantively through the operation or the sale of the collateral, an entity may estimate the ECL based on the fair value of the collateral (if operating the collateral for repayment of the financial asset), or the fair

value of the collateral less costs to sell (if selling the collateral for repayment of the financial asset).

- For certain financial assets that provide for collateral to be replenished as necessary, the fair value of collateral may be compared to the amortized cost basis to estimate ECL. If the contract requires the collateral to be continually replenished to an amount that always equals or exceeds the amortized cost basis of the instrument, an entity may be able to conclude that the ECL on the instrument is zero.

PwC observation:

The ASU provides limited guidance on the application of the practical expedient related to instruments with collateral replenishment provisions. Areas of consideration may include which party controls the collateral, the legal terms of the arrangement, how often the collateral is replenished, and whether the collateral is liquid. Careful consideration and judgment is needed to assess whether it is appropriate for an entity to apply this practical expedient.

Off balance sheet credit exposures

.18 The CECL model also applies to off-balance sheet credit exposures such as unfunded revolving lines of credit, non-derivative financial guarantees, and other unfunded loan commitments. Because they are often legally binding agreements to extend credit under certain terms and conditions, loan commitments can expose an entity to credit losses.

.19 For unfunded loan commitments, a reporting entity should first determine whether the commitment can be unconditionally (i.e., unilaterally and irrevocably) cancelled by the issuer. If this is the case, then no estimate of expected credit losses is required for the unused or undrawn portion of the commitment. Where the issuer does not have the unconditional right to cancel the commitment, an estimate of credit losses is required for the unfunded portion. The estimate of credit losses would include a determination of the likelihood that funding will occur, and if funded, the related expected credit losses under the CECL model. The estimate of ECL for an unfunded commitment is recorded as a liability.

.20 For the funded portion of a loan commitment, the methodology and principles of calculating impairment under the CECL model should be consistent with the approach used for similar receivables.

PwC observation:

When an unfunded commitment becomes funded, the ECL for the liability should be reclassified as the ALLL for the funded loan. An entity should first reassess whether the amount of the ALLL is appropriate, as the initial estimate of ECL for the unfunded loan would have considered the probability of the commitment not being funded in the loss estimate. The same consideration is not necessary for a funded loan.

.21 Loan commitments can be either revolving (in which the amount of the overall commitment is re-established upon repayment of previously drawn amounts) or non-revolving (in which the amount of the overall commitment is not re-established upon repayment of previously drawn amounts). For revolving commitments, the estimate of expected credit losses is more complex, as the provider of the commitment will need to consider the probability of future draws and repayments.

Expectations of non-payment are zero

.22 Generally, the ASU requires an entity to estimate expected credit losses for a financial asset, even when the risk of loss is remote. However, the CECL model provides a practical expedient when an expectation of nonpayment of the amortized cost basis is zero (i.e., where the risk of default may be greater than zero, but the amount of the expected loss is zero) based on historical loss information, adjusted for current conditions and reasonable and supportable forecasts. As mentioned above, the existence of collateral, in and of itself, does not necessarily lead to an assumption of no loss of the amortized cost basis.

PwC observation:

Limited guidance is provided on the application of this practical expedient to "credit risk-free" financial assets. Therefore, an entity should exercise careful judgment and ensure their use of the practical expedient is well supported and documented. The illustration in the ASU (Example 8) sets a high bar for the application of this practical expedient, describing US Treasury securities as a financial asset that may qualify for this practical expedient.

Write-offs and recoveries

.23 Reporting entities are required to write-off financial assets (or a portion thereof) in the period in which a determination is made that the financial asset (or portion) is uncollectible. This generally occurs when all commercially reasonable means of recovering the loan balance have been exhausted. Factors an entity may consider include (1) significant changes in the borrower's financial position such that they can no longer pay the obligation or (2) whether the proceeds from collateral will be sufficient to repay the loan. Certain regulatory agencies have provided guidance to financial institutions with respect to when write-offs are appropriate or required. Recoveries of financial instruments should be recorded when received.

PwC observation:

The threshold for when write-offs should occur under the CECL model is consistent with the threshold in current GAAP. This was a conscious decision by the FASB in an effort to permit companies to leverage existing policies and procedures to the extent possible. However, the term "uncollectible" is not defined and continues to require the application of judgment. It is likely that regulatory agencies will continue to heavily influence write-off policies for institutions subject to their oversight.

Troubled debt restructurings

.24 According to the ASU, "*restructuring of a debt constitutes a troubled debt restructuring if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider.*" This description of TDRs is consistent with current US GAAP. In addition, similar to today's GAAP, a loan that has been restructured through a TDR is not considered to be a new loan, but instead the continuation of the original loan. In a departure from current GAAP, loans subject to a TDR will be assessed for impairment using the CECL model.

.25 In measuring an impairment on an instrument that has been restructured through a TDR, the value of certain concessions made by the creditor should be reflected in the ALLL. When using a discounted cash flow approach, the value of the concession will be captured in the ALLL estimate. If an entity uses a model other than a discounted cash flow approach, the entity will need to determine an approach to incorporate the

concession in the ALLL estimate. When using a discounted cash flow approach, the pre-modification effective interest rate should be used.

.26 As noted in paragraph .14, if a TDR is reasonably expected to occur, the expected life of a financial asset should consider any extensions that may result from the TDR.

Available-for-sale debt securities

Scope

.27 Available-for-sale (AFS) debt securities are not within the scope of the CECL model. Debt securities classified as AFS will apply a new impairment model with some important changes from today's model. The AFS debt security impairment model will apply to all debt securities classified as AFS (including corporate bonds, mortgage backed securities, municipal bonds, and other fixed income instruments). As a result of the differences between the CECL and AFS debt security impairment models, the timing and recognition of impairment will be different.

PwC observation:

AFS debt securities and HTM debt securities were previously assessed for impairment using the same model. The FASB concluded that a security available to be sold should be assessed for impairment differently than an amortized cost asset being held to collect cash flows. Accordingly, the new model will apply to AFS debt securities while HTM debt securities will be assessed for impairment using the CECL model.

Equity instruments are not with the scope of the ASU and should be accounted for under ASU 2016-1: *Recognition and Measurement of Financial Assets and Financial Liabilities* (other than those that result in consolidation or the application of the equity method). ASU 2016-01 includes a specific impairment model for certain equity investments.

Available-for-sale debt securities impairment model

.28 Similar to current GAAP, the impairment model for AFS debt securities will require an estimate of ECL only when the fair value is below the amortized cost of the asset. One of the key changes to the model includes the removal of the requirement to consider the length of time the fair value of an AFS debt security has been below the amortized cost when determining whether a credit loss exists. In addition, recoveries or subsequent declines in fair value after the balance sheet date should not be considered in determining the estimate of expected credit losses. As a result of these changes, the AFS impairment model is no longer based on an impairment being "other-than-temporary."

.29 Unlike the CECL model, the impairment model for AFS debt securities does not permit pooling of securities (i.e., the ALLL must be calculated on an individual security level but may use assumptions consistent with expectations of credit losses for a group of similar securities) and requires an entity use present value of expected cash flows when estimating the ECLs. The key steps under this impairment analysis are:

a. Assess if the investment is considered impaired (i.e., is the fair value less than amortized cost). If fair value is greater than amortized cost, then the investment is not considered impaired as of the reporting date and no allowance is required.

b. Similar to current GAAP, if the asset is impaired, consider whether management has: (i) the intent to sell, or (ii) will more-likely-than-not be required to sell the impaired security before recovery of its amortized cost basis. If either of these requirements are met, the reporting entity should record the entire impairment

loss (i.e., the difference between fair value and amortized cost) in earnings. This impairment (inclusive of any ALLL) must be written off against the amortized cost basis of the security. Subsequent to this write-off, the difference between the amortized cost basis and the cash flows expected to be collected should be accreted as interest income.

c. If neither of the conditions in (b) apply, determine if the decline in fair value below the amortized cost of the security is credit or non-credit related. An ALLL is only required for credit-related losses. To determine the portion of a decline in fair value that is credit related, an entity should compare the present value of expected cash flows of the security with the amortized cost basis of the security. A reporting entity should recognize the credit loss through earnings by recording an ALLL. However, the ALLL should be limited to the difference between fair value and the amortized cost of the security (a provision known as "the fair value floor"). Any difference between the fair value of the security and the amortized cost basis, less the ALLL will be reported in other comprehensive income.

PwC observation:

The AFS debt security impairment model requires consideration of the time value of money, and therefore, a DCF calculation must be performed. It does not provide the same modelling flexibility as the CECL model for estimating expected credit losses.

The AFS debt security impairment model for instruments described in paragraph .29(c) differs from the one applied to instruments that meet one of the criteria in paragraph .29(b). If one of the requirements in paragraph .29(b) are met, the asset should be written-down to its fair value through current earnings (i.e., a basis adjustment). This basis adjustment includes the credit and non-credit related losses. If neither of the requirements in paragraph .29(b) are met, only credit-related losses are recorded through an allowance and current earnings.

.30 The ALLL should be assessed each reporting period. Improvements in expected cash flows due to improvements in credit should be recognized through a reversal of the ALLL. However, a reversal of the ALLL should not be greater than the allowance recognized.

PwC observation:

The requirement to recognize expected credit losses through an ALLL for these instruments is a significant change from the current model for AFS debt securities. The current model requires that increases in credit loss estimates be recognized as basis adjustments, and improvements in credit loss estimates be recognized as an adjustment to the effective yield of the security. The new AFS impairment model may require significant changes to systems, processes, and controls.

.31 Write-offs and recoveries related to credit losses will follow the same guidance as the CECL model (see CECL guidance at paragraph .23 for more details).

Purchased financial assets with credit deterioration

Purchased financial assets with credit deterioration impairment model

.32 A different model is applied to certain purchased financial assets. Purchased financial assets with credit deterioration (PCD assets) are "*acquired individual financial assets (or acquired groups of financial assets with similar risk characteristics) that, as of the date of acquisition, have experienced a more-than-insignificant deterioration in*

credit quality since origination, as determined by an acquirer's assessment." PCD assets can be loans or debt securities (HTM or AFS). Beneficial interests can meet the definition of a PCD asset or would also be subject to the PCD asset model if there is a significant difference between their expected cash flows and contractual cash flows at the date of initial recognition.

PwC observation:

The FASB intended the definition of PCD assets to be broader and encompass more instruments than currently meet the definition of purchased credit impaired assets under ASC 310-30. Under today's guidance, a purchased credit impaired asset is one for which it is probable that not all contractual cash flows will be collected and that has experienced a deterioration in credit quality. The new model does not require an assessment of probability, but focuses only on whether there has been a more-than-insignificant deterioration in credit quality.

The ASU also does not define what is considered a more-than-insignificant deterioration in credit quality since origination. The determination will require judgment.

.33 For PCD assets, an investor will need to recognize an ALLL on initial recognition by estimating the expected credit losses of the purchased assets. Unlike the CECL model for financial assets that are not considered PCD, an entity should not recognize the initial estimate of ECL through current earnings, but through an adjustment to the amortized cost basis of the related financial asset at acquisition (i.e., a balance sheet gross-up). A similar gross up should be recorded for AFS instruments that are deemed to be PCD assets. Specifically, both the recorded asset balance (i.e., the purchase price) and the ALLL should be increased by the amount of the expected credit losses at acquisition. For example, if an entity purchases a PCD loan for $70 (with a par of $100) and estimates the ECL for the asset to be $15, then the entity should add $15 to the purchase price of $70, record an initial cost basis of $85, and recognize an ALLL of $15. The ASU prohibits extending PCD accounting to other financial assets with the exception of certain beneficial interests. See paragraph .38 for more details.

.34 If a discounted cash flow method is used to estimate expected credit losses, the initial ALLL should be calculated by discounting expected credit losses (i.e., the difference between contractual and expected cash flows) by the effective interest rate. The effective interest rate is the discount rate that makes the present value of the asset's expected cash flows equal the purchase price.

.35 If an entity uses a non-discounted cash flow method to estimate expected credit losses, such as a loss rate approach, the initial estimate of expected credit losses would be based on the unpaid principal balance. Under a loss rate approach, the loss rate would be applied to the par amount at initial recognition to determine the ALLL.

.36 Subsequently, the accounting for PCD assets will follow the CECL model or AFS debt security impairment model (as appropriate) with all adjustments to the ALLL recognized through current earnings.

.37 Interest income for a PCD asset should be recognized by accreting the amortized cost basis of the instrument to the contractual cash flows of the instrument. Under the PCD asset model, the discount related to estimated credit losses will not be accreted into interest income; only the non-credit related discount will be accreted. This results from the increase to the cost basis recorded in connection with the day-one allowance for PCD instruments. The accretable yield may be different for ALLLs estimated using a DCF model versus a non-discounted cash flow model.

PwC observation:

The new guidance is intended to simplify the accounting for PCD asset from today's purchased credit impaired asset model in ASC 310-30. It is designed to eliminate some of the asymmetrical treatment between credit losses and credit recoveries observed under today's model, as well as to simplify the calculation of interest income for these instruments. The PCD model is also meant to more closely align the accounting in periods subsequent to acquisition for these instruments with the accounting for originated assets.

Beneficial interests

Beneficial interests impairment model

.38 The ASU updates the accounting guidance in ASC 325-40, *Beneficial Interests in Securitized Financial Assets*. Upon initial recognition, beneficial interests classified as either held-to-maturity or AFS will apply the PCD asset guidance (i.e., initial recognition of an ALLL and an offsetting entry to the amortized cost basis) if either of the following conditions are met: (i) the beneficial interest meets the definition of a PCD asset or (ii) there is a significant difference between contractual cash flows and expected cash flows at the date of recognition.

.39 When expected cash flows change from the estimate of expected cash flows previously projected, an entity should first apply the CECL or AFS impairment model, depending on whether the beneficial interest is classified as HTM or AFS, respectively. For any changes in expected cash flows not accounted for under the CECL or AFS impairment model (i.e., increases or decreases in credit losses), the effective yield should be adjusted prospectively. The accretable yield for the beneficial interest should be recalculated as the excess of cash flows expected to be collected over the beneficial interest's reference amount. The reference amount is equal to the initial investment (or amortized cost basis if the PCD model was applied) minus cash received and write-offs recorded to date plus the yield accreted to date.

PwC observation:

A key change under the new model for beneficial interests is that favorable and adverse changes in cash flows that relate to credit will be recorded through the ALLL and current earnings. This is different than today's GAAP that requires a direct write-down (if there is an impairment) or a prospective yield adjustment if credit loss estimates decline. Given the change to the accounting model, entities will likely need to make a number of changes to systems, processes, and controls.

.40 Beneficial interests that are recorded at fair value through net income or where an entity has elected to apply the fair value option are not addressed by the new impairment guidance. However, other GAAP (e.g., investment company GAAP) may require or permit interest income to be recognized separately from the rest of the change in fair value of a beneficial interest. To determine the interest income for those beneficial interests and the appropriate accretable yield, an entity will need to consider the new guidance in this ASU.

Interest income recognition

.41 Although not addressed directly, the recognition of interest income will be impacted as a result of the changes introduced by the new ASU that affect the amortized cost basis of certain instruments. The ASU also eliminates the interest income model that existed for purchased credit impaired assets within ASC 310-30.

.42 Similar to current GAAP, the ASU does not provide proscriptive guidance for when an entity should put an instrument on non-accrual status, but it does permit existing non-accrual practices to continue. The ASU allows a creditor to use existing methods for recording payments received on non-accrual assets, including a cash basis method, a cost recovery method, or some combination of both.

Disclosures

.43 The new guidance requires a number of disclosures, some of which are incremental to what is required by current US GAAP. The disclosures are intended to enable users of the financial statements to understand (i) the credit risk inherent in the portfolio and how management monitors credit quality, (ii) management's models, inputs, and assumptions in estimating expected credit losses, and (iii) changes in the estimate of expected credit losses that have taken place during the period. The ASU includes examples of the required disclosures.

.44 One of the more significant changes to disclosures is the ASU's requirement for public business entities to disclose the amortized cost basis within each credit quality indicator (CQI) by vintage year of origination for financing receivables and the net investment in leases.

PwC observation:

The ASU provides a phase-in approach for applying the vintage disclosure requirements for public business entities that are not SEC filers. Specifically, each of the most recent three years of CQIs will be required at adoption. Subsequently, an incremental year of CQI disclosures will be required for every fiscal year thereafter until five separate fiscal years are disclosed. Public business entities that are SEC filers will need to present separately five fiscal years of CQI disclosures. For instruments originated prior to the fifth separately presented fiscal year, public business entities may present CQI disclosures in the aggregate.

Transition

.45 In general, the new guidance will require modified retrospective application to all outstanding instruments, with a cumulative effect adjustment recorded to opening retained earnings as of the beginning of the first period in which the guidance becomes effective. However, prospective application of the ASU is required for PCD assets previously accounted for under ASC 310-30 (the current PCI guidance) and for debt securities for which an other-than-temporary impairment was recognized prior to the date of adoption. The transition guidance provides other special provisions for instruments that will be considered PCD assets. Reporting entities should carefully consider the transition provisions relating to PCD assets and debt securities.

What's next?

.46 The new guidance will be effective for:

- Public business entities (PBEs) that meet the definition of an SEC filer for annual and interim periods beginning after December 15, 2019;

- Other PBEs that do not meet the definition of an SEC filer for annual and interim periods beginning after December 15, 2020; and

- All other entities, including certain not-for-profit organizations and employee benefit plans, for annual periods beginning after December 15, 2020 and interim periods within fiscal years beginning after December 15, 2021.

.47 Early adoption is permitted for all entities for annual and interim periods beginning after December 15, 2018.

.48 Given the complexities of the new impairment guidance, implementation issues will likely arise between now and the effective dates. The FASB has formed a Transition Resource Group (TRG) that may meet periodically to discuss these implementation issues as they arise. Reporting entities should monitor the related FASB and TRG communications.

Questions?

PwC clients who have questions about this *In depth* should contact their engagement partner. Engagement teams who have questions should contact the Financial Instruments team in the National Professional Services Group (1-973-236-7803).

Authored by:

John Althoff
Partner
Phone: 1-973-236-7021
Email: john.althoff@pwc.com

Edward Lee
Director
Phone: 1-973-236-4478
Email: edward.x.lee@pwc.com

Chip Currie
Partner
Phone: 1-973-236-5331
Email: frederick.currie@pwc.com

© 2016 PricewaterhouseCoopers LLP, a Delaware limited liability partnership. All rights reserved. PwC refers to the United States member firm, and may sometimes refer to the PwC network. Each member firm is a separate legal entity. Please see www.pwc.com/structure for further details. This content is for general information purposes only, and should not be used as a substitute for consultation with professional advisors. To access additional content on financial reporting issues, visit www.pwc.com/cfodirect, PwC's online resource for financial executives.

Real Estate Alert

Non-GAAP financial measures – a focus on publically registered real estate companies

Why are we talking about non-GAAP financial measures?

There has been a great deal of focus recently on non-GAAP financial measures, primarily through speeches and other public comments made by the SEC staff at conferences and through other forms of media. These comments have not been limited to the typical sources of accounting and reporting commentary (e.g., Division of Corporate Finance or the Office of the Chief Accountant) as even Mary Jo White, Chair of the SEC, has made comments on non-GAAP financial measures over the past year, including at the 2015 AICPA National Conference on Current SEC and PCAOB Developments.

Given their importance among publically-registered real estate companies, non-GAAP financial measures were also one of the featured topics at NAREIT's 2016 REITWise conference, most notably during the Future of Financial Reporting session, which featured Wes Bricker, Deputy Chief Accountant of the SEC, and Russ Golden, Chair of the FASB.

Registrants across the real estate industry continue to receive comments from the SEC's Division of Corporate Finance related to the presentation of non-GAAP financial measures, including inquiries on the adequacy of disclosures around the comparability of non-GAAP financial measures to those used by peers, the prominence with which non-GAAP financial measures presented, and the usefulness of the non-GAAP financial measures presented. On May 17, 2016, the SEC staff issued new Compliance and Disclosure Interpretations (CDI) on non-GAAP financial measures, which provide clarifying guidance and examples in areas of frequent SEC staff comment, including non-GAAP presentations that are misleading or presented with greater prominence than the comparable GAAP measures. As such, the comments received from the SEC's Division of Corporate Finance are not expected to become less frequent in the near future.

What is a non-GAAP financial measure?

To level set, non-GAAP financial measures are numerical measures derived by adjusting the most directly comparable GAAP measure. Publically-listed real estate companies often present non-GAAP financial measures in their MD&A, earnings releases, and other public communications to provide investors and other constituents with insight into its business and performance not otherwise attainable by GAAP measures. From a regulatory perspective, non-GAAP financial measures are governed by SEC regulations, specifically:

- Regulation G governs all public disclosures and communications that contain non-GAAP financial measures by any registrant, including press releases, investor presentations, and conference calls;
- Item 2.02 of Form 8-K governs earnings releases; and
- Item 10(e) of Regulation S-K governs all filings with the SEC under the Securities Act or Exchange Act.

While publically-registered real estate companies use a variety of non-GAAP financial measures, there are a few that are tailored to real estate investments trusts (REITs), most notably:

- Funds from Operations (FFO), as defined by the National Association of Real Estate Investments Trusts (NAREIT) and applicable to all publically registered REITs. FFO is defined by NAREIT as net income (computed in accordance with GAAP), adjusted to exclude gains or losses from sales of real estate properties, impairment charges and depreciation and amortization from real estate assets, and similar adjustments for unconsolidated investees.

- Adjusted FFO (AFFO). AFFO is not a standardized non-GAAP financial measure, but it is commonly presented by publically registered REITs. AFFO is generally comprised of company-specific adjustments to FFO (as defined by NAREIT) to exclude certain non-recurring or non-cash items, such as share-based compensation charges and straight-line rent adjustments. Similar adjustments are typically made for non-recurring or non-cash items of unconsolidated investees.

- Modified FFO (MFFO), as defined by the Investment Program Association (IPA) and applicable to publicly registered, non-listed REITs. MFFO is defined by the IPA as FFO (as defined by NAREIT), adjusted for a number of non-recurring or non-cash items, such as acquisition fees, straight-line rent adjustments, amortization of above or below intangible lease assets and liabilities, and similar adjustments for unconsolidated investees.

In addition to these REIT-specific non-GAAP financial measures, there are other non-GAAP financial measures commonly used by publically-registered real estate companies, including:

- Net Operating Income (NOI)

- Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA)

- Adjusted EBITDA

What's changed with the issuance of the CDI on non-GAAP financial measures?

The CDI does not change the SEC's rules and regulations around non-GAAP financial measures. However, it is important for publically-registered real estate companies to consider the SEC's interpretive guidance.

In the CDI, the SEC staff cautions preparers against certain adjustments in deriving non-GAAP financial measures that could violate Regulation G, including:

- Presenting a performance measure that excludes normal, recurring, cash operating expenses necessary to operate a registrant's business;

- Presenting non-GAAP financial measures inconsistently between periods without disclosing the change and the reasons for it;

- Presenting non-GAAP financial measures that exclude non-recurring charges but do not exclude non-recurring gains; and

- Presenting non-GAAP measures that substitute tailored revenue policies for those that comply with GAAP.

The SEC staff also cautions preparers against certain non-GAAP financial measure presentations that could lead to the non-GAAP financial measure being disclosed more prominently than the comparative GAAP measure, which could violate Item 10(e) of Regulation S-K, including:

- Providing a discussion and analysis of a non-GAAP financial measure without a similar discussion and analysis of the comparable GAAP measure in a location with equal or greater prominence;
- Providing tabular disclosure of non-GAAP financial measures without preceding it with an equally prominent tabular disclosure of the comparable GAAP measures or including the comparable GAAP measures in the same table;
- Omitting comparable GAAP measures from an earnings release headline or caption that includes non-GAAP financial measures;
- Presenting a non-GAAP financial measure using a style of presentation (e.g., bold, larger font) that emphasizes the non-GAAP financial measure over the comparable GAAP measure; and
- Presenting a non-GAAP financial measure that precedes the most directly comparable GAAP measure (including in an earnings release headline or caption).

Finally, the SEC staff provided the following interpretive guidance related to FFO specifically:

- The SEC staff confirmed that FFO, as discussed in Footnote 50 to its *Final Rule on Conditions for Use of Non-GAAP Financial Measures*, is meant to be FFO as defined by NAREIT. Footnote 50 states that companies may use FFO per share in earnings releases and materials that are filed or furnished to the Commission, subject to the requirements of Regulation G, Item 2.02 of Form 8-K, and Item 10(e) of Regulation S-K. Further, the SEC staff confirmed that they continue to accept NAREIT's definition of FFO in effect as of May 17, 2016 as a performance measure and does not object to its presentation on a per share basis.
- The SEC staff confirmed that a registrant may present FFO on a basis other than as defined by NAREIT, provided that any adjustments comply with Item 10(e) of Regulation S-K and the measure does not violate Rule 100(b) of Regulation G. The SEC staff highlighted that certain adjustments might preclude a registrant from presenting the performance measure on a per share basis.

What does this mean for publically registered real estate companies?

The impact of the recent focus on non-GAAP financial measures, including the issuance of the CDI, on publically registered real estate companies depends on the non-GAAP financial measures they choose to present.

What types of adjustments are appropriate when presenting non-GAAP financial measures?

The SEC staff continues to support the presentation of FFO both when it is presented in accordance with NAREIT's definition and when adjustments are in compliance with Item 10(e) of Regulation S-K and the measure does not violate Rule 100(b) of Regulation G. When presenting MFFO or AFFO, or any other non-GAAP financial measure, such as NOI or EBITDA, companies should continue to consider whether the non-GAAP financial measure could be misleading or is provided with undue prominence. Further, companies should carefully evaluate the nature of the adjustments to ensure:

- Charges that represent normal, recurring costs of running their business are not excluded;
- The items being excluded are consistent from period-to-period;
- Non-recurring charges are not excluded without excluding non-recurring income when both existed during the period or in comparable periods; and
- Excluded items are not labelled as "non-recurring" when they have occurred in recent prior periods or are expected to recur in near-term future periods.

Can non-GAAP financial measures be presented on a per share basis?

Non-GAAP financial measures that are used as liquidity measures are prohibited from being presented on a per share basis. The SEC staff continues to support FFO calculated based on NAREIT's definition as a performance measure, in which case the presentation of FFO is permitted. When presenting other non-GAAP financial measures, including MFFO and AFFO, companies should carefully assess the nature of the adjustments to determine if the resulting non-GAAP measure represents a liquidity measure rather than a performance measure. For example, the SEC staff prohibits the presentation of EBITDA on a per share basis as they view it to represent a liquidity measure.

Should companies maintain internal controls over non-GAAP financial measures?

All publically registered real estate companies that present non-GAAP financial measures should ensure they have appropriately designed internal controls over the creation and reporting of non-GAAP financial measures. Existing internal controls should be reassessed to ensure they adequately address the risks of presenting non-GAAP financial measures as highlighted in the CDI.

For additional information, please contact:

Brian Ness
Partner, Real Estate Assurance Practice
(646) 471 8365
brian.ness@pwc.com

Brian Robertson
Senior Manager, Real Estate Assurance Practice
(973) 236 7715
brian.j.robertson@pwc.com

PwC Real Estate Contacts

Byron Carlock
US Real Estate Leader
(214) 754 7580
byron.carlock.jr@pwc.com

Tim Conlon
US Real Estate Clients and Markets Leader
(646) 471 7700
timothy.c.conlon@pwc.com

Richard Fournier
US Real Estate Assurance Leader
(617) 530 7168
richard.e.fournier@pwc.com

Tapan Nagori
US Real Estate Advisory Leader
(312) 298 3574
tapan.nagori@pwc.com

David Voss
US Real Estate Tax Leader
(646) 471 7462
david.m.voss@pwc.com

Tom Wilkin
US REIT Leader
(646) 471 7090
tom.wilkin@pwc.com

www.pwc.com/us/realestate

© 2016 PricewaterhouseCoopers LLP, a Delaware limited liability partnership. All rights reserved. PwC refers to the US member firm, and may sometimes refer to the PwC network. Each member firm is a separate legal entity. Please see www.pwc.com/structure for further details. This content is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.

SFO Alert (October 21, 2015)

NAREIT Alert Important Industry Updates from NAREIT

SEC and FASB Seek Input on Respective Proposals

October 21, 2015

SEC Request for Public Comment on the Effectiveness of Financial Disclosures about Entities other than the Registrant

On Sept. 25, the Securities and Exchange Commission (the Commission) published a request for public comment (Request for Comment) that is part of the Commission's Disclosure Effectiveness Initiative on the effectiveness of financial disclosure requirements in Regulation S-X. The Request for Comment focuses on the requirements for the form and content of financial disclosures that companies must file with the Commission about acquired businesses, affiliated entities, and guarantors and issuers of guaranteed securities. The Request for Comment will be of particular interest to equity REITs given the frequency with which REITs make acquisitions of investment properties. Comments are due to the Commission by Nov. 24.

FASB Proposal on the Conceptual Framework for Financial Reporting – Chapter 3: Qualitative Characteristics of Useful Financial Information

On Sept. 24, the Financial Accounting Standards Board (FASB or Board) published a proposed accounting standards update (the Proposal) that is intended to ensure that the materiality concepts included in the conceptual framework are consistent with the legal concept of materiality. Comments are due to the Board by Dec. 8.

FASB Proposal on Notes to the Financial Statements – Assessing Whether Disclosures are Material

On Sept. 24, the FASB published a proposed accounting standards update (the Proposal) that would promote the use of discretion by companies in determining whether disclosures are material. Among other items, the Proposal would clarify that the omission of disclosure of immaterial information would not be considered an accounting error. Comments are due to the Board by Dec. 8.

If you are interested in joining NAREIT's Task Force that will evaluate the SEC Request for Comment and each FASB Proposal, and consider whether NAREIT should develop a comment letter, please contact Christopher Drula, NAREIT's VP, Financial Standards, by Oct. 31.

Contact

For further information, please contact NAREIT Vice President of Financial Standards Christopher Drula at cdrula@nareit.com or Senior Vice President of Financial Standards George Yungmann at gyungmann@nareit.com.