Concurrent Session: FASB Update

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Real Estate

Accounting and Financial Reporting Update

December 2, 2016

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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,

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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

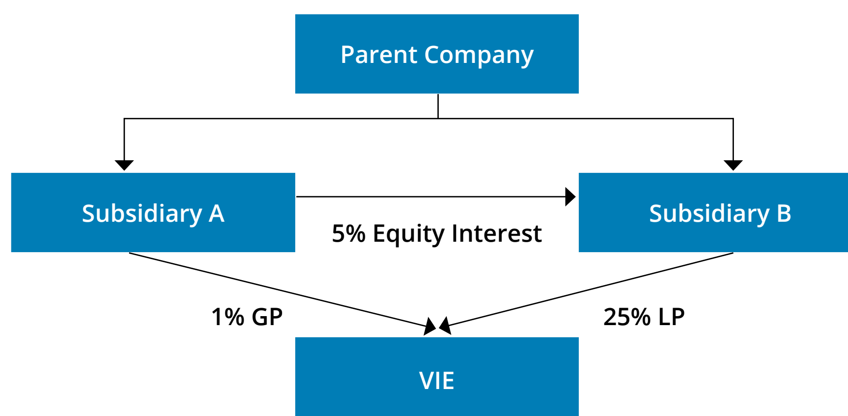
Background

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):

	Current U.S. GAAP		ASU 2015-17	
Description	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)

Cash Flow Issues	Amendments
Distributions received from equity method investees	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.
Beneficial interests in securitization transactions	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.
Separately identifiable cash flows and application of the predominance principle	The guidance provides a three-step approach for classifying cash receipts and payments that have aspects of more than one class of cash flows: 1. An entity should first apply specific guidance in U.S. GAAP, if applicable. 2. 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. 3. 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.

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*

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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*

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- 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)"

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Rule 13n-4, "Regulation SBSR; Duties and Core Principles of Security-Based Swap Data Repository"

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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

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FASB Amends Guidance on Derecognition and Partial Sales of Nonfinancial Assets

by Kristin Bauer and Vesna Ciringer, Deloitte & Touche LLP

Introduction

On February 22, 2017, the FASB issued ASU 2017-05,[1] which clarifies the scope of the Board's recently established guidance on nonfinancial asset derecognition (ASC 610-20[2]) as well as the accounting for partial sales of nonfinancial assets. The ASU conforms the derecognition guidance on nonfinancial assets with the model for transactions in the new revenue standard[3] (ASC 606, as amended).

The FASB issued the ASU 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 confusing and complex and does not specify how a partial sales transaction should be accounted for or which model entities should apply.

[1] FASB Accounting Standard Update No. 2017-05, *Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets*.
[2] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."
[3] FASB Accounting Standards Update No. 2014-09, *Revenue From Contracts With Customers (Topic 606)*.

Key Provisions of the ASU

Scope

The ASU clarifies that ASC 610-20 applies to the derecognition of all nonfinancial assets and in-substance nonfinancial assets. While the guidance in ASC 360-20[4] contained references to in-substance assets (e.g., in-substance real estate), it would not have applied to transactions outside of real estate. The FASB therefore added the definition of an in-substance nonfinancial asset to the ASC master glossary. The definition states, in part:

> An in substance nonfinancial asset is a financial asset (for example, a receivable) promised to a counterparty in a contract if substantially all of the fair value of the assets (recognized and unrecognized) that are promised to the counterparty in the contract is concentrated in nonfinancial assets. If substantially all of the fair value of the assets that are promised to a counterparty in a contract is concentrated in nonfinancial assets, then all of the financial assets promised to the counterparty in the contract are in substance nonfinancial assets. For purposes of this evaluation, when a contract includes the transfer of ownership interests in one or more consolidated subsidiaries that is not a business, an entity shall evaluate the underlying assets in those subsidiaries.

Accordingly, all business or nonprofit activities are excluded from the scope of ASC 610-20 and should be accounted for under the consolidation guidance in ASC 810-10. Further, all investments should be accounted for under the guidance in ASC 860 on transfers and servicing transactions, regardless of whether they are business or nonprofit activities or are in-substance nonfinancial assets.

Editor's Note

In January 2017, the FASB issued ASU 2017-01,[5] which clarifies and narrows the definition of a business. An entity should apply that definition when adopting the guidance in ASU 2017-05. Under the revised definition, an entity is likely to consider fewer real estate transactions to be businesses than it does in current practice, and therefore more transactions will be accounted for in accordance with ASC 610-20. For additional information about ASU 2017-01, see Deloitte's January 13, 2017, *Heads Up*.

ASU 2017-05 also clarifies that if a transaction (not involving a subsidiary) is partially within the scope of ASC 610-20 and partially within the scope of other guidance, an entity should apply the separation and allocation guidance in ASC 606. However, the entity should not separate the transferred assets of an individual subsidiary. That is, a transaction involving a subsidiary that does not have in-substance nonfinancial assets is excluded from the scope of ASC 610-20 in its entirety. The example below, which is reproduced from the ASU, illustrates the application of this guidance.

ASC 610-20

Case B — Nonfinancial Assets and Financial Assets

55-6 Entity X enters into a contract to transfer machinery and financial assets, both of which have significant fair value. Entity X concludes that the assets promised in the contract are not a business within the scope of Topic 810 and are not an output of the entity's ordinary activities within the scope of Topic 606. Entity X also concludes that substantially all of the fair value of the assets promised in the contract is not concentrated in nonfinancial assets. Therefore, the financial assets promised in the contract are not in substance nonfinancial assets.

55-7 In accordance with the guidance in paragraph 610-20-15-9, Entity X should derecognize only the machinery in accordance with this Subtopic. Entity X should apply the guidance in paragraph 606-10-15-4 to separate and measure the financial assets.

[4] ASC 360-20, which provides guidance on real estate sale transactions, was partially superseded by ASC 606 and ASC 610-20. However, ASC 360-20 continues to apply to sale-leaseback transactions involving real estate assets until the amendments in ASU 2016-02, *Leases*, become effective.

[5] FASB Accounting Standards Update No. 2017-01, *Clarifying the Definition of a Business*.

ASC 610-20 (continued)

55-8 If Entity X transfers the machinery and financial assets by transferring ownership interests in a consolidated subsidiary, it would still conclude that the financial assets are not in substance nonfinancial assets. As described in paragraph 610-20-15-8, if all of the assets promised to the counterparty in an individual consolidated subsidiary within a contract are not nonfinancial assets and/or in substance nonfinancial assets, those assets should not be derecognized in accordance with this Subtopic. Instead, Entity X should apply the guidance in paragraph 810-10-40-3A(c) or 810-10-45-21A(b)(2) to determine the guidance applicable to that subsidiary.

Assets can also be transferred to a counterparty under a contract with one or more subsidiaries. To determine the accounting, an entity should first assess whether substantially all of the fair value of all assets under the contract is concentrated in nonfinancial assets. If it is not, the entity should evaluate whether substantially all of the fair value of the assets in any individual subsidiary under the contract is concentrated in nonfinancial assets, in which case the financial assets of that subsidiary are, in substance, nonfinancial assets that are within the scope of ASC 610-20. The example below, which is reproduced from the ASU, illustrates the application of this guidance.

ASC 610-20

Case C — One Subsidiary That Holds Nonfinancial Assets and One Subsidiary That Holds Financial Assets

55-9 Entity A enters into a contract to transfer ownership interests in two consolidated subsidiaries to a single counterparty. Subsidiary 1 consists entirely of nonfinancial assets, and Subsidiary 2 consists entirely of financial assets. Assume that the assets in Subsidiary 1 and Subsidiary 2 have an equal amount of fair value. Entity A concludes that the transaction is not the transfer of a business within the scope of Topic 810 and that the subsidiaries are not outputs of the entity's ordinary activities within the scope of Topic 606.

55-10 Entity A first considers whether substantially all of the fair value of the assets promised to the counterparty in the contract is concentrated in nonfinancial assets. Because the contract includes the transfer of ownership interests in one or more consolidated subsidiaries, Entity A evaluates the underlying assets in those subsidiaries. Entity A concludes that because both the financial assets and nonfinancial assets have an equal amount of fair value, substantially all of the fair value of the assets promised to the counterparty in the contract is not concentrated in nonfinancial assets. Entity A next considers whether substantially all of the fair value of the assets within Subsidiary 1 or Subsidiary 2 is concentrated in nonfinancial assets. Because the assets transferred within Subsidiary 1 are entirely nonfinancial assets, Entity A concludes that those assets are within the scope of this Subtopic. Entity A also concludes that the financial assets in Subsidiary 2 are not in substance nonfinancial assets and, therefore, are not within the scope of this Subtopic. Entity A should apply the guidance in paragraph 606-10-15-4 to separate and measure the financial assets in Subsidiary 2 from the nonfinancial assets in Subsidiary 1 that are derecognized within the scope of this Subtopic.

The ASU provides a decision tree (reproduced in the appendix of this *Heads Up*) for entities to use in determining whether assets promised to a counterparty are within the scope of ASC 610-20.

Distinct Nonfinancial Assets

The ASU clarifies that the unit of account is defined as a distinct nonfinancial asset. At the inception of a contract, an entity should therefore identify each distinct nonfinancial and in-substance nonfinancial asset in accordance with the guidance on identifying distinct performance obligations in ASC 606. The entity should then, in a manner consistent with the approach outlined in ASC 606, allocate consideration to each distinct asset and derecognize the asset when a counterparty obtains control of it.

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. Such sales are common in the real estate industry (e.g., a seller transfers a building (or an asset) to a buyer but either retains an interest in the building (or the asset) or has an interest in the buyer).

Before adopting the new revenue standard, entities account for partial sales principally under the transaction-specific guidance in ASC 360-20 on real estate sales, the industry-specific guidance in ASC 970-323, and (sometimes) ASC 845-10-30. The ASU amends the guidance in ASC 970-323 to align it with the requirements in ASC 606 and ASC 610-20. It also eliminates ASC 360-20 as well as the initial-measurement guidance on nonmonetary transactions in ASC 845-10-30 to simplify the accounting treatment for partial sales (i.e., entities would use the same guidance to account for similar transactions) and to remove inconsistencies between ASC 610-20 and the noncash consideration guidance in the new revenue standard. As a result of these changes, 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) should be accounted for in accordance with ASC 610-20.

To determine when to derecognize a nonfinancial asset or in-substance nonfinancial asset, an entity should first assess whether it has transferred control of it. If the entity retains a controlling financial interest in a subsidiary (e.g., because the entity sold a noncontrolling ownership interest in a consolidated subsidiary), the entity should account for the transaction as an equity transaction in accordance with ASC 810 and should not recognize a gain or loss on the derecognition of nonfinancial assets.

However, if the entity has not retained a controlling financial interest in the nonfinancial asset or in-substance nonfinancial asset, it should derecognize it when it transferred control of the asset in a manner consistent with the principles in ASC 606. Further, the entity should measure any retained noncontrolling ownership interest (and resulting gain or loss to be recognized) at fair value in a manner consistent with the guidance on noncash consideration in ASC 606-20-32-21 through 32-24.

The following example, which is reproduced from the ASU, illustrates the application of this guidance:

ASC 610-20

Case A — Control Transfers Under Topics 810 and 606

55-11 Entity A owns 100 percent of Entity B, a consolidated subsidiary. Entity B holds title to land with a carrying amount of $5 million. Entity A concludes that the land is not an output of its ordinary activities within the scope of Topic 606 and that Entity B does not meet the definition of a business within the scope of Topic 810.

55-12 Entity A enters into a contract to transfer 60 percent of Entity B to Entity X for $6 million cash due at contract inception. For ease of illustration, assume that at contract inception the fair value of the 40 percent interest retained by Entity A is $4 million. Because all of the assets (the land) promised to Entity X in the contract are nonfinancial assets, Entity A concludes that it should derecognize the land in accordance with this Subtopic.

ASC 610-20 (continued)

55-13 As described in paragraphs 610-20-25-2 through 25-7, Entity A first considers the guidance in Topic 810 and concludes that it no longer has a controlling financial interest in Entity B or in Entity X (the buyer). Entity A then determines that the contract meets the criteria in paragraph 606-10-25-1 and that control of the land has been transferred in accordance with the guidance in paragraph 606-10-25-30. Because Entity A continues to have a noncontrolling interest in Entity B, it evaluates the point in time at which Entity B, its former subsidiary, has control of the distinct nonfinancial asset as described in paragraph 610-20-25-7. Entity A concludes that it has transferred control of the distinct nonfinancial asset because Entity B controls the distinct nonfinancial asset. When evaluating the indicators of control in paragraph 606-10-25-30, Entity A concludes the following:

a. It has the present right to payment.
b. Entity B has legal title to the land.
c. It does not have physical possession of the asset because it cannot restrict or prevent other entities from accessing the land.
d. Entity B has the significant risks and rewards of ownership.
e. There is no acceptance clause (assumption).

55-14 Entity A derecognizes the land and calculates the gain or loss as the difference between the amount of consideration measured in accordance with the guidance in paragraphs 610-20-32-2 and 610-20-32-6 and the carrying amount of the land. The amount of the consideration is $10 million, which includes $6 million in cash plus $4 million for the fair value of the noncontrolling interest in Entity B. Entity A recognizes a gain of $5 million ($10 million consideration – $5 million carrying amount of the assets) and presents the gain in the income statement in accordance with the guidance in paragraph 360-10-45-5. In accordance with the guidance in paragraph 610-20-32-4, Entity A records the noncontrolling interest in Entity B at $4 million and subsequently accounts for that interest in accordance with other Topics.

Editor's Note

The ASU requires an entity to derecognize the nonfinancial asset or in-substance nonfinancial asset in a partial sale transaction when (1) the entity ceases to have a controlling financial interest in a subsidiary pursuant to ASC 810 and (2) control of the asset is transferred in accordance with ASC 606. The entity therefore has to consider repurchase agreements (e.g., a call option to repurchase the ownership interest in a subsidiary) in its assessment and may not be able to derecognize the nonfinancial assets, even though it no longer has a controlling financial interest in a subsidiary in accordance with ASC 810. The ASU illustrates the application of this guidance in ASC 610-20-55-15 and 55-16.

Effective Date and Transition

The effective date of the new guidance is aligned with the requirements in the new revenue standard, which is effective for public companies for annual reporting periods (including interim reporting periods within those periods) beginning after December 15, 2017, and for nonpublic companies for annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019.[6] If the entity decides to early adopt the ASU's guidance, it must also early adopt ASC 606 (and vice versa).

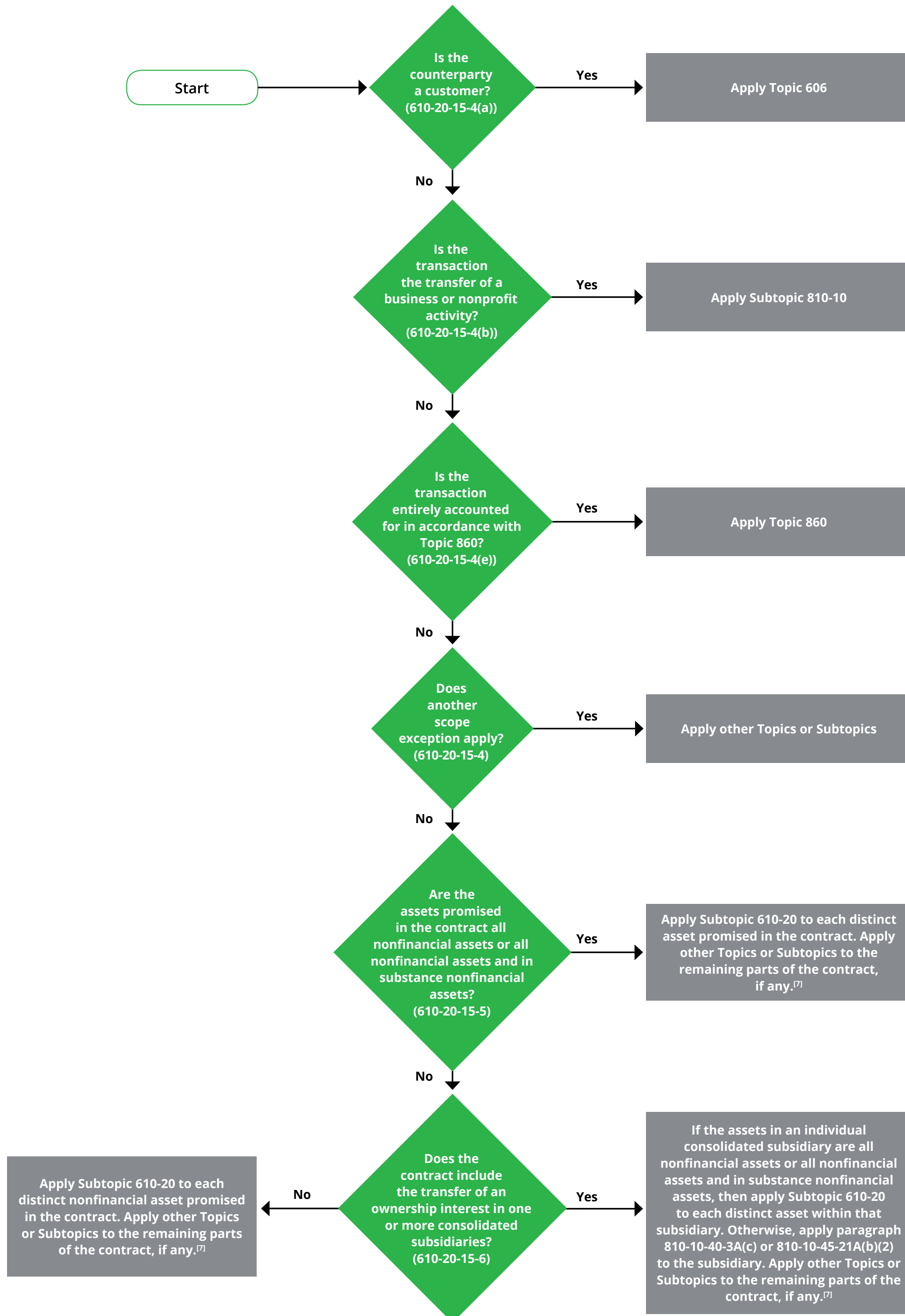
Like the new revenue standard, the ASU allows an entity to use a full or modified retrospective adoption approach. The entity can also elect to apply (1) different adoption approaches for ASC 610-20 and ASC 606 (e.g., modified retrospective for ASC 610-20 and full retrospective for ASC 606) and (2) practical expedients for contracts within the scope of ASC 610-20 that are different from those for contracts within the scope of ASC 606.

[6] FASB Accounting Standards Update No. 2015-14, *Revenue From Contracts With Customers (Topic 606): Deferral of the Effective Date*, delayed the effective date of the new revenue standard by one year and permits early adoption on a limited basis.

If the entity uses different transition methods, it would need to provide the transition-method disclosures required by ASC 606 for each transition method elected and indicate the method it used to adopt ASC 610-20. Regardless of the transition method the entity elects, it should apply the definition of a business as amended by ASU 2017-01 (see discussion in the Editor's Note above), under which a transaction that was previously considered a disposal of a business may be considered a disposal of an asset. The ASU clarifies that in such instances, the amounts previously allocated to goodwill associated with the disposal should not be reinstated.

Appendix — Decision Tree: Determining Whether ASC 610-20 Applies to Assets Promised to a Counterparty

An entity can use the decision tree below, reproduced from the ASU, to determine whether assets promised to a counterparty are within the scope of ASC 610-20.



[7] If the transfer includes other contractual arrangements that are not assets of the seller to be derecognized (for example, guarantees), those contracts are separated and accounted for in accordance with other Topics or Subtopics.

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- Effective Date and Transition

FASB Clarifies the Definition of a Business

by Emily Hache and Stefanie Tamulis, Deloitte & Touche LLP

On January 5, 2017, the FASB issued ASU 2017-01[1] to clarify the definition of a business in ASC 805.[2] The FASB issued the ASU in response to stakeholder feedback that the definition of a business in ASC 805 is being applied too broadly. In addition, stakeholders said that analyzing transactions under the current definition is difficult and costly. Concerns about the definition of a business were among the primary issues raised in connection with the Financial Accounting Foundation's post-implementation review report on FASB Statement No. 141(R), *Business Combinations* (codified in ASC 805). The amendments in the ASU are intended to make application of the guidance more consistent and cost-efficient.

Editor's Note

The definition of a business in ASC 805 also affects other aspects of accounting, such as disposal transactions, determining reporting units when goodwill is tested for recoverability, and the business scope exception in ASC 810.

Significance of the Standard

An entity uses the definition of a business in ASC 805 in determining whether to account for a transaction as an asset acquisition or a business combination. This distinction is important

[1] FASB Accounting Standards Update No. 2017-01, *Clarifying the Definition of a Business*.

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

because the accounting for an asset acquisition significantly differs in certain respects from the accounting for a business combination. For example, the acquirer's transaction costs are capitalized in an asset acquisition but are expensed in a business combination. Another difference is that in a business combination, the assets acquired are recognized at fair value and goodwill is recognized; in an asset acquisition, however, the cost of the acquisition is allocated to the assets acquired on a relative fair value basis and no goodwill is recognized. The amendments are expected to cause fewer acquired sets of assets (and liabilities) to be identified as businesses.

Editor's Note

The scope of ASC 610-20 raised questions about the interaction between the definition of a business and the guidance on in-substance nonfinancial assets. The FASB intends to address the accounting for partial sales of real estate and clarify that a business is outside the scope of ASC 610-20 in the second phase of its project on the definition of a business.

Key Provisions of the ASU

The ASU's Basis for Conclusions indicates that the amendments "narrow the definition of a business and provide a framework that gives entities a basis for making reasonable judgments about whether a transaction involves an asset or a business." Specifically, the ASU:

- Provides a "screen" for determining when a set is not a business. The screen requires a determination that when substantially all of the fair value of the gross assets acquired (or disposed of) is concentrated in a single identifiable asset or group of similar identifiable assets, the set is not a business. The screen will reduce the number of transactions that an entity must further evaluate to determine whether they are business combinations or asset acquisitions.
- Specifies that if the screen's threshold is not met, a set cannot be considered a business unless it includes an input and a substantive process that together significantly contribute to the ability to create output. The ASU provides a framework to assist entities in the evaluation of whether both an input and a substantive process are present, and it removes the evaluation of whether a market participant could replace the missing elements.
- Narrows the definition of the term "output" to be consistent with the description of outputs in ASC 606.

The standard also provides examples that illustrate how an entity should apply the amendments in determining whether a set is a business.

"Single Identifiable Asset" or "Group of Similar Identifiable Assets" Screen

As noted above, the ASU provides a screen for determining when a set is not a business. In accordance with the screen, when substantially all of the fair value of the gross assets acquired (or disposed of) is concentrated in a single identifiable asset or group of similar identifiable assets, the set would not be considered a business. An entity would not further evaluate the set if the screen's threshold is met.

The ASU requires an entity to compare the fair value of a single identifiable asset or group of similar identifiable assets with the gross assets acquired, as opposed to the total consideration paid or net assets, to ensure that debt or other liabilities do not affect the analysis. The gross assets acquired exclude cash and cash equivalents, deferred tax assets, and goodwill resulting from the effects of deferred tax liabilities. However, they include the consideration transferred in excess of the fair value of the net assets acquired.

The ASU's Basis for Conclusions notes that the assessment may be either qualitative or quantitative. Sometimes, an entity may be able to qualitatively determine that the screen's threshold is met if, for example, all of the fair value would be assigned to a single asset. Alternatively, an entity may be able to qualitatively determine that the fair value of the acquisition would be assigned to multiple dissimilar assets, in which case the screen's threshold would not be met. However, in some cases, an entity would need to perform a quantitative assessment.

Single Identifiable Asset

The ASU states that a "single identifiable asset includes any individual asset or group of assets that could be recognized and measured as a single identifiable asset in a business combination." The standard also provides that the following should be considered a single identifiable asset for purposes of the screen:

a. A tangible asset that is attached to and cannot be physically removed and used separately from another tangible asset (or an intangible asset representing the right to use a tangible asset) without incurring significant cost or significant diminution in utility or fair value to either asset (for example, land and building)

b. In-place lease intangibles, including favorable and unfavorable intangible assets or liabilities, and the related leased assets.

Group of Similar Identifiable Assets

As stated in the ASU's Basis for Conclusions, the FASB "also decided that the [screen's] threshold could be met if the fair value is concentrated in a group of similar identifiable assets" (i.e., when "an entity acquires, for example, multiple versions of substantially the same asset type instead of . . . one asset").

The Basis for Conclusions further notes that "[a]lthough it was the Board's intent to make the analysis practical, the criteria are intended to weigh the need for practicality with the risk that too many items are grouped together to avoid being considered a business." Accordingly, the FASB provided that the following should not be considered similar assets:

a. A tangible asset and an intangible asset

b. Identifiable intangible assets in different major intangible asset classes (for example, customer-related intangibles, trademarks, and in-process research and development)

c. A financial asset and a nonfinancial asset

d. Different major classes of financial assets (for example, accounts receivable and marketable securities)

e. Different major classes of tangible assets (for example, inventory, manufacturing equipment, and automobiles)

f. Identifiable assets within the same major asset class that have significantly different risk characteristics.

The example below, which is reproduced from the ASU, illustrates the application of the screen.

Case A: Acquisition of Real Estate

Scenario 1

805-10-55-52 ABC acquires, renovates, leases, sells, and manages real estate properties. ABC acquires a portfolio of 10 single-family homes that each have in-place leases. The only elements included in the acquired set are the 10 single-family homes and the 10 in-place leases. Each single-family home includes the land, building, and property improvements. Each home has a different floor plan, square footage, lot, and interior design. No employees or other assets are acquired.

805-10-55-53 ABC first considers the threshold guidance in paragraphs 805-10-55-5A through 55-5C. ABC concludes that the land, building, property improvements, and in-place leases at each property can be considered a single asset in accordance with paragraph 805-10-55-5B. That is, the building and property improvements are attached to the land and cannot be removed without

incurring significant cost. Additionally, the in-place lease is an intangible asset that should be combined with the related real estate and considered a single asset.

805-10-55-54 ABC also concludes that the 10 single assets (the combined land, building, in-place lease intangible, and property improvements) are similar. Each home has a different floor plan; however, the nature of the assets (all single-family homes) are similar. ABC also concludes that the risks associated with managing and creating outputs are not significantly different. That is, the risks associated with operating the properties and tenant acquisition and management are not significantly different because the types of homes and class of customers are not significantly different. Similarly, the risks associated with operating in the real estate market of the homes acquired are not significantly different. Consequently, ABC concludes that substantially all of the fair value of the gross assets acquired is concentrated in the group of similar identifiable assets; thus, the set is not a business.

Substantive Process

The ASU clarifies that "to be considered a business, the set must include, at a minimum, an input and a *substantive* process that together significantly contribute to the ability to create output" (emphasis added). In addition, the ASU clarifies that a substantive process is capable of being applied to inputs to create outputs and is therefore distinguishable from (1) processes that do not typically create outputs, such as accounting, billing, or payroll, or (2) processes that are considered ancillary or minor in the context of all of the processes required to create outputs.

The standard includes different criteria for entities to evaluate depending on whether a set has outputs.

A Set With No Outputs

When a set does not have outputs (e.g., an early-stage company that has not generated revenues), an entity would need to apply more stringent criteria when determining whether a set has a substantive process. Therefore, to qualify as a business, the set would have "both an input and a substantive process that together significantly contribute to the ability to create outputs only if it includes employees that form an organized workforce and an input that the workforce could develop or convert into output." However, the existence of any employee does not mean that a set without outputs should be considered a business. The "organized workforce must have the necessary skills, knowledge, or experience to perform an acquired process (or group of processes)," which is critical to producing outputs. The ASU notes that in the evaluation of whether an acquired workforce is performing a substantive process, the following factors should be considered:

a. A process (or group of processes) is not critical if, for example, it is considered ancillary or minor in the context of all the processes required to create outputs.

b. Inputs that employees who form an organized workforce could develop (or are developing) or convert into outputs could include the following:

   1. Intellectual property that could be used to develop a good or service
   2. Resources that could be developed to create outputs
   3. Access to necessary materials or rights that enable the creation of future outputs.

   Examples of inputs that could be developed include technology, mineral interests, real estate, and in-process research and development.

The example below, which is reproduced from the ASU, illustrates the assessment an entity would perform when a set has no outputs.

Case C: Acquisition of Biotech

805-10-55-70 Pharma Co. buys all of the outstanding shares of Biotech. Biotech's operations include research and development activities on several drug compounds that it is developing (in-process research and development projects). The in-process research and development projects are in different phases of the U.S. Food and Drug Administration approval process and would treat significantly different diseases. The set includes senior management and scientists that have the necessary skills, knowledge, or experience to perform research and development

activities. In addition, Biotech has long-lived tangible assets such as a corporate headquarters, a research lab, and lab equipment. Biotech does not yet have a marketable product and, therefore, has not generated revenues. Assume that each research and development project has a significant amount of fair value.

805-10-55-71 Pharma Co. first considers the guidance in paragraphs 805-10-55-5A through 55-5C. The identifiable assets in the set include multiple in-process research and development projects and tangible assets (the corporate headquarters, the research lab, and the lab equipment). Pharma Co. concludes that the in-process research and development projects are not similar assets because the projects have significantly different risks associated with managing the assets and creating the outputs (that is, because there are significantly different development risks in the different phases of development, market risks related to the different customer base, and potential markets for the compounds). In addition, Pharma Co. concludes that there is fair value associated with the acquired workforce because of the proprietary knowledge of and experience with Biotech's ongoing development projects and the potential for creation of new development projects that the workforce embodies. As such, Pharma Co. concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets and that it must further evaluate whether the set has the minimum requirements to be considered a business.

805-10-55-72 Because the set does not have outputs, Pharma Co. evaluates the criteria in paragraph 805-10-55-5D to determine whether the set has both an input and a substantive process that together significantly contribute to the ability to create outputs. Pharma Co. concludes that the criteria are met because the scientists make up an organized workforce that has the necessary skills, knowledge, or experience to perform processes that when applied to the in-process research and development inputs is critical to the ability to develop those inputs into a product that can be provided to a customer. Pharma Co. also determines that there is a more-than-insignificant amount of goodwill (including the fair value associated with the workforce), which is another indicator that the workforce is performing a critical process. Thus, the set includes both inputs and substantive processes and is a business.

A Set With Outputs

The ASU's Basis for Conclusions indicates that when a set has outputs (i.e., there is a continuation of revenues before and after the transaction), "it is more likely that the set includes both an input and a substantive process when compared with a set that is not generating outputs." Therefore, the criteria for determining whether a set with outputs has a substantive process are less stringent. A set with outputs would include a substantive process if any of the following criteria are met:

a. Employees that form 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. A process (or group of processes) is not critical if, for example, it is considered ancillary or minor in the context of all of the processes required to continue producing outputs.

b. 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. An entity should assess the substance of an acquired contract and whether it has effectively acquired an organized workforce that performs a substantive process (for example, considering the duration and the renewal terms of the contract).

c. The acquired process (or group of processes) when applied to an acquired input or inputs significantly contributes to the ability to continue producing outputs and cannot be replaced without significant cost, effort, or delay in the ability to continue producing outputs.

d. The acquired process (or group of processes) when applied to an acquired input or inputs significantly contributes to the ability to continue producing outputs and is considered unique or scarce.

An organized workforce may represent a substantive process but is not required if outputs are present. The Basis for Conclusions states, for example, that "an organized workforce might not be required if the set includes automated processes (for example, through acquired technology, infrastructure, or specialized equipment) or other significant processes that contribute to the ability to continue producing outputs."

However, the ASU clarifies that a continuation of revenues alone does not mean that both an input and a substantive process have been acquired. The ASU states that "assumed contractual arrangements that provide for the continuation of revenues (for example, customer contracts, customer lists, and leases [when the set is the lessor]) should be excluded from the analysis . . . of whether a [substantive] process has been acquired."

The example below, which is reproduced from the ASU, illustrates the assessment an entity would perform when a set has outputs.

> **Case F: License of Distribution Rights**
>
> **805-10-55-82** Company A is a distributor of food and beverages. Company A enters into an agreement to sublicense the Latin American distribution rights of Yogurt Brand F to Company B, whereby Company B will distribute Yogurt Brand F in Latin America. As part of the agreement, Company A transfers the existing customer contracts in Latin America to Company B and an at-market supply contract with the producer of Yogurt Brand F. Company A retains all of its employees and distribution capabilities.
>
> **805-10-55-83** Company B first considers the guidance in paragraphs 805-10-55-5A through 55-5C. The identifiable assets that could be recognized in a business combination include the license to distribute Yogurt Brand F, customer contracts, and the supply agreement. Company B concludes that the license and customer contracts will have fair value assigned to them. Company B concludes that neither asset represents substantially all of the fair value of the gross assets. Company B then considers whether the license and customer contracts are a group of similar intangible assets. Because the license and customer contracts are in different major classes of identifiable intangible assets, they are not considered similar assets. Therefore, substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets, and Company B must evaluate whether the set has both an input and a substantive process.
>
> **805-10-55-84** The set has outputs through the continuation of revenues with customers in Latin America. As such, Company B must evaluate the criteria in paragraph 805-10-55-5E to determine whether the set includes an input and a substantive process that together significantly contribute to the ability to create outputs. Company B considers whether the acquired contracts are providing access to an organized workforce that performs a substantive process. However, because the contracts are not providing a service that applies a process to another acquired input, Company B concludes that the substance of the contracts [is] only that of acquiring inputs. The set is not a business because:
>
> a. It does not include an organized workforce that could meet the criteria in paragraph 805-10-55-5E(a) through (b).
>
> b. There are no acquired processes that could meet the criteria in paragraph 805-10-55-5E(c) through (d).
>
> c. It does not include both an input and a substantive process.

Definition of Output

The ASU changes the definition of an output to the "result of inputs and processes applied to those inputs that provide goods or services to customers, investment income (such as dividends or interest), or other revenues." This change narrows the definition to be consistent with ASC 606, which, as noted in the ASU's Basis for Conclusions, "describes goods or services that are an output of the entity's ordinary activities." However, not every entity has revenues within the scope of ASC 606. Therefore, the Board decided to incorporate into the definition of output other types of revenues. For example, the reference to investment income in the definition of an output was included to ensure that the purchase of an investment company could still qualify as a business combination.

Convergence With IFRSs

The definition of a business in ASC 805 is currently identical to that in IFRS 3.[3] Nevertheless, the interpretation and application of this term in jurisdictions that apply U.S. GAAP do not appear consistent with those in jurisdictions that apply IFRSs (i.e., the definition of a business

[3] IFRS 3, *Business Combinations*.

in IFRS jurisdictions is not applied as broadly). Although the ASU adds implementation guidance to U.S. GAAP that is not found in IFRSs, the FASB intends to more closely align practice under U.S. GAAP with that under IFRSs by narrowing the application of the U.S. GAAP definition. Further, the IASB has added to its agenda a project on the definition of a business and issued an exposure draft, which proposes amendments similar to those described herein for U.S. GAAP.

Effective Date and Transition

The ASU is effective for public business entities in annual periods beginning after December 15, 2017, including interim periods therein. For all other entities, the ASU is effective in annual periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019. The ASU must be applied prospectively on or after the effective date, and no disclosures for a change in accounting principle are required at transition.

Early adoption is permitted for transactions (i.e., acquisitions or dispositions) that occurred before the issuance date or effective date of the standard if the transactions were not reported in financial statements that have been issued or made available for issuance.

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12 December 2016

2016 AICPA National Conference on Current SEC and PCAOB Developments

Compendium of significant accounting and reporting issues

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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

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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. 2016-27
20 December 2016

Technical Line

FASB — proposed guidance

A closer look at the FASB's hedge accounting proposal

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What you need to know

- The FASB proposed amendments to its hedge accounting guidance that are aimed at enabling entities to more clearly portray the economics of their risk management activities in their financial statements.
- The proposal would expand the strategies that qualify for hedge accounting, change how many hedging relationships are presented in the financial statements and simplify the application of hedge accounting in certain situations.
- The proposal would also provide entities with additional flexibility in how they measure the change in the fair value of the hedged item in certain hedging relationships.
- Certain disclosure requirements would be modified or added.
- The FASB recently held two public roundtable discussions on the proposal. Redeliberations will begin in 2017.

Overview

The Financial Accounting Standards Board (FASB or Board) proposed targeted amendments[1] to the hedge accounting model in Accounting Standards Codification (ASC) 815[2] that are aimed at enabling entities to more clearly portray the economics of their risk management activities in their financial statements.

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While the proposal would change the guidance on a broad range of hedge accounting topics, the FASB decided against creating an entirely new model. As a result, many aspects of today's guidance would not change, including:

- The three types of hedge accounting relationships that can be designated under the model (i.e., fair value hedges, cash flow hedges and hedges of net investments in foreign operations)
- The highly effective threshold to qualify for hedge accounting
- The requirement for concurrent designation and documentation of hedging relationships
- The need for entities to consider hedge effectiveness prospectively and retrospectively
- The ability for entities to voluntarily discontinue hedge accounting

Aspects of ASC 815 that do not relate to hedge accounting also would remain unchanged, including the definition of a derivative, the scope exceptions to derivative accounting, the guidance on bifurcating embedded derivatives and the income statement presentation requirements for derivative instruments not designated in a hedging relationship (e.g., derivatives held for trading purposes or derivatives used as economic hedges).

Aspects of ASC 815 that do not relate to hedge accounting would remain unchanged.

Key provisions of the proposal

Alignment of an entity's risk management activities and financial reporting

This aspect of the proposal addresses risk component hedging, fair value hedges of interest rate risk and recognition and presentation of the effects of hedging instruments.

Risk component hedging — For cash flow hedges, the proposal would expand the strategies that qualify for hedge accounting to include hedging the variability in cash flows due to changes in:

- A contractually specified component in the forecasted purchase or sale of a nonfinancial asset
- A contractually specified variable interest rate in a variable-rate financial instrument

For hedges of fixed-rate financial instruments, component hedging would continue to be limited to benchmark interest rates, but the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Rate would be added as an acceptable US benchmark interest rate.

Fair value hedges of interest rate risk — Current US GAAP contains limitations on how an entity can measure changes in the fair value of a hedged item attributable to interest rate risk in fair value hedging relationships. The proposal would provide entities with flexibility in how to measure the change in the fair value of the hedged item (i.e., a fixed-rate financial instrument) in order to better reflect the effectiveness of these hedging strategies. These proposed changes include:

- Determining the change in the fair value of the hedged item by using only the portion of the contractual cash flows related to the benchmark interest rate, not the entire coupon
- Considering only how changes in the benchmark interest rate affect the decision to prepay the instrument, rather than all factors that would affect this decision (e.g., credit risk)
- Calculating the change in the fair value of the hedged item in a partial-term hedge by assuming that the hedged item has a term that reflects only the designated cash flows being hedged (i.e., the maturity date of the hedged item would be assumed to be the same as that of the derivative designated as the hedging instrument)

Recognition and presentation of the effects of a hedging instrument — The proposal would further align the income statement presentation and timing of earnings recognition of the hedging instrument with the hedged item.

To accomplish this, the proposal would (1) eliminate today's US GAAP requirement to separately measure and report hedge ineffectiveness and (2) generally require entities to report the entire effect of the hedging instrument and hedged item in the same income statement line item.

Simplification of hedge accounting requirements

The proposal would also simplify certain hedge documentation and assessment requirements. While entities would still need to perform an initial quantitative assessment of effectiveness for many hedging relationships, the proposal would reduce the administrative burden of applying hedge accounting by:

- Giving entities more time to complete the initial quantitative hedge effectiveness assessment portion of their hedge documentation (i.e., generally until the end of the quarter in which the hedge is designated)
- Allowing an entity to subsequently assess hedge effectiveness qualitatively unless the facts and circumstances change to an extent that the entity can no longer assert qualitatively that the hedge is highly effective
- Permitting entities to use the critical terms match method to assess hedge effectiveness of a group of forecasted transactions that occur within the same 31-day period as the hedging derivative's maturity date, without performing a de minimis test
- Allowing an entity to switch to a quantitative assessment of hedge effectiveness if it inappropriately used the shortcut method, as long as it documented at hedge inception the quantitative methodology to be used if necessary and the hedge is highly effective when this methodology is applied

Disclosures

To help users of the financial statements better understand the effects of hedge accounting, the Board proposed requiring the following new or modified disclosures:

- Revised tabular disclosures that would focus on the effect of hedge accounting by income statement line
- The cumulative basis adjustment to the hedged item in fair value hedges
- A description of any quantitative goals of the entity's hedge accounting program and whether they were met

The proposal would also eliminate the current requirement to disclose hedge ineffectiveness because ineffectiveness would no longer be separately measured.

How we see it

Overall, we believe the proposal would significantly improve the US GAAP hedge accounting model. The proposed amendments would increase the number of strategies that qualify for hedge accounting and reduce operational complexities associated with certain existing strategies.

Background

Statement of Financial Accounting Standards (SFAS) No. 133,[3] issued in 1998, established financial accounting and reporting guidance for derivative instruments and provided special hedge accounting that entities could elect to apply if certain criteria were met. While this guidance has been amended numerous times in order to address various practice issues (primarily based on interpretations by the Derivatives Implementation Group), critics continue to say that the hedge accounting model is overly restrictive and complex.

For example, various common risk management strategies do not qualify for hedge accounting. For other strategies that do qualify, the financial reporting results do not always accurately reflect the economics of the risk management activities undertaken. Some entities also choose to forgo hedge accounting for strategies that would qualify to avoid having to navigate the complex rules.

In an attempt to address these concerns, the Board issued proposals to amend its hedge accounting model in 2008[4] and 2010.[5] The current proposal reflects feedback the FASB received on those proposals, as well as a 2011 discussion paper[6] the Board issued on the hedge accounting model the International Accounting Standards Board (IASB) ultimately issued as part of IFRS 9 *Financial Instruments*.

Although the IASB and FASB were both seeking to better align their hedge accounting models with the risk management activities employed by entities, certain broad principles in the current proposal differ from those in IFRS 9. Refer to the appendix for a summary of key differences.

The proposal would eliminate the requirement to separately measure and report hedge ineffectiveness.

Proposed amendments to the overall hedge accounting model

Recognition and presentation of the effects of hedging instruments

While ASC 815 currently requires disclosure of the income statement line item where gains and losses on derivative instruments are reported, it is generally silent on the line item where those gains and losses should be presented. The proposal would generally require the entire change in the fair value of hedging instruments to be presented in the same income statement line where the earnings effect of the hedged item is presented. The only exception would be changes in the hedging instrument's time value excluded from the assessment of hedge effectiveness in a net investment hedge.

The proposal also would eliminate the requirement to separately measure and report hedge ineffectiveness. As a result, the entire change in the fair value of the hedging instrument included in the assessment of effectiveness for cash flow and net investment hedges would be recorded in accumulated other comprehensive income (AOCI) and reclassified into earnings when the hedged item affects earnings (or when it becomes probable that the forecasted transaction being hedged in a cash flow hedge will not occur in the required time period).

The Board believes that further aligning the recognition and presentation of the effects of the hedging instrument and the hedged item in the financial statements would help users better understand the results of an entity's hedge accounting strategies and would make the total cost of hedging more transparent.

Excluded components

The proposal would continue to permit certain portions of the change in fair value of a hedging instrument related to time value (e.g., the forward points in a forward contract, the premium paid on an option) to be excluded from the assessment of hedge effectiveness and recognized immediately in earnings. The proposal would require the change in excluded time value for cash flow and fair value hedges to be presented in the same income statement line

where the earnings effect of the hedged item is presented. For net investment hedges, the proposal would not specify where amounts excluded from the assessment of hedge effectiveness should be presented.

Timing of initial prospective quantitative hedge effectiveness assessment

Like today's guidance, the proposal would require entities to perform an initial prospective assessment of hedge effectiveness at the inception of a hedging relationship. To qualify for hedge accounting, the hedging relationship must be expected to be "highly effective" in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period that the hedge is designated.

The proposal would clarify that the initial prospective assessment of hedge effectiveness must be performed on a quantitative basis (e.g., based on a regression analysis) except in the following situations:

- In a cash flow or fair value hedge, where an entity applies the shortcut method
- In a cash flow or fair value hedge, where an entity determines that the critical terms of the hedging instrument and hedged item match
- In a cash flow hedge, where an entity assesses hedge effectiveness based on an option's terminal value
- In a cash flow hedge, where a private company applies the simplified hedge accounting approach
- In a cash flow hedge, where an entity assesses hedge effectiveness under the change in variable cash flow method, and all the conditions to assume the hedge is perfectly effective are met
- In a cash flow hedge, where an entity assesses hedge effectiveness under the hypothetical derivative method, and all of the critical terms of the hypothetical derivative and hedging instrument are the same
- In a net investment hedge, where an entity assesses hedge effectiveness based on changes in spot exchange rates, and the conditions to assume perfect effectiveness are met
- In a net investment hedge, where an entity assesses hedge effectiveness based on changes in forward exchange rates, and the conditions to assume perfect effectiveness are met

The proposal also would give entities more time to perform the initial prospective quantitative hedge effectiveness assessment that is part of the concurrent documentation required to be prepared at the inception of the hedging relationship. The proposal indicates that this assessment would be considered to be performed at hedge inception if it is completed by the earliest of the following dates:

- The first quarterly hedge effectiveness assessment date
- The date that financial statements are available to be issued
- The date that the hedging relationship no longer meets the hedge accounting criteria in ASC 815-20-25
- The date of expiration, sale, termination or exercise of the hedging instrument
- The date of dedesignation of the hedging relationship

- For a cash flow hedge of a forecasted transaction, the date that the forecasted transaction occurs

The proposal could provide entities with as much as three additional months to perform their initial quantitative effectiveness tests. However, in performing that assessment, an entity would need to use data as of the date of hedge designation. The following example illustrates when an entity would be required to perform this assessment.

Illustration 1 — Timing of initial quantitative prospective effectiveness assessment

Assume that Company A has determined that it is probable it will purchase 100 bushels of corn on 16 December 20X1 at the spot price in location Y on that day. To lock in the base corn price associated with this forecasted purchase, Company A purchases a two-month corn futures contract on the Chicago Mercantile Exchange on 16 October 20X1. This futures contract will net settle on 16 December 20X1.

Company A designates the futures contract as the hedging instrument in a cash flow hedge of the variability in the total price of its forecasted purchase of corn at location Y. On 16 December 20X1, the forecasted purchase occurs.

While Company A would need to concurrently document its hedging relationship on 16 October 20X1 (the hedge inception date), it would have until 16 December 20X1 to perform its initial prospective quantitative assessment to validate that the hedge was expected to be highly effective. The data used for this assessment would be as of 16 October 20X1.

The reason Company A would have to complete its initial prospective quantitative assessment of hedge effectiveness before the end of the quarter is because the forecasted transaction occurred during the same quarter that the hedging relationship was initiated.

How we see it

Giving entities more time to perform their initial prospective quantitative assessment could provide relief to entities that do not have significant hedging activities or lack the resources to complete this quantitative analysis on the date the hedge is executed. However, the FASB would still require entities to concurrently complete all the other hedge documentation requirements so they would not have the benefit of hindsight when determining whether to designate a derivative instrument as part of a hedging relationship. For example, as of the hedge inception date, they would still need to document their risk management strategy, identify the hedging instrument and hedged item and define the methodology that will be used to initially assess hedge effectiveness.

We also note that even if the initial prospective quantitative assessment of hedge effectiveness is performed at the end of the quarter in which the hedging relationship is designated, this assessment cannot be used to conclude that the hedging relationship was effective during the quarter (i.e., as a retrospective assessment at quarter end) or is expected to be effective in future periods (i.e., as a prospective assessment at quarter end).

Subsequent hedge effectiveness assessments

The proposal would retain the current requirement to assess hedge effectiveness on an ongoing basis (i.e., whenever financial statements or earnings are reported, and at least every quarter). Each assessment must consider whether the hedge has been highly effective (i.e., a retrospective assessment) and is expected to continue to be highly effective (i.e., a prospective assessment).

ASC 815 currently requires entities to perform ongoing assessments quantitatively, unless the hedging relationship meets the criteria to be considered perfectly effective (e.g., under the shortcut or critical terms match methods). The proposal would permit entities to assess ongoing hedge effectiveness qualitatively, even for hedging relationships that are not assumed to be perfectly effective, if (1) an initial quantitative assessment is performed and demonstrates that the relationship is expected to be highly effective and (2) at inception, the entity can reasonably support an expectation of high effectiveness on a qualitative basis in subsequent periods. However, if the facts and circumstances change and the entity can no longer assert qualitatively that the hedging relationship was and continues to be highly effective, the entity would be required to perform subsequent effectiveness assessments on a quantitative basis.

At the inception of a hedging relationship, an entity would need to document its election to subsequently assess hedge effectiveness qualitatively. This documentation would need to include how the entity intends to perform the qualitative assessment and what quantitative method would be used if a qualitative assessment is no longer appropriate. The proposal would also require an entity to document that it will perform the same quantitative assessment for both initial and subsequent prospective assessments.

The proposal also would require an entity to apply its election to qualitatively assess hedging relationships consistently for similar hedges.

Ongoing hedge effectiveness assessments could be performed qualitatively for hedging relationships that are not assumed to be perfect.

How we see it

The proposal would provide a one-time transition election that would allow entities to change their documentation for existing hedges and switch to a qualitative subsequent assessment without dedesignating the hedging relationships.

It is unclear to us whether the FASB intended to preclude an entity that did not make this election from using a qualitative method to subsequently assess hedge effectiveness for similar new hedges after adoption. The proposal seems to suggest this by stating that the requirement to assess effectiveness for similar hedges in a similar manner applies to an entity's selection of hedging relationships for which qualitative assessments are elected. The FASB also states in paragraph BC168 of the proposal that the one-time transition election "would ensure that similar hedging relationships are assessed for effectiveness in accordance with paragraph 815-20-25-81."

In our view, entities should be permitted to assess hedge effectiveness qualitatively for hedging relationships entered into after adoption, even if they elect not to change their approach for similar existing hedging relationships.

Initial quantitative test of hedge effectiveness

The proposal would permit entities to assess ongoing hedge effectiveness qualitatively for hedging relationships that are not assumed to be perfectly effective. However, as noted above, one of the requirements to use this approach is that the entity initially performed a prospective assessment of hedge effectiveness on a quantitative basis. This is different from those hedging relationships whose effectiveness can be assessed qualitatively under the current guidance, including hedging relationships assessed under the critical terms match method, because no initial prospective quantitative assessment is required for hedging relationships that are assumed to be perfectly effective.

Accordingly, the proposed guidance in paragraphs ASC 815-20-35-2A through 35-2E and 815-20-55-79G through 55-79U of the proposal would not apply to hedging relationships where an initial prospective assessment of hedge effectiveness is not performed quantitatively.

The complete list of situations where an initial prospective quantitative assessment of hedge effectiveness is not required is shown above in the "Timing of initial prospective quantitative hedge effectiveness assessment" section of this publication.

This is an important distinction as it could have an effect on whether subsequent assessments can continue to be performed on a qualitative basis. In paragraph BC139 of the proposal, the Board states that the criteria for continuing to apply the critical terms match method are more "stringent" than the proposed criteria for continuing to perform a subsequent qualitative assessment. That is, any change in the critical terms of the hedging relationship would preclude subsequent assessments under the critical terms match method. In contrast, an entity would not be precluded from continuing to perform a qualitative assessment unless the facts and circumstances change such that the entity can no longer assert qualitatively that the relationship is highly effective.

The Board believes this difference is reasonable because, under the critical terms match method, effectiveness of the hedging relationship is assumed to be perfect if the critical terms of the hedging instrument and the hedged item match at the inception and on an ongoing basis. In contrast, an entity that would apply the proposed guidance on using a qualitative method to subsequently assess effectiveness is required to establish the effectiveness of that hedging relationship on a quantitative basis at hedge inception.

How we see it

Allowing entities to subsequently assess hedge effectiveness qualitatively would not eliminate the need for them to perform ongoing "math" related to the hedged item. For fair value hedging relationships, entities would still need to measure the change in the hedged item attributable to the hedged risk in order to appropriately adjust the carrying value of the hedged item.

Because this aspect of the proposal relates to hedging relationships that are not assumed to be perfect, it would be inappropriate to assume that the change in the fair value of the hedged item is equal to the change in the fair value of the hedging instrument. However, the proposed amendments related to measuring the change in fair value of the hedged item in a fair value hedge of interest rate risk would likely reduce the earnings mismatch recognized in these hedging relationships.

Expectation of high effectiveness on a qualitative basis

The proposal would provide implementation guidance[7] on determining whether an entity can reasonably support performing assessments of effectiveness on a qualitative basis after hedge inception. While acknowledging that this determination would require judgment, the proposal indicates that an entity should carefully consider the following factors:

- Results of the quantitative assessment performed at hedge inception
- Alignment of the critical terms of the hedging relationship

For example, the proposal says an entity should consider whether changes in market conditions could cause the fair value of the hedging instrument and hedged item to diverge, due to differences in their critical terms. If the underlyings of the hedging instrument and hedged item differ, the proposal states that an entity should consider the extent and consistency of correlation between changes in the different underlyings, as this could inform the entity about how expected changes in market conditions could affect the effectiveness of the hedging relationship prospectively.

The proposal also provides a number of examples[8] that indicate that an entity could not reasonably support subsequently assessing hedge effectiveness on a qualitative basis unless the initial quantitative assessment indicates that the hedging relationship is not close to failing, and changes in the underlyings of the hedged item and the hedging instrument have been consistently highly correlated.

Changes in facts and circumstances

At every assessment date, the proposal would require an entity to verify and document that the facts and circumstances have not changed to an extent that it can no longer assert qualitatively that the relationship was and is expected to continue to be highly effective. While this assessment may be relatively straightforward in certain cases, it may require significant judgment in others. The proposal provides the following indicators that may, individually or in the aggregate, support an entity's assertion that a qualitative assessment continues to be appropriate:

- The factors assessed at hedge inception 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 that is not mirrored in the hedging instrument, 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 the changes in a contractually specified component of a forecasted purchase or sale of a nonfinancial asset with a cap or floor that is not mirrored in the hedging instrument, the price associated with the contractually specified component does not approach or move above or below the price associated with the cap or floor

The proposal provides two examples of facts and circumstances changing to an extent that an entity could no longer assert qualitatively that a relationship was and would continue to be highly effective. In one example,[9] an entity designates a euro-denominated forward contract as a foreign currency cash flow hedge of its forecasted sales denominated in a currency that is pegged to the euro. When the currency became unpegged to the euro during the relationship, the entity concluded that a qualitative assessment was no longer appropriate.

In the other example,[10] an entity concludes that subsequent assessment of hedge effectiveness on a qualitative basis is no longer appropriate for its fair value hedge of fixed-rate debt when the counterparty to its hedging instrument experiences significant credit deterioration.

How we see it

In some cases, determining whether a change in facts and circumstances is significant enough to necessitate switching from a qualitative to a quantitative assessment would require significant judgment. However, we would expect that this determination could, in part, depend on the methodology the entity used to perform its initial quantitative assessment.

For example, the determination may require less judgment if the entity's initial quantitative assessment included scenario or stress testing that indicated the extent to which facts and circumstances (including market factors) could change without calling into question the effectiveness of the hedge. Such an approach may be especially helpful in situations where a high level of correlation has existed between the hedging instrument and the hedged item under relatively stable market conditions.

If an entity determines that a qualitative effectiveness assessment is no longer appropriate, the proposal indicates that it should begin performing quantitative effectiveness assessments (using the method documented at hedge inception) as of the period in which the facts and circumstances changed. If the entity cannot determine when the facts and circumstances changed, it would need to quantitatively assess all periods that were previously assessed qualitatively since inception of the hedging relationship.

If there are any periods in which the hedging relationship is not highly effective based on a quantitative test, the entity would apply the guidance in ASC 250[11] on error corrections to the difference between the recorded results of applying hedge accounting and the results without applying hedge accounting.

If a subsequent quantitative assessment is required, the proposal would prohibit the entity from reverting back to assessing hedge effectiveness qualitatively without dedesignating and redesignating the hedging relationship. However, the proposal notes that an entity could perform occasional quantitative assessments to prove to a third party (presumably a regulator or an independent auditor) that the hedging relationship is highly effective, without losing the ability to subsequently assess hedge effectiveness qualitatively, as long as the results of the quantitative test show that the hedge was and continues to be highly effective.

The likelihood that misapplying the shortcut method will result in a restatement would be significantly reduced under the proposal.

Misapplication of the shortcut method

The proposal would retain the shortcut method of assessing hedge effectiveness.

However, the proposal addresses a practice issue that has resulted in numerous restatements. Under current practice, if an entity determines that its use of the shortcut method was not appropriate, the entity is required to apply the guidance on error corrections in ASC 250 to the difference between the results recorded when applying the shortcut method and the results of not applying hedge accounting. That is, an entity may not currently assess the need for restatement by considering whether the hedging relationship would have qualified for hedge accounting under a quantitative assessment methodology.

The proposal would allow entities that misapplied the shortcut method to use a quantitative method to assess hedge effectiveness and measure hedge results without dedesignating the hedging relationship only if both of the following conditions are met:

- The entity documented at hedge inception the quantitative method it would use to assess effectiveness and measure hedge results if necessary
- Based on that quantitative method, the hedging relationship was highly effective on a prospective and retrospective basis for the periods in which the shortcut criteria were not met

If both of these conditions are met, an entity would apply the guidance on error corrections in ASC 250 to the difference, if any, between its financial results reflecting the use of the shortcut method and the financial results when the hedging relationship is assessed under the quantitative method previously documented.

This approach would not only reduce the likelihood of a restatement but could also enable entities to continue hedge accounting without having to dedesignate and redesignate hedging relationships. This would mean that the ongoing assessment of hedge effectiveness would not be impacted by a hedging instrument having a fair value other than zero at hedge inception, which would typically be the case if the entity dedesignated and redesignated the hedging relationship.

If the entity does not document a quantitative method to be used if it misapplies the shortcut method (i.e., the first condition is not met), the hedging relationship would be invalid in the period in which the shortcut criteria were not met and in all subsequent periods. If the entity does document such a quantitative method (i.e., the first condition is met), the hedging relationship would be considered invalid in all periods in which (1) the shortcut criteria were not met and (2) the quantitative assessment indicates that the hedging relationship was not highly effective on a prospective and retrospective basis. In both cases, the entity would apply the guidance on error corrections in ASC 250 to the difference between the results recorded from applying the shortcut method and the results of not applying hedge accounting in the periods in which the hedging relationship was considered invalid.

If the entity could not determine when the shortcut criteria were no longer met, it would have to assess effectiveness beginning at hedge inception. This would also be the case if the entity determines that the hedging relationship never qualified for use of the shortcut method.

How we see it

This aspect of the proposal would be a welcome change to current practice, which often results in restatements when the shortcut method is inappropriately applied to hedging relationships that are clearly highly effective.

Historically, the Securities and Exchange Commission (SEC) staff has emphasized that there is no "spirit" to the shortcut method because it represents a specific, rules-based exception to the general hedging guidance in ASC 815. As a result, the SEC staff has indicated that this rule should be strictly applied and an entity should quantify the error resulting from misapplication as if it had never qualified for hedge accounting, even if the hedging relationship would have been highly effective under the long-haul method.

Proposed amendments to fair value hedges

Recognition and presentation of the effects of hedging instruments

The proposal would not change the timing of when the change in fair value of the hedging instrument is recognized in earnings for fair value hedges. That is, gains and losses on the hedging instrument and on the hedged item (attributable to the hedged risk) would continue to be recognized in earnings every period. As a result, consistent with today's guidance, there would be an immediate earnings effect in the income statement if there is a mismatch between the change in the fair value of the hedged item attributable to the hedged risk and the change in fair value of the hedging instrument.

However, the proposal would require all changes in the fair value of a hedging instrument in a fair value hedge to be presented in the same income statement line item as the earnings effect of the hedged item. This would include changes in the hedging instrument's time value that is excluded from the assessment of hedge effectiveness.

Current guidance does not specify an income statement line in which the gains and losses of derivatives designated in fair value hedging relationships should be presented. However, the SEC staff[12] expects registrants to present the effective portion of an effective hedging relationship in the income statement line associated with the hedged item. We understand there is diversity in practice regarding where the ineffective portion of the hedge, as well as any amounts excluded from the assessment of hedge effectiveness, are presented but note that for fair value hedges of interest rate risk, many financial institutions currently report these amounts in other income/expense.

How we see it

The Board's view that all changes in the fair value of the hedging instrument should be recognized in the same income statement line as the earnings effect of the hedged item would have different consequences in a fair value hedge than in a cash flow hedge.

Some constituents believe that, for fair value hedges, recognizing the entire change in fair value of the hedging instrument in the same income statement line where changes in the value of the hedged item are presented would reduce transparency of reporting about certain key income statement line items such as interest expense.

Consider a hedge of fixed-rate debt with an interest rate swap that is not fully collateralized. Under the proposal, valuation adjustments made to the overall fair value of the hedging instrument related to credit risk would be reported in current-period interest expense. While the effect of presenting these adjustments in interest expense would ultimately net out over the life of the hedging relationship (assuming there is no default on the hedging instrument), the proposal would result in increased volatility in interest expense reported in each period.

The following chart compares the recognition and presentation requirements for the various components of the change in a hedging instrument's fair value under today's guidance and under the proposal:

	Fair value hedges			
	Current guidance		Proposed guidance	
Hedging instrument's change in fair value	**Recognition**	**Income statement presentation**	**Recognition**	**Income statement presentation**
Ineffective portion*	Immediately in earnings	No guidance	Immediately in earnings	Same line item as hedged item effect
Effective portion*	Immediately in earnings	Same line item as hedged item effect	Immediately in earnings	Same line item as hedged item effect
Excluded component (e.g., time value of an option)	Immediately in earnings	No guidance	Immediately in earnings	Same line item as hedged item effect

* These amounts are included in the assessment of hedge effectiveness.

Benchmark interest rates

ASC 815 permits entities to designate interest rate risk as the hedged risk in fair value hedges of fixed-rate financial instruments but requires the designated risk to be defined as the changes in fair value attributed to one of the following benchmark interest rates:

- Direct Treasury obligations of the US government
- The London Interbank Offered Rate (LIBOR) Swap Rate
- The Fed Funds Effective Swap Rate (also referred to as the Overnight Index Swap Rate or OIS)

The proposal would add the SIFMA Municipal Swap Rate to the list of permissible benchmark rates. The SIFMA rate represents the rate at which municipalities with the highest credit quality can obtain short-term financing and is widely recognized and quoted in the US. For these reasons, the Board believes that it should be considered a benchmark rate.

Total coupon or benchmark rate coupon cash flows

In a fair value hedge of interest rate risk that does not qualify for the shortcut method, the change in the fair value of the hedged item (i.e., a fixed-rate debt instrument) attributable to changes in the benchmark interest rate must be determined quantitatively.

Current guidance includes various methodologies to measure the change in fair value of a fixed-rate debt instrument attributable to changes in the benchmark interest rate, but all require that the entire contractual cash flows of the hedged item, including the portion of the coupon payment in excess of the benchmark interest rate (i.e., credit spread), be used in the calculation performed. Because these excess cash flows are generally not present in the hedging instrument, a mismatch between the change in the fair value of the hedging instrument and the change in the fair value of the hedged item is created, and that difference is recognized immediately in earnings.

Over the years, the Board received feedback from many constituents who said that measuring changes in the fair value of the hedged item using the total coupon cash flows misrepresents the true effectiveness of these hedging relationships. They emphasized that these hedging relationships are not meant to manage credit risk, and that using the total contractual cash flows to determine the change in the fair value of the hedged item attributable to the change in the benchmark interest rate creates an earnings mismatch that reflects the portion of the financial instrument that the entity does not intend to hedge.

The proposal would add the SIFMA Municipal Swap Rate to the list of permissible benchmark interest rates.

The proposal would address this concern by allowing entities to use either (1) the full contractual coupon cash flows or (2) the benchmark component (determined at hedge inception) of the contractual coupon cash flows to calculate the change in the fair value of the hedged item in a fair value hedge of interest rate risk.

How we see it

This aspect of the proposal would result in fair value hedges of interest rate risk being more effective, but certain mismatches would likely continue to exist and cause earning volatility.

The proposal includes examples of how to determine the hedged item's change in fair value attributable to changes in the benchmark interest rate under two different methodologies.[13] While both examples conclude that the hedges are perfectly effective, we note that this likely would not be the case absent the assumptions that the FASB used to simplify these examples (e.g., a flat yield curve, no changes in the counterparty's creditworthiness). For example, if a hedging derivative is not fully collateralized, the credit risk associated with the derivative would continue to result in an earnings mismatch, even when benchmark cash flows are used to determine the change in the fair value of the hedged item. If the hedging derivative is fully collateralized, an earnings mismatch could still occur if different discount rates are used to measure the collateralized derivative (i.e., OIS discount rate) and the hedged item (i.e., LIBOR discount rate, assuming the benchmark interest rate being hedged is LIBOR).

We also note that the examples in the proposal illustrate calculations for only the first assessment period following hedge inception. We do not believe that both methodologies described in the examples would result in a perfect offset in subsequent assessment periods. Instead, we would expect the adjustment to the hedged item due to changes in interest rates to differ between the two methodologies, while the change in the fair value of the hedging derivative would be the same under both.

Sub-benchmark issue

The proposal would prohibit the use of benchmark cash flows to determine the change in the fair value of the hedged item in a fair value hedge of interest rate risk if the current market yield of the hedged item is less than the benchmark interest rate, at the inception of the hedging relationship. This situation is commonly referred to as the "sub-benchmark issue" and could occur when a high credit-quality borrower obtains financing at a fixed rate that is less than the current benchmark rate (i.e., the instrument has a "negative credit spread").

The proposal would require a comparison, at the inception of the hedging relationship, of the market yield of the hedged item with the benchmark interest rate being hedged, not the benchmark interest rate and the contractual coupon rate. This distinction is important for hedging relationships designated after the issuance of the fixed-rate financial instrument, which are known as "late hedges." By comparing the benchmark interest rate to the market yield of the hedged item at hedge inception, an entity would not be precluded from using benchmark cash flows to measure the change in fair value of the hedged item in a "late hedge" simply because benchmark interest rates have increased from the time the fixed-rate financial instrument was issued.

How we see it

This proposed limitation seems inconsistent with the treatment of negative credit spreads in cash flow hedges of interest rate risk. That is, a comparable limitation does not exist for an entity seeking to hedge interest rate risk in a variable-rate financial instrument whose coupon payments are based on a contractually specified variable interest rate (e.g.,LIBOR) less a fixed credit spread.

In addition, as noted in paragraph BC126 of the proposal, many stakeholders believe that "treasurers view risk management as managing cash flows (such as managing the fixed/floating cash flow profile) rather than managing instruments." With this view in mind, we find it difficult to understand why the treatment of a negative credit spread should differ when an entity hedges benchmark interest rate risk in a fair value hedge and a cash flow hedge if, in both instances, the entity is trying to manage its fixed/floating cash flow profile.

Prepayment features

A prepayment option that allows a hedged financial instrument to be settled before its scheduled maturity can also complicate a fair value hedge of interest rate risk. ASC 815-20-25-6 states that the effect of an embedded prepayment option should be "considered" when designating a hedge of interest rate risk. Many have interpreted this guidance to require the consideration of all factors that could cause the hedged item to be prepaid, including changes in interest rates and credit spreads, among other factors.

As a result, when hedging benchmark interest rate risk, a mismatch between the change in fair value of the hedging instrument and the hedged item will occur even when the hedging instrument includes a similar prepayment feature. This is because the factors, other than changes in interest rates, that could cause the hedged item to be prepaid would affect the prepayment feature in the hedging instrument differently, if at all. Some stakeholders have indicated that this mismatch, which is recognized in earnings immediately, can be so significant that the hedge would not be highly effective.

Under the proposal, when measuring the change in the fair value of a prepayable financial instrument that is the hedged item in a fair value hedge, an entity would be able to consider only how changes in the benchmark interest rate affect the decision to settle the hedged item

prior to its scheduled maturity. The Board believes that this proposed amendment would more accurately reflect the change in fair value of the hedged item attributable solely to interest rate risk.

Illustration 2 — Fair value hedge of callable debt

Assume that Entity ABC issued $100,000,000 of fixed-rate debt that is due in 10 years. The debt is issued at par and pays 5% interest due quarterly. The debt contains a call option that permits Entity ABC to prepay the debt at par plus accrued interest after five years. Entity ABC hedges the change in fair value of the debt due to changes in LIBOR by entering into a cancelable interest rate swap under which Entity ABC receives a fixed rate of 4% and pays the three-month LIBOR rate. The floating leg resets on a quarterly basis, and net settlements occur once each quarter.

Entity ABC accounts for the swap and debt as part of a fair value hedging relationship under ASC 815 and elects to compute the change in the fair value of the hedged item due to changes in LIBOR using the benchmark coupon payments.

Under current guidance, Entity ABC would consider how changes in its credit spread would affect its decision to exercise the call option when estimating the change in the debt's fair value due to changes in the benchmark interest rate. Under the proposal, Entity ABC would be able to ignore changes in its credit spread and consider only how changes in the benchmark interest rate would affect its decision to call the debt.

How we see it

Because the proposed guidance on measuring the effect of prepayment features when hedging changes in the benchmark interest rate of a fixed-rate financial instrument is written very broadly, there could be differing views on how to apply it.

For instance, some prepayment features in financial instruments are not exercisable unless a specified event occurs (e.g., there is a change in control). Since the proposal does not specifically address how contingently exercisable prepayment features in a hedged item would be assessed, it is unclear how entities would consider contingencies that are unrelated to interest rate risk. One approach could be to ignore the prepayment feature until the contingent event occurs. Another would be to determine the fair value of the prepayment feature based solely on changes in the benchmark interest rate and then multiply this value by the probability of the non-interest related contingent event occurring.

The Board may provide additional clarity on this issue in redeliberations.

Partial-term hedges

ASC 815 currently permits designating one or more contractual cash flows in a financial instrument (e.g., the first three years of interest rate payments on a five-year fixed-rate debt instrument) as the hedged item in a fair value hedge. However, it includes an example[14] that indicates that it would likely be difficult to find a derivative instrument that will be highly effective as a fair value hedge of selected fixed cash flows of a financial instrument. This lack of effectiveness would result from the fact that the hedging instrument (e.g., a three-year receive fixed, pay floating interest rate swap) and the hedged item (e.g., five-year fixed-rate debt) would react differently to changes in interest rates because the principal repayment of the debt occurs on a different date than the swap's maturity.

Stakeholders have identified the inability to hedge selected fixed interest rate payments in a fair value hedge as one of the weaknesses of the current hedge accounting model. They note that many entities view the purpose of their risk management activities as managing cash

flows (i.e., managing fixed versus variable cash flows) rather than managing instruments. They also note that the guidance on cash flow hedges allows entities to convert variable cash flows into fixed cash flows for a portion of the hedged item.

The proposal would address this inconsistency by allowing entities to measure the change in the fair value of the hedged item attributable to interest rate risk using an assumed term that begins with the first hedged cash flow and ends with the last hedged cash flow. That is, when measuring the change in the fair value of the hedged item attributable to the change in interest rate risk, entities could assume that the maturity of the hedged item, and thus principal repayment, occurs on the date when the last hedged cash flow is due and payable. As a result, partial-term fair value hedges could be highly effective when the assumed terms of the hedged item match those of the hedging instrument.

The following example, which is based on an example provided in the proposal,[15] illustrates this concept.

Illustration 3 — Fair value hedge of fixed-rate debt using the partial-term approach

On 1 January 20X1, Entity S issues a non-callable, five-year, $100,000,000 debt instrument with a 3% semiannual interest coupon. On the same date, the issuer also enters into a two-year interest rate swap with a notional amount of $100,000,000. Entity S designates the swap as a fair value hedge of the fixed-rate debt attributable to benchmark interest rate risk for the first two years of its term. The swap pays LIBOR and receives a fixed rate of 2% (annual rate), with payments made semiannually. The swap has a fair value of zero at inception. The designated benchmark interest rate is the LIBOR swap rate.

To simplify the example, the yield curve is assumed to be flat at the level of the current benchmark interest rate, and there are assumed to be no changes in creditworthiness that would change the effectiveness of the relationship.

Entity S elected to calculate fair value changes in the hedged item attributable to benchmark interest rate risk based on the benchmark component of the contractual coupon cash flows of the hedged item determined at hedge inception.

At 30 June 20X1, the LIBOR swap rate increased by 50 basis points to 2.5% (annual rate). The change in fair value of the interest rate swap for the period 1 January 20X1 to 30 June 20X1 is a decline of $731,633, calculated as follows:

- Receive fixed leg = semiannual fixed rate of 1% x $100,000,000 notional = $1,000,000 each period. Present value of fixed leg = [(1,000,000/$(1.0125)^1$) + (1,000,000/$(1.0125)^2$) + (1,000,000/$(1.0125)^3$)] = $2,926,534
- Pay floating leg (based on flat yield curve) = semiannual floating rate of 1.25% x ($100,000,000) notional = ($1,250,000) each period. Present value of floating leg = [(1,250,000 /$(1.0125)^1$) + (1,250,000/$(1.0125)^2$) + (1,250,000/$(1.0125)^3$)] = ($3,658,167)

In calculating the change in fair value of the debt attributable to changes in the benchmark interest rate, Entity S assumes the debt has the same maturity as the hedging instrument (i.e., two years). The change in fair value of the debt attributable to changes in the benchmark interest rate for the period 1 January 20X1 to 30 June 20X1 is a gain of $731,633, calculated as follows:

- Beginning balance (discounted using semiannual rate of 1% on 1 January 20X1) = (1,000,000/$(1.01)^1$) + (1,000,000/$(1.01)^2$) + (1,000,000/$(1.01)^3$)+ (101,000,000/$(1.01)^4$) = $100,000,000

- Ending balance (discounted using semiannual rate of 1.25% on 30 June 20X1) = $(1,000,000/(1.0125)^1) + (1,000,000/(1.0125)^2) + (101,000,000/(1.0125)^3)$ = $99,268,367

By assuming the maturity of the debt is the same as the maturity of the hedging instrument and using the benchmark coupon rate to compute the change in fair value of the hedged item due to changes in the benchmark interest rate, Entity S determines that the change in fair value of the hedged item perfectly offsets the change in fair value of the hedging instrument.

While this example relates to a hedge of the first two years of interest payments associated with an existing financial instrument, the proposal would permit an entity to hedge any consecutive interest payments associated with an existing financial instrument.

The proposal also clarifies how permitting partial-term fair value hedging would interact with the guidance on portfolio hedges and the requirements for using the shortcut method.

Portfolio hedges

ASC 815-20-25-12(b)(1) requires that if similar assets or similar liabilities are aggregated and hedged as a portfolio, the individual assets or individual liabilities must share the risk exposure for which they are designated as being hedged. The change in fair value attributable to the hedged risk for each individual item in a hedged portfolio is expected to respond in a generally proportionate manner to the overall change in fair value of the aggregate portfolio attributable to the hedged risk.

The proposal would allow entities to apply the shortcut method to partial-term fair value hedges of interest rate risk.

In a partial-term hedge of interest rate risk, the proposal would allow entities to determine whether a group of fixed-rate financial instruments meets this requirement by considering the assumed maturity of the instruments in the portfolio (i.e., the term of the cash flows designated as being hedged) rather than the contractual maturity of these instruments. For example, assuming all other requirements were met, an entity could hedge only the first four years of interest coupons in a portfolio of fixed-rate loans with various scheduled maturity dates that exceeded four years.

Shortcut method

The proposal would allow entities to apply the shortcut method to partial-term fair value hedges of interest rate risk even though the expiration date of the interest rate swap used as the hedging instrument does not match the actual maturity date of the interest-bearing asset or liability being hedged. As long as all other criteria to apply the shortcut method are satisfied, an entity could apply the shortcut method as the assumed maturity date of the hedged item would be deemed to match the expiration date of the hedging instrument.

One of the criteria to qualify for the shortcut method is that the interest-bearing asset or liability being hedged can generally not be prepayable.[16] However, under the proposal, the shortcut method could be applied to partial-term hedges of fixed-rate financial instruments that are prepayable, as long as the instrument cannot be prepaid before its assumed maturity date (and all other criteria to qualify for the shortcut method are satisfied).

For example, assume Company X issued a 10-year fixed-rate instrument with an embedded call option that was exercisable only after year seven. The proposal would permit Company X to designate a fair value hedge of interest rate risk for a term ending any time prior to the date the call option becomes exercisable in year seven and qualify for the shortcut method, assuming all other conditions for that method are met.

Proposed amendments to cash flow hedges

Recognition and presentation of the effects of hedging instruments

Under today's guidance, the change in the fair value of the hedging instrument included in the effectiveness assessment of a cash flow hedge is split into two components: (1) the effective portion and (2) the ineffective portion. The ineffective portion is the amount by which the cumulative change in the fair value of the hedging instrument exceeds the cumulative change in expected cash flows on the hedged transaction from the inception of the hedging relationship. ASC 815 provides various ways to calculate the cumulative change in expected cash flows of the hedged transaction. For example, ASC 815-30-35 provides the following approaches for hedges involving interest rate swaps: (1) the change-in-variable-cash-flows method, (2) the hypothetical-derivative method and (3) the change-in-fair-value method.

Currently, an entity is required to measure and immediately recognize in earnings any ineffectiveness related to a cash flow hedge, although ASC 815 does not specify the income statement line where ineffectiveness should be presented. The effective portion of the change in the fair value of the hedging instrument is deferred in AOCI until the hedged transaction affects earnings, and it is then reclassified from AOCI to the same income statement line as the earnings effect of the hedged item.

The proposal would eliminate the requirement to separately measure and report ineffectiveness. Instead, the entire change in the fair value of the hedging instrument included in the assessment of hedge effectiveness would be deferred in AOCI until the hedged transaction affects earnings. At that time, this amount would be reclassified from AOCI to the same income statement line as the earnings effect of the hedged item.

How we see it

While the proposal would eliminate the current requirement to separately measure and report ineffectiveness, the extent to which a hedging instrument does or does not offset changes in the fair value or cash flows of the hedged item would still be important for cash flow hedges.

To initially qualify for hedge accounting, an entity must expect the hedging instrument to be highly effective at offsetting changes in the fair value or cash flows attributable to the hedged risk during the period that the hedge is designated. To maintain hedge accounting, an ongoing assessment of hedge effectiveness indicating that the hedging instrument has been, and is expected to continue to be, highly effective at offsetting these changes is required. Although the FASB didn't define the term "highly effective" in the proposal, practice has consistently interpreted the term to mean an offset of 80% to 125%.

Even for hedging relationships determined to be highly effective, the income statement line where the hedged item is reported will ultimately be affected if the hedging instrument is not perfectly effective at offsetting changes in the fair value or cash flows attributable to the hedged risk. Any mismatch will be reported in this line item when the hedged transaction affects earnings.

Excluded components

As previously noted, under ASC 815, an entity may elect to exclude the time value associated with option and forward contracts used as hedging instruments from the assessment of hedge effectiveness. Changes in these excluded components are recognized in earnings immediately. While current guidance does not specify the income statement line in which these amounts should be presented, many companies present them in other income or expense.

The proposal would require changes in these excluded components to be presented in the same income statement line item as the earnings effect of the hedged item as illustrated in the following example.

Illustration 4 — Presentation of excluded component

Entity A manufactures gold watches and forecasts the purchase of 1,000 troy ounces of gold in the next six months. To hedge against a price increase above $1,300/troy ounce in the next six months, Entity A purchases an option that provides it with the right, but not the obligation, to purchase 1,000 troy ounces of gold at a fixed price of $1,300/troy ounce. If the market price does not exceed that strike price, the option will expire unexercised. The purchase price of the option is $1 million, which represents the time value of the option at inception.

Assume that Entity A designates the purchased option in a cash flow hedging relationship and elects to assess hedge effectiveness based solely on the option's intrinsic value, pursuant to ASC 815-20-25-82 and 815-30-35-3. While changes in the option's intrinsic value would be deferred in AOCI and reclassified to cost of goods sold when the gold watches are ultimately sold, changes in the option's time value would be recognized immediately in cost of goods sold. As result, the decay of the option's time value could affect Entity A's reported cost of goods sold over multiple periods before the watches are sold.

Although some may consider these excluded amounts to be outside of the hedging relationship since they are not considered when assessing hedge effectiveness, the Board believes these amounts, along with the effective and ineffective portions of the hedging relationship, represent the total cost of hedging. As such, the proposal would require the entire change in the fair value of the hedging instrument in a cash flow hedge to be presented in the same income statement line item as the earnings effect of the hedged item.

How we see it

The proposal would require entities to present changes in any excluded components in the income statement line where the effect of the hedged item is reported, but does not amend the existing requirement in US GAAP that these changes be recognized in earnings immediately. This could create volatility in these line items that stems not only from the proposed presentation requirement but also from the mismatch in the timing of when the excluded amount is recognized in earnings and when the hedged item and the rest of the changes in the fair value of the hedging derivative are recognized in earnings.

One potential fix the FASB could consider to address concerns about volatility distorting key income statement line items would be to allow the change in excluded time value of the hedging instrument to be deferred and recognized in earnings at the same time the hedged item affects earnings. Such an approach would be consistent with the treatment of these amounts under IFRS 9 and the treatment of an option's time value under US GAAP when hedge effectiveness is based on an option's terminal value. Alternatively, the FASB could consider allowing the time value of the hedging instrument to be recognized in earnings on a systematic and rational basis over the life of the hedge, if this amount is excluded from the assessment of hedge effectiveness.

The following chart compares the recognition and presentation requirements for the various components of the change in a hedging instrument's fair value under today's guidance and under the proposal:

	Cash flow hedges			
	Current guidance		Proposed guidance	
Hedging instrument's change in fair value	**Recognition**	**Income statement presentation**	**Recognition**	**Income statement presentation**
Ineffective portion*	Immediately in earnings	No guidance	AOCI until hedged item affects earnings	Same line item as hedged item effect
Effective portion*	AOCI until hedged item affects earnings	Same line item as hedged item effect	AOCI until hedged item affects earnings	Same line item as hedged item effect
Excluded component (e.g., time value of an option)	Immediately in earnings	No guidance	Immediately in earnings	Same line item as hedged item effect

* These amounts are included in the assessment of hedge effectiveness.

Amounts reclassified from AOCI due to a missed forecasted transaction would be presented where the hedged item would have affected earnings.

Missed forecasted transactions

When it becomes probable that a forecasted transaction will not occur within the originally specified time period (as documented at the inception of the hedging relationship) or two months thereafter (as provided for in ASC 815-30-40-4), the hedging relationship must be dedesignated, and any deferred gains and losses on the derivative instrument that have been recorded in AOCI must be reclassified into earnings. ASC 815 does not currently specify the income statement line where this amount should be presented.

The proposal would require that the amount reclassified from AOCI in these situations be presented in the same income statement line as the effect of the hedged item had the transaction occurred within the required time period. This presentation is consistent with the Board's view that the entire change in the fair value of the hedging instrument should be considered part of the cost of hedging and, therefore, presented in the same income statement line as the effect of hedged item. The Board notes in paragraph BC64 of the proposal that it believes that changes in the fair value of the hedging derivative represent a cost of hedging, regardless of whether the forecasted transaction occurs.

Component hedging

US GAAP currently contains limitations on how an entity can designate the hedged risk in certain cash flow hedging relationships. The proposal would expand the types of permissible hedging strategies to include hedging the variability in cash flows due to changes in:

- A contractually specified component in the forecasted purchase or sale of a nonfinancial asset
- A contractually specified variable interest rate in a variable-rate financial instrument

The Board believes that expanding the ability for entities to hedge specific risk components would result in financial reporting that more accurately reflects an entity's risk management activities. In addition, the Board believes that designating the variability in cash flows attributable to changes in a contractually specified component or interest rate as the hedged risk is objective and would be relatively straightforward to apply.

Nonfinancial items

Except for foreign exchange risk, ASC 815 does not currently allow entities to hedge risk components related to the forecasted purchase or sale of a nonfinancial asset such as a commodity. For example, if an entity wants to hedge the price risk related to the forecasted purchase or sale of a commodity, it is required to designate changes in the total price of the commodity as the hedged risk. The total price to purchase or sell a commodity at a specific location typically comprises a base price or market index (e.g., New York Mercantile Exchange or NYMEX price of natural gas at Henry Hub in Louisiana) and a basis differential related to the location and/or the grade of the commodity involved (e.g., transportation costs, quality, supply and demand).

However, many entities employ hedging strategies that focus on hedging a particular component of the total price. As a result, the current requirement that the hedged risk be designated as the variability in total price leads to the recognition of ineffectiveness or, in some cases, the failure to qualify for hedge accounting. This is the case even though the variability that creates the ineffectiveness, or the inability to apply hedge accounting, typically results from a factor (e.g., basis risk) that the entity never intended to hedge.

By allowing entities to hedge nonfinancial risk components, the proposal would resolve for components that are contractually specified, what many have long believed to be a fundamental weakness in the existing hedge accounting model.

Contractually specified components

The proposal would define 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. An example of this would be a contract for the sale of natural gas that is contractually linked to the Henry Hub (Louisiana) NYMEX price (i.e., Henry Hub, plus or minus a basis differential).

How we see it

While the proposed definition of a contractually specified component refers to an index or price explicitly referenced in an agreement, the proposal does not define what constitutes an agreement.

As such, it is not clear whether the counterparties would be required to have a legally binding obligation to provide a payment or product (e.g., a commodity) before the transaction is executed. For example, it is not clear whether an entity could designate a contractually specified component as the hedged risk in the forecasted purchase or sale of a commodity in the spot market if it receives an invoice or receipt at the time of purchase or sale that specifies how the spot price was determined (i.e., the spot price is decomposed).

If the FASB clarifies that a component needs to be specified in a legally binding agreement, this could limit an entity's ability to hedge contractually specified components in certain situations.

The following illustration, which is based on an example in the proposal,[17] shows how a contractually specified risk component can be defined and assessed for hedge effectiveness.

Illustration 5 — Cash flow hedge of a contractually specified component in a forecasted purchase of a nonfinancial asset
An entity manufactures keys for door locks. On 1 January 20X1, the entity enters into an agreement with a supplier to purchase 100,000 key plates on 1 July 20X1. The contract specifies a per-unit purchase price comprising the spot price of COMEX copper, the spot price of COMEX zinc, the current cost of refining copper and zinc into key plates and the current cost of transporting the key plates to the entity as of the delivery date. The key plates will require 10,000 pounds of copper for the manufacturing process. The entity would like to hedge the variability in the cost of the key plates attributable only to the change in the price of copper. Therefore, on 1 January 20X1, the entity enters into a forward contract to purchase 10,000 pounds of COMEX copper on 1 July 20X1 at a fixed price and designates it in a cash flow hedge of the forward purchase of key plates for the variability in the purchase price attributable to changes in the COMEX copper price index. As long as all of the critical terms of the hedging relationship match (i.e., notional, index and settlement date), the hedging relationship would be perfectly effective. However, the entity's assessment of effectiveness would need to incorporate the effect of a change in timing if the hedging instrument's maturity date and the date on which the price of the copper component is expected to be fixed no longer match.

The proposal would permit an entity to designate the variability in cash flows attributable to changes in a contractually specified component as the hedged risk in the forecasted purchase or sale of a nonfinancial asset for a period longer than the contractual term of the agreement or for a not-yet-existing contract to purchase or sell a nonfinancial asset. However, all the conditions required to hedge a nonfinancial component (including the additional criteria discussed below) would need to be met in the future contract, as well as all the other requirements for cash flow hedge accounting.

The following example, which is based on an example in the proposal,[18] illustrates the designation of a contractually specified component in a contract that doesn't exist yet.

Illustration 6 — Hedge of a contractually specified component in a contract that doesn't exist yet
Entity A's objective is to hedge the variability in cash flows attributable to changes in a contractually specified component to purchase soybeans in six months, on 30 June 20X1. Entity A only purchases soybeans from Supplier Z, and Entity A only has executed contracts to purchase soybeans from Supplier Z from 1 January 20X1 through 31 March 20X1. All of Entity A's contracts to purchase soybeans from Supplier Z are based on the ABC soybean index price, plus a basis differential for transportation costs that varies. Entity A expects that the forecasted transaction to purchase soybeans from Supplier Z on 30 June 20X1 will be based on the ABC soybean index price, plus a basis differential. On 1 January 20X1, Entity A designates the variability in cash flows attributable to changes in the contractually specified ABC soybean index in the contract it expects to enter into as the hedged risk in a cash flow hedging relationship. (Although Entity A designates this hedging relationship on 1 January 20X1, it could enter into a derivative and designate it as the hedging instrument in a hedging relationship at any time before it enters into the contract on 31 March 20X1.)

On 31 March 20X1, Entity A enters into a contract with Supplier Z to purchase soybeans on 30 June 20X1. If the contract references a different contractually specified component than the designated ABC soybean index or the contract is a fixed-price contract, Entity A would discontinue hedge accounting in accordance with the guidance in ASC 815-30-40-1 through 40-6 because the designated hedged risk is not present in the executed contract. If it is still probable that the hedged forecasted cash flows will occur, the net gain or loss on the hedging instrument in AOCI would not be reclassified into earnings immediately. Instead, Entity A would reclassify amounts from AOCI to earnings when the hedged forecasted transaction affects earnings in accordance with ASC 815-30-35-38 through 35-41 and present those amounts in the same income statement line item as the earnings effect of the hedged item.

Immediate reclassification would be required only if it becomes probable that the hedged forecasted transaction (that is, the purchase of soybeans on 30 June 20X1) will not occur. As discussed in ASC 815-30-40-5, if an entity has a pattern of determining that it is not probable that hedged forecasted transactions will occur, that would call into question both the entity's ability to accurately predict forecasted transactions and the propriety of applying cash flow hedge accounting for similar forecasted transactions in the future.

As noted in the example above, if the contract that is executed references a contractually specified component that differs from the contractually specified component that was designated at hedge inception or is a fixed-price contract, the entity would discontinue the hedging relationship because the designated hedged risk would not be present in the executed contract. However, unless it becomes probable that the hedged forecasted transaction (i.e., the purchase of soybeans) will not occur on 30 June 20X1, or within two months thereafter, the gain or loss on the hedging instrument previously deferred will remain in AOCI until the hedged forecasted transaction affects earnings.

How we see it

Although the proposed guidance on hedging nonfinancial risk components would benefit many companies, some entities would likely continue to be required to designate the total price risk as the hedged risk related to the forecasted purchase or sale of nonfinancial assets.

This would be the case if the component the entity wishes to hedge is not contractually specified. For example, many airlines hedge forecasted purchases of jet fuel with crude oil derivatives. Because a purchase contract for jet fuel generally does not specify the crude oil price as a component of the total price, an airline would not be permitted to designate only changes in the crude oil price as the hedged risk, even though the price of crude oil and the price of jet fuel may be highly correlated. The airline would be required to designate the hedged risk as the total purchase price of the jet fuel.

Another example would be entities that purchase commodities using fixed-price contracts. In many instances, because a fixed-price contract can only be entered into one to two months prior to delivery of the product, entities will hedge the variability in the commodity price they are exposed to prior to entering the fixed-price contract (i.e., the variability in price from the date the forecasted purchase is deemed probable, which may be six months in advance of delivery, to the date when the fixed-price contract is entered into, which may be one month prior to delivery). In these situations, the example in the proposal would suggest that an entity would be required to continue to hedge the variability in the total price risk (including basis risk) during this period.

It should be noted that if the hedging relationship is highly effective, the effect of a cash flow hedge on the entity's financial statements would be virtually identical, regardless of whether the designated risk is the total price risk or a component of the total price risk. This is because under the proposal, the entire change in fair value of the derivative included in the assessment of a highly effective cash flow hedge would be deferred in AOCI and recognized in the income statement line affected by the hedged item only when that hedged item affects earnings.

However, hedges of total price risk have a greater likelihood of losing hedge accounting (e.g., due to volatility in the basis) and could require additional effort to assess hedge effectiveness.

In addition to requiring the index or price to be contractually specified, the proposal would require the following conditions to be met for an entity to designate a nonfinancial component as the hedged risk in a cash flow hedge:

- The purchase or sale contract for the nonfinancial asset creates an exposure related to the variability in cash flows attributable to 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 (e.g., transportation costs, labor costs, local supply and demand factors).
- All of the stated components of the price of the nonfinancial contract reflect market conditions at contract inception (e.g., transportation costs reflect market conditions for the distance between the supplier and the customer).

Component hedging for variable-rate financial instruments would be expanded beyond benchmark interest rates.

It's important to note that the first condition listed above would not prevent an entity from hedging a contractually specified component that is limited by a cap or floor, even when the hedging instrument does not contain a similar cap or floor. However, in these instances, the effect of the price cap or floor in the hedged item must be considered when establishing whether the hedging relationship will be highly effective in accordance with the guidance in ASC 815-20-25-75, 25-79(a) and 25-100. This is consistent with the requirements for other hedging relationships where the hedged exposure is limited and the hedging instrument is not (e.g., debt with an embedded floor at 0% hedged with a plain vanilla interest rate swap).

The second and third conditions are intended to address the Board's concerns that an entity could (1) inappropriately elect hedge accounting by fabricating a contractually specified component to which the entity does not have price exposure and then enter into a derivative to hedge that component or (2) specify a component in a contract that it may not have price exposure to if other terms of the contract are written in a way that the exposure to the component is mitigated or eliminated.

Financial items

Under today's guidance, entities are limited to hedging benchmark interest rates in cash flow hedges of variable-rate financial instruments. Accordingly, if a variable-rate financial instrument is indexed to a nonbenchmark interest rate, entities are required to designate the overall variability in cash flows as the hedged risk. The proposal would allow an entity to designate any contractually specified interest rate in a variable-rate financial instrument as the hedged risk in a cash flow hedge. For example, an entity could hedge the variability in cash flows of a variable-rate financial instrument due to changes in the prime rate, as long as this rate is contractually specified in the instrument. This guidance would apply to cash flow hedges of existing variable-rate financial instruments, as well the forecasted issuance or purchase of a variable-rate financial instrument.

The proposal would also provide guidance on designating a hedge of interest rate risk associated with a forecasted issuance or purchase of a debt instrument if the entity does not know at the designation date whether the debt will have fixed or variable interest rate payments. In this case, the interest rate designated as the hedged risk would be required to qualify both as a benchmark interest rate (for the purchase or sale of fixed-rate debt) and as a contractually specified interest rate (for the purchase of sale of variable-rate debt). Therefore, any benchmark rate specified in ASC 815 (e.g., LIBOR) would meet this requirement as long as it is contractually specified when a variable-rate debt instrument is issued or purchased.

Critical terms match method of assessment

Under today's guidance, certain cash flow hedging relationships are assessed qualitatively by comparing the critical terms of the hedging instrument with those of the hedged item every period. If the critical terms match, an entity may assume that the hedging relationship is perfectly effective and, therefore, highly effective retrospectively and prospectively.

While the SEC staff historically interpreted "match" to mean "match exactly," the staff's comments at an Emerging Issues Task Force meeting in 2007 led to the development in practice of what is known as the "de minimis" test. Under this approach, the critical terms match method can be applied when the terms of the hedging instrument do not exactly match those of the hedged item if a quantitative analysis is performed at hedge inception to support an assertion that any ineffectiveness would not exceed a de minimis amount. This approach is often applied to a cash flow hedge of a group of forecasted transactions using a single hedging instrument (e.g., hedging variability in monthly sales denominated in a foreign currency due to changes in foreign exchange rates with a single foreign exchange forward contract).

The proposal would allow an entity to apply the critical terms match method to a group of forecasted transactions without performing a de minimis test if the forecasted transactions occur within the same 31-day period as the maturity of the hedging derivative.

The Board views this proposed amendment as a reasonable accommodation for hedges of groups of forecasted transactions that occur within a narrow time frame that otherwise would meet all of the criteria to apply the critical terms match method. This is based on the Board's belief that when a single derivative is designated and is highly effective as a hedge of a group of exposures in which the settlement of individual transactions and the derivative instrument occur within the same 31-day period but on different days, any mismatches between the change in the fair value of the hedging instrument and the individual hedged forecasted transactions would be minimal.

The following illustration highlights how this approach would be applied.

Illustration 7 — Proposed 31-day rule for applying critical terms match

Company A, whose functional currency is US dollars, expects to have euro-denominated sales throughout the year. To limit its exposure to the dollar/euro exchange rate over the next year, Company A designates a series of forward contracts to buy US dollars and sell euros as the hedging instruments in cash flow hedges of its forecasted monthly euro sales in each of the next 12 months. Each forward contract hedges the first 1 million euros in sales each month. The forward contracts mature at the end of each month in which the forecasted sales occur.

Because the hedged forecasted monthly sales occur within the same 31-day period as the forward contracts' maturities, Company A could elect to assess hedge effectiveness using the critical terms match method without performing a quantitative analysis to support that any ineffectiveness would not exceed a de minimis amount.

How we see it

This accommodation would apply only to a group of forecasted transactions, not to hedges of individual forecasted transactions. That is, the proposal would not provide a 31-day "window" for individual forecasted transactions to qualify for use of the critical terms match method or to continue to use this method if any of the critical terms have changed.

For example, an entity that initially assesses the effectiveness of a cash flow hedge of a single forecasted transaction using the critical terms match method (because its best estimate of the timing matches the terms of the hedging instrument) would be required to perform subsequent quantitative assessments of hedge effectiveness if the expected timing of the forecasted transaction changes (even if the expected change in timing is less than 31 days).

Foreign currency hedges

The proposal would continue to permit the following hedges of foreign currency exposure:

- A fair value hedge of an unrecognized firm commitment or a recognized asset or liability (including an available-for-sale security)
- A cash flow hedge of any of the following:
    - A forecasted transaction
    - An unrecognized firm commitment
    - The forecasted functional-currency-equivalent cash flows associated with a recognized asset or liability
    - A forecasted intra-entity transaction
- A hedge of a net investment in a foreign operation

The proposed amendments to the guidance on cash flow and fair value hedges discussed in the previous sections of this publication would also apply to cash flow and fair value hedges of foreign currency exposures. While the same is generally true for net investment hedges, certain aspects of the proposal differ.

Recognition and presentation of the effects of hedging instruments

The entire change in the fair value of a hedging instrument included in the assessment of hedge effectiveness in a net investment hedge would be recorded in the cumulative translation adjustment (CTA) section of AOCI. That amount would remain in the CTA section of AOCI until the period in which the hedged item affects earnings (e.g., the foreign subsidiary is sold). At that time, the amount in the CTA section of AOCI would be reclassified to the same income statement line where the earnings effect of the hedged item is presented

Today's guidance on net investment hedges requires measuring and recognizing immediately in earnings any ineffectiveness, regardless of whether the relationship is underhedged or overhedged. Therefore, the proposal to eliminate the requirement to separately measure and report ineffectiveness could be viewed as having a greater effect on net investment hedges than on cash flow hedges for which ineffectiveness is currently recognized only for overhedges. In addition, because amounts accumulated in the CTA section of AOCI are not released until a sale or liquidation of the hedged investment in a foreign entity, "ineffectiveness" under the proposal that would be deferred in the CTA section of AOCI may never be recognized in earnings.

Excluded components

The proposal would not require the change in time value excluded from the assessment of a net investment hedge to be presented in the same income statement line as the earnings effect of the hedged item. Like today's guidance, the proposal would not specify the income statement line in which excluded components in net investment hedges should be presented.

The Board noted in paragraph BC77 of the proposal that requiring the excluded component in a net investment hedge to be presented in the same income statement line as the earnings effect of the hedged item could result in the presentation in a line item called "gain or loss on the sale of subsidiary," when a sale did not occur in the current period and may not occur within a reasonable time period, if at all. The Board did not believe that mandating this presentation would be an improvement to financial reporting.

The following chart compares the recognition and presentation requirements for the various components of the change in a hedging instrument's fair value under today's guidance and under the proposal:

The proposal would not specify the income statement line where excluded components in net investment hedges should be presented.

	Net investment hedges			
	Current guidance		Proposed guidance	
Hedging instrument's change in fair value	**Recognition**	**Income statement presentation**	**Recognition**	**Income statement presentation**
Ineffective portion*	Immediately in earnings	No guidance	CTA until hedged item affects earnings	Same line item as hedged item effect
Effective portion*	CTA until hedged item affects earnings	Same line item as hedged item effect	CTA until hedged item affects earnings	Same line item as hedged item effect
Excluded component (e.g., time value of an option)	Immediately in earnings	No guidance	Immediately in earnings	No guidance

* These amounts are included in the assessment of hedge effectiveness.

Disclosures

The proposal would modify the disclosure requirements for both interim and annual reporting periods. The Board believes the proposed changes would enhance disclosures of an entity's hedging activities and the effect those activities have on the financial statements. The proposed disclosures include:

- A revised tabular disclosure that shows the effect of hedge accounting by income statement line
- The cumulative basis adjustment to the hedged item in fair value hedges
- A description of any quantitative goals of the entity's hedging program and whether they were met

Tabular disclosures that show the effect of hedge accounting by income statement line

The proposal would amend the tabular disclosure requirements regarding the effect of hedge accounting on the income statement as follows:

- For fair value, cash flow and net investment hedges, the current requirement to disclose the ineffective portion of gains and losses on hedging instruments and related hedged items would be eliminated because this amount would no longer be separately measured and reported.
- For fair valued hedges, entities would be required to include in the tabular disclosures the amount of periodic gains and losses on hedged items, as well as the amount of gains and losses on hedging instruments excluded from the assessment of effectiveness.
- For fair value and cash flow hedges, entities would be required to disclose the total amount of each income and expense line in the income statement in which hedge accounting adjustments have been recorded, as well as the amount of gains and losses from both hedging instruments and hedged items that are included in these line items, so that users would have all relevant information in one location.

The FASB believes these proposed changes would not require entities to generate any new information and would better reflect the results of its proposed cost of hedging model where the full change in the fair value of the designated hedging instrument would be presented in the same income statement line item as the earnings effect of the hedged item.

The cumulative basis adjustment to the hedged item in fair value hedges

Under today's guidance, an entity is required to disclose the periodic basis adjustments to the hedged item in a fair value hedge, either in a tabular or non-tabular format. The proposal would require the following additional information to be disclosed regarding the hedged item in a fair value hedge:

- The carrying value of the hedged item recognized in the statement of financial position
- The cumulative amount of fair value hedging adjustments to the hedged item included in the carrying amount of the hedged item recognized in the statement of financial position
- The specific line in the statement of financial position that includes the hedged item
- The cumulative amount of fair value hedging adjustments remaining for any hedged items for which hedge accounting has been discontinued

The Board believes the additional disclosures would assist users in evaluating the amount, timing and uncertainty of prospective cash flows associated with hedged assets or liabilities.

A description of the quantitative goals of the entity's hedging program

US GAAP currently requires an entity that holds or issues derivative instruments (or nonderivative instruments that are designated as hedging instruments) to disclose the following:

- Its objectives for holding or issuing those instruments
- The context needed to understand those objectives
- Its strategies for achieving those objectives

To help users better understand an entity's objectives and success in hedging its risk exposures, the proposal would require an entity to disclose its quantitative goals, if any, that it sets when developing its hedging objectives and strategies and whether it met those goals. The proposal provides an example of an entity disclosing that its goal is to apply hedge accounting to 80% of forecasted commodity purchases in 20X3, 20X2 and 20X1, and that this goal was met.

This disclosure requirement would relate only to hedge accounting activities that have occurred in the current and prior financial reporting periods.

How we see it

It is not clear to us whether requiring entities to disclose their quantitative hedge accounting goals, if any, and whether those goals were met would result in decision useful information for financial statement users. Because this disclosure would focus solely on an entity's hedge accounting objectives and would not include information about the entity's broader risk management strategies, the information would potentially be incomplete and its usefulness would seem to be limited. For instance, many financial institutions manage their exposure to interest rate risk through a variety of techniques that might include offsetting interest-bearing asset and liability positions, entering into economic hedges, and electing the fair value option as a means to reduce earnings volatility resulting from accounting mismatches, in addition to entering into strategies that qualify for hedge accounting.

Even when only strategies to which hedge accounting is applied are used, the proposed disclosures may not include all relevant information. Consider a USD functional reporting entity that has forecasted future monthly revenues and expenses in euros (e.g., forecasted revenue of 1,000 euros and forecasted expenses of 700 euros). Economically, this entity would like to hedge its net margin in euros (i.e., 300 euro). However, because ASC 815 prohibits hedging offsetting exposures on a net basis, from an accounting perspective the entity would need to document that it was hedging an amount of either its forecasted gross euro-denominated revenues or euro-denominated expenses (e.g., hedging the first 300 of monthly euro revenue). Requiring this entity to disclose that its quantitative goal was to hedge 30% of its monthly euro denominated revenue would not provide useful information about its actual risk management strategy.

Transition

Entities would apply the proposal on a modified retrospective basis to hedging relationships that exist at the date of adoption. Existing relationships would be those in which the hedging instrument has not expired, been sold, terminated or exercised or relationships that the entity has not dedesignated.

The proposal would not apply to amounts in AOCI as of the adoption date that relate to hedging relationships that no longer exist (e.g., amounts associated with a cash flow hedge of interest rate risk related to the forecasted issuance of fixed-rate debt where the hedging relationship was terminated years earlier when the debt was issued).

For existing cash flow and net investment hedges, an entity would record the cumulative effect of applying the proposal as an adjustment to the opening balance of retained earnings as of the most recent period presented at the date of adoption with an offsetting adjustment to AOCI.

How we see it

We believe this approach is superior to either a prospective or full retrospective transition approach when considered from a cost/benefit perspective. Transition on a prospective basis could result in entities needing to apply two different hedge accounting models until their existing hedges expire. Full retrospective transition would also be costly and complex because it would require entities to apply the guidance to hedging relationships that no longer exist as of the date of adoption.

However, it's worth noting that applying the modified retrospective approach could result in previously recognized hedge ineffectiveness for cash flow hedges being reported through earnings more than once. Consider an existing hedge of a single cash flow with ineffectiveness of $100 that has been recognized in earnings prior to adoption. Under the proposal, this amount would be recorded in AOCI upon adoption with an offset to beginning retained earnings. When the hedged item affects earnings, this amount could once again be recorded in earnings as part of the reclassification of amounts in AOCI to earnings.

The proposed disclosure requirements would be required only prospectively. As such, an entity would continue to provide disclosures in accordance with the current guidance for comparative periods before the date of adoption. However, in accordance with the requirements of ASC 250, an entity would need to disclose the following information in each interim and annual financial statement period in the fiscal year of adoption:

- The nature of and reason for the change in accounting principle
- The cumulative effect of the change on the opening balance of each affected component of equity or net assets in the statement of financial position as of the date of adoption

Early adoption of the proposal would be permitted at the beginning of any fiscal period before the effective date.

The Board will set an effective date after it considers feedback on the proposal. However, the proposal indicates that early adoption would be permitted at the beginning of any fiscal period before the effective date.

One-time elections

The proposal would provide three one-time elections an entity could use to apply aspects of the proposal to existing hedging relationships.

Subsequent qualitative assessments

During the first fiscal year after adoption, an entity would be able to elect to modify its hedge documentation of an existing hedging relationship to specify that subsequent prospective and retrospective effectiveness assessments will be performed qualitatively rather than quantitatively.

Misapplication of shortcut method

During the first fiscal year after adoption, an entity would be able to elect to modify its hedge documentation for existing hedging relationships assessed under the shortcut method to specify a quantitative assessment methodology to be used if it determines that it inappropriately applied the shortcut method.

Hedging contractually specified components in a cash flow hedge

Before its first quarterly assessment of effectiveness after adoption, an entity would be able to elect to amend its hedge documentation for existing cash flow hedging relationships to specify the hedged risk as a contractually specified component (for nonfinancial items) or a contractually specified interest rate (for variable-rate financial instruments).

However, the Board noted that changing the hedged risk would trigger a dedesignation of the existing hedging relationship, and that redesignating the same hedging instrument would likely result in the ongoing hedging relationship being less effective. This is because when the hedge is redesignated, the actual hedging instrument would likely have a fair value that isn't zero, while the hypothetical derivative used to assess hedge effectiveness would have a fair value of zero because its terms are required to be set at market rates as of the hedge inception date.

To allow entities to more accurately reflect their risk management activities immediately upon adoption, the proposal would permit entities to set the market terms of the hypothetical derivative to those that existed on the original hedge inception date rather than the market terms on the date the hedging relationship is redesignated.

Transition considerations for fair value hedges of interest rate risk

The proposal would provide transition guidance for entities that want to incorporate certain of the proposed amendments to their existing fair value hedges of interest rate risk. This could include modifying existing hedging relationships to:

- Calculate the change in fair value of the hedged item using only the benchmark cash flows
- Calculate the change in fair value of a prepayable hedged item considering only how changes in the benchmark interest rate affect the decision to exercise an embedded prepayment feature
- Change the hedged risk from total price risk to interest rate risk related to the SIFMA rate

To make any of these changes to existing fair value hedges of interest rate risk, an entity would be required to dedesignate and redesignate the hedging relationship. However, the proposal provides different guidance with respect to how the effect of these changes would be subsequently accounted for.

For the first two types of changes, the cumulative basis adjustment to the hedged item related to the dedesignated hedging relationship would be carried forward to the hedged item in the redesignated hedging relationship at an amount that would have been recorded if the revised measurement methodology had been used throughout the hedging relationship's life. The change in the basis adjustment of the hedged item would be recorded with a corresponding adjustment to the opening balance of retained earnings on the date of adoption as illustrated below.

Illustration 8 — Election to use only benchmark cash flows upon adoption

Assume that, upon adoption, an entity elects to incorporate the proposed amendment permitting the change in fair value of the hedged item in a fair value hedge of interest rate risk to be calculated using only benchmark cash flows. As of the adoption date, the entity has one existing fair value hedging relationship of interest rate risk. The hedged item's carrying amount is $105, which comprises the hedged item's par amount of $100 and a $5 basis adjustment that was determined by applying the existing guidance. That is, the change in fair value was calculated using the hedged item's full contractual coupon. The entity has not begun amortizing the basis adjustment pursuant to ASC 815-25-35-9.

Using only the benchmark cash flows, the entity determines that there has been a $7 change in fair value of the hedged item attributable to the benchmark interest rate from hedge inception to the adoption date. Therefore, upon adoption, the entity would increase the carrying amount of the hedged item by $2, with an offset to the opening balance of retained earnings.

In contrast, if an entity elects to use the SIFMA Municipal Swap Rate, the cumulative basis adjustment of the hedged item from the dedesignated hedging relationship would be amortized to earnings over the remaining life of the hedged item on a "level-yield" basis. The Board indicated that because the hedged risk has changed, it would not be appropriate for an entity to carry forward the dedesignated hedged item's cumulative basis adjustment to the redesignated hedging relationship.

Endnotes:

[1] Proposed Accounting Standards Update, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*.

[2] ASC 815, *Derivatives and Hedging*.

[3] Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* (SFAS 133).

[4] Proposed Statement of Financial Accounting Standards, *Accounting for Hedging Activities, an amendment of FASB Statement No. 133*.

[5] Proposed Accounting Standards Update, *Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815): Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*.

[6] FASB Discussion Paper, "Selected Issues about Hedge Accounting (Including IASB Exposure Draft, *Hedge Accounting*)."

[7] Proposed ASC 815-20-55-79G.

[8] Proposed ASC 815-20-55-79H through 55-79N.

[9] Proposed ASC 815-20-55-79P through 55-79R.

[10] Proposed ASC 815-20-55-79S through 55-79U.

[11] ASC 250, *Accounting Changes and Error Corrections*.

[12] See remarks by E. Michael Pierce at the 2000 AICPA National Conference on Current SEC Developments.

[13] Proposed ASC 815-25-55-61A through 55-61C, Example 9: Fair Value Hedge of the LIBOR Swap Rate in a $100,000 BBB-Quality 5-Year Fixed-Rate Noncallable Note, and proposed ASC 815-25-55-106 through 55-108, Example 16: Fair Value Hedge of the LIBOR Swap Rate in a $100 Million A1-Quality 5-Year Fixed-Rate Noncallable Debt.

[14] ASC 815-20-55-5 through 55-8 (formerly part of Statement 133 Implementation Issue F2).

[15] Proposed ASC 815-25-55-94 through 55-99, Example 15: Fair Value Hedge of Interest Rate Risk using the Partial-Term Approach.

[16] ASC 815-20-25-104(e).

[17] Proposed ASC 815-30-55-134 through 55-142, Example 22: Assessing Effectiveness of a Cash Flow Hedge of a Forecasted Purchase of Inventory with a Forward Contract (Contractually Specified Component).

[18] Proposed ASC 815-20-55-26A through 55-26C.

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Appendix: Comparison with IFRS 9

The following table highlights certain key differences between the proposal and IFRS 9.

Issue	FASB proposal	IFRS 9
Hedging nonfinancial risk components	Only contractually specified components can be identified and designated as the hedged risk.	Contractually specified or non-contractually specified components (if separately identifiable and reliably measurable) can be identified and designated as the hedged risk.
Hedging financial risk components	For cash flow hedges, only contractually specified components can be identified and designated as the hedged risk. For fair value hedges, only benchmark interest rates can be separately identified and designated as the hedged risk.	Contractually specified or non-contractually specified components (if separately identifiable and reliably measureable) can be identified and designated as the hedged risk.
Recognition of "ineffectiveness" for cash flow and net investment hedges	"Ineffectiveness" is recorded in AOCI and reclassified to earnings when the hedged item affects earnings (or when it becomes probable that the forecasted transaction being hedged in a cash flow hedge will not occur in the required time period).	Ineffectiveness is recognized through earnings each reporting period. For cash flow hedges the ineffectiveness recorded is limited to overhedges.
Presentation of changes in the fair value of hedging instruments included in the effectiveness assessment	The entire change in fair value of the hedging instruments included in the assessment of hedge effectiveness is presented in the same income statement line item as the earnings effect of the hedged item.	No guidance specifying where the change in fair value of the hedging instrument included in the assessment of hedge effectiveness should be presented.
Recognition and presentation of changes in the fair value of hedging instruments excluded from the effectiveness assessment	For fair value and cash flow hedges, the change in time value excluded from the assessment of hedge effectiveness is recognized in earnings immediately and presented in the same income statement line item as the earnings effect of the hedged item. For net investment hedges, the change in time value excluded from the assessment of hedge effectiveness is recognized in earnings immediately, but no presentation guidance is provided. Foreign currency basis spreads are not addressed in the proposal.	The change in time value or the value of foreign currency basis spreads excluded from the assessment of hedge effectiveness is deferred in AOCI and reclassified to earnings based on the nature of the hedged item. For transaction-related hedged items, this amount is reclassified to earning when the hedged item impacts earnings or reclassified to the carrying amount of the nonfinancial item being hedged when the nonfinancial item is recognized. For time-period related hedged items, the deferred amount is reclassified to earnings on a systematic and rational basis. No guidance specifying where the change in time value excluded from the assessment of hedge effectiveness should be presented.

Issue	FASB proposal	IFRS 9
Assessment of hedge effectiveness and effectiveness threshold	Prospective and retrospective assessment of hedge effectiveness is required on an ongoing basis. Hedging relationships must be highly effective to qualify for hedge accounting.	Only prospective assessment of hedge effectiveness is required. To qualify for hedge accounting, there must be an economic relationship between the hedging instrument and hedged item, the value changes that result from that economic relationship may not be dominated by the effect of credit risk and the designation cannot reflect an imbalance between the weightings of the hedged item and hedging instrument that would create hedge ineffectiveness.
Voluntary dedesignation	Permitted at any point during the hedging relationship.	Prohibited unless the designated risk objective changes. Rebalancing is required in certain circumstances.
Disclosure of ineffectiveness	No requirement to separately measure and disclose	Required to separately measure and disclose.

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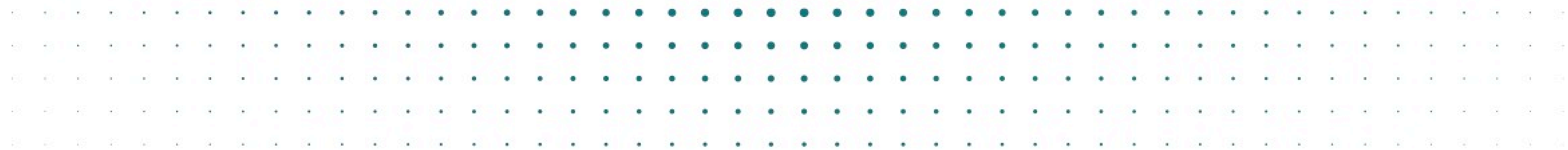
FASB Update



Presenters

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Rob Barton, Director – Accounting Advisory, Chatham Financial

Moderator

Jon W. Clark, Chief Financial Officer, Gramercy Property Trust

Standard Disclaimer

The views expressed herein are those of the presenters and do not necessarily reflect the views of their respective organizations.

ASU 2017-01

Overview

- Adds the ‘substantially all’ threshold
- Requires that a business include at least one substantive process
- Eliminates the evaluation of a market participant’s ability to replace the missing elements
- Aligns the definition of outputs with goods and services to customers

ASU 2017-01

‘Substantially all’ threshold

If *substantially all of the fair value* of the gross assets acquired is concentrated in a single identifiable tangible or intangible asset (or group of similar identifiable tangible or intangible assets), the set is not a business	- Single assets include: - Tangible assets that are attached to and cannot be physically removed from other tangible assets without significant cost or diminution in utility or value (or an intangible asset representing the right to use a tangible asset that cannot be used separately from the tangible asset such as leased land and a building) - In-place lease intangible assets (and liabilities) and related leased assets - Similar assets do not include: - Assets in different major asset classes - Assets that have significantly different risk characteristics

ASU 2017-01

Example – 'Substantially all' threshold

- RE Co. purchases a fully leased office building for $100 million and incurs $4 million of transaction costs. The assets and their fair values include land ($20m), building ($65m) and lease intangibles ($15m).
  - **Legacy guidance**: Business combination – the continuation of outputs indicates processes are embedded in the set. RE Co. would expense the transaction costs and record each asset at fair value.
  - **ASU 2017-01**: Asset acquisition – the set meets the 'substantially all' threshold (as all assets in set are considered a single asset). RE Co. would capitalize the transaction costs and allocate the consideration transferred on a relative fair value basis.

ASU 2017-01

Polling question

- What percentage of your acquisitions do you anticipate meeting the ‘substantially all’ threshold?
  - All (100%)
  - Most (75-99%)
  - Some (50-74%)
  - Less than 50%
  - Unknown

ASU 2017-01

Substantive process

To be a business, the set of acquired activities and assets must include inputs and *one or more substantive processes* that <u>together</u> contribute to the ability to create outputs	- For a set generating outputs, a process is substantive if it includes ***any*** of the following:
	  - Employees that form an organized workforce ***or*** an acquired contract that provides access to an organized workforce that are critical
	  - A process that cannot be replaced without significant cost, effort or delay
	  - A process that is considered unique or scarce
	- For a set not generating outputs, a process is substantive if it includes employees that form an organized workforce that is critical
	- Existence of continuing revenues (i.e., an in-place lease) would not indicate on its own a substantive process was acquired

ASU 2017-01

Example – Substantive process

- RE Co. purchased a portfolio of fully leased properties and the ‘substantially all’ threshold was not met. RE Co. assumes the existing outsourced cleaning, security and maintenance contracts in the acquisition.
  - **Legacy guidance**: Business combination – RE Co. determines the continuation of outputs indicates processes are embedded in the acquisition.
  - **ASU 2017-01**: Asset acquisition – RE Co. evaluates the processes acquired and determines they are not substantive processes. The processes are not unique, critical or scarce and could be replaced with little cost, effort or delay in set’s ability to generate outputs.

ASU 2017-01
Transition

- When is it effective?
  - 2018 for calendar-year public business entities
  - 2019 for all other calendar-year end entities
  - Early adoption permitted, including for interim or annual periods in which financial statements have not been issued or made available for issuance
- What are the transition provisions?
  - Applied prospectively as of the beginning of the period of adoption to all acquisitions and dispositions
  - No disclosures are required at transition

ASU 2017-01

10-K disclosures: REITs adopting the new definition of a business

Early Adopted Q4 2016	Early Adopted Q1 2017	Early Adopting in 2017	Not Early Adopting	Didn't Clarify Timing of Adoption
26	42	3	5	81
17%	27%	2%	3%	52%

10-K reports filed as of March 1, 2017

ASU 2017-01

10-K disclosures: REITs adopting the new definition of a business – by Industry

	Early Adopted Q4 2016	Early Adopted Q1 2017	Early Adopting in 2017	Not Early Adopting	Didn't Clarify Timing of Adoption
Retail	3	8	0	1	11
Residential	1	8	1	0	12
Lodging	3	3	0	2	12
Health Care	4	7	0	1	4
Net Lease	0	4	0	0	10
Diversified	2	3	2	0	6
Office	4	5	0	0	3
Industrial	2	0	0	1	6
Specialty/other	4	3	0	0	12

ASU 2017-01

How It May Change Business Practices

Eliminating Market Participants Ability to Replace Missing Elements and

Substantive Processes

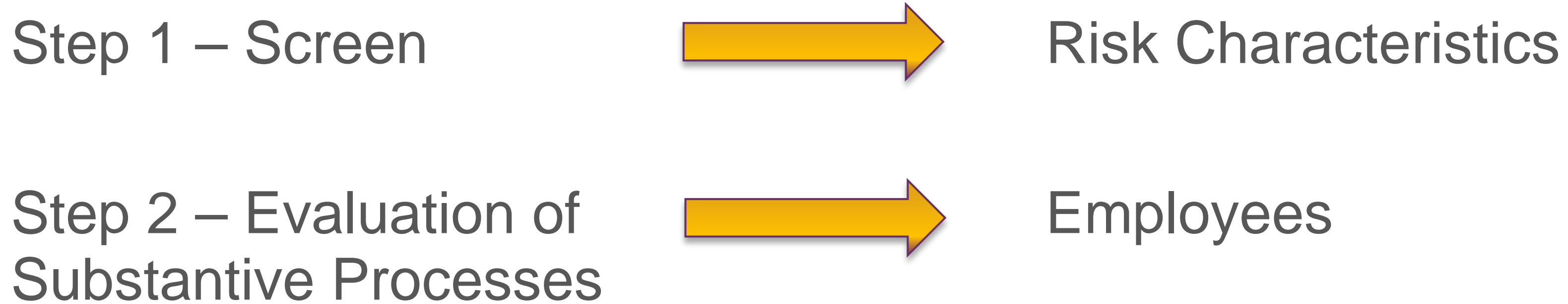
Greater Structuring of Transactions

Loss of Measurement Period

Timing of Acquisitions

ASU 2017-01

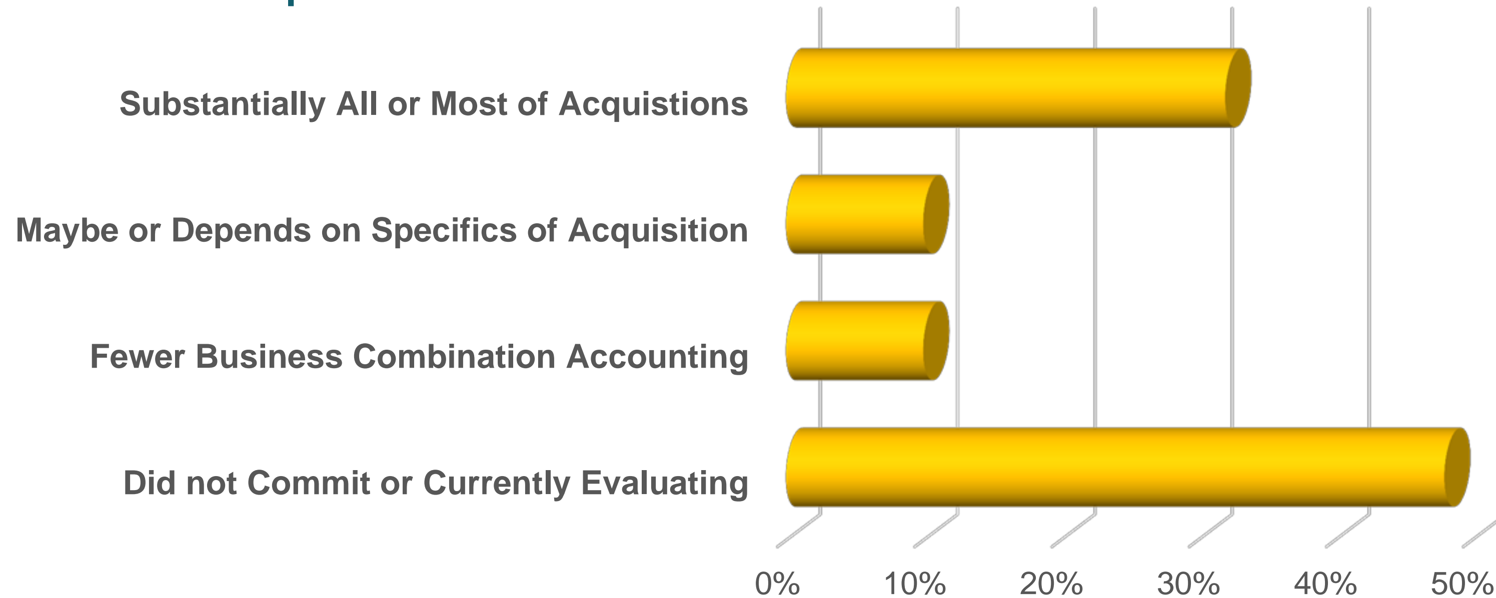
Acquisition of a Portfolio of Properties



If Step 2 Conclusion is "Not a Business" Step 1 – Screen Need Not Be Performed

ASU 2017-01

Disclosed Anticipated Future Accounting Asset Acquisitions – All Sectors



ASU 2017-01

December 31, 2016 Form 10-K Disclosure

"The Company expects that acquisitions of real estate or in-substance real estate will not meet the revised definition of a business because substantially all of the fair value is concentrated in a single identifiable asset or group of similar identifiable assets (i.e. land, buildings, and related intangible assets) or because the acquisition does not include a substantive process in the form of an acquired workforce or an acquired contract that cannot be replaced without significant cost, effort or delay."

ASU 2017-01

December 31, 2016 Form 10-K Disclosure Office

"As a result of this adoption, we evaluated three real estate acquisitions completed during the fourth quarter of 2016 under the new framework and determined that the assets acquired did not meet the definition of a business. Accordingly, we accounted for these transactions as asset acquisitions."

ASU 2017-01

December 31, 2016 Form 10-K Disclosure
Retail

"Given this change in definition, we believe most of our shopping center acquisitions will no longer be considered business combinations but rather asset acquisitions."

"…we expect future acquisitions of single investment properties will not result in the recognition of transaction cost expenses, as the single investment properties will likely not meet the definition of a business…."

ASU 2017-01

December 31, 2016 Form 10-K Disclosure
Diversified

"As a result, we anticipate that fewer of our acquisitions made in the normal course of business will meet the definition of a business, as our typical acquisitions consist of properties whereby substantially all of the fair value of gross assets acquired is concentrated in a single asset (land, building and in-place leases)."

ASU 2017-01

December 31, 2016 Form 10-K Disclosure Industrial

"This standard is effective for periods beginning after December 31, 2017, however we plan to adopt this standard in 2017 for the annual and interim reporting periods beginning after December 31, 2016. We do not expect the adoption to have a significant impact on the Consolidated Financial Statements."

ASU 2017-01

December 31, 2016 Form 10-K Disclosure Lodging/Resorts

"While we are currently evaluating the potential impact of the standard, we currently expect that certain future hotel acquisitions may be considered asset acquisitions rather than business combinations, which would affect capitalization of acquisitions costs (such costs are expensed for business combinations and capitalized for asset acquisitions)."

ASU 2017-01

December 31, 2016 Form 10-K Disclosure

Lodging/Resorts

"We are evaluating the effect of ASU No. 2017-01 on our consolidated financial statements and related disclosures"

ASU 2017-01

Disclosed Anticipated Future Accounting Asset Acquisitions

Sector	Substantially All or Most of Acquistions	Maybe or Depends on Specifics	Fewer Business Combination Accounting	Did not Commit or Currently Evaluating
Office	39%	11%	6%	44%
Industrial	33%	0%	11%	56%
Retail	26%	10%	23%	42%
Apartments	50%	0%	17%	33%
Diversified	42%	8%	17%	33%
Lodging/Resorts	13%	20%	0%	67%

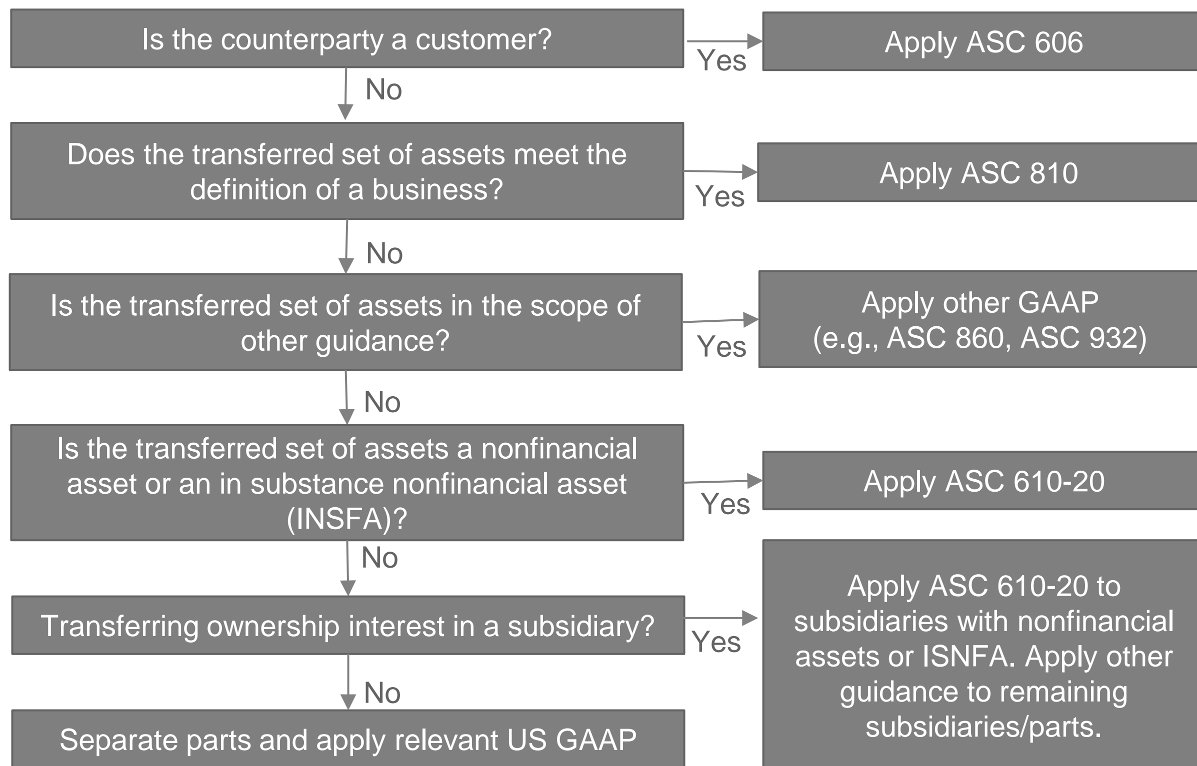
ASU 2017-05

Overview

- Clarifies the scope of ASC 610-20
- Defines in substance nonfinancial asset
  - An *in substance nonfinancial asset* is a financial asset that is in a group of assets in which "substantially all" of fair value is concentrated in nonfinancial assets
- Provides guidance on the derecognition of nonfinancial assets and in substance nonfinancial assets, including partial sales of those assets

ASU 2017-05

Scoping



ASU 2017-05

Scoping – other real estate considerations

- Contributions of nonfinancial assets to equity method investments or joint ventures are in the scope of this guidance
- Most transactions that today are in the scope of ASC 845 on nonmonetary exchanges will now be in the scope of this guidance
- All transfers of equity method investments generally will be in the scope of ASC 860
  - Exception for equity method investments that are in substance nonfinancial assets removed

ASU 2017-05

Derecognition and measurement

- Derecognition
  - Step 1 — Seller evaluates whether it has lost control under ASC 810. If yes, it continues to step 2. If no, the asset is not derecognized.
  - Step 2 – Seller evaluates whether it has transferred control using the principles in ASC 606.
- Measurement
  - Consideration is the transaction price determined using ASC 606 plus carrying value of any liabilities assumed by the buyer.
  - Noncontrolling interest received or retained by selling entity measured at fair value.
    - Currently measured at carrying value under ASC 360-20

ASU 2017-05

Transition

- When is it effective?
  - 2018 for calendar-year end public entities
  - 2019 for all other calendar-year end entities
  - Early adoption permitted in 2017
  - Period of adoption must be aligned with adoption of ASC 606
- What are the transition provisions?
  - Full retrospective or modified retrospective
  - Transition method for transactions with customers and noncustomers does not have to be the same

ASU 2017-05
Polling question

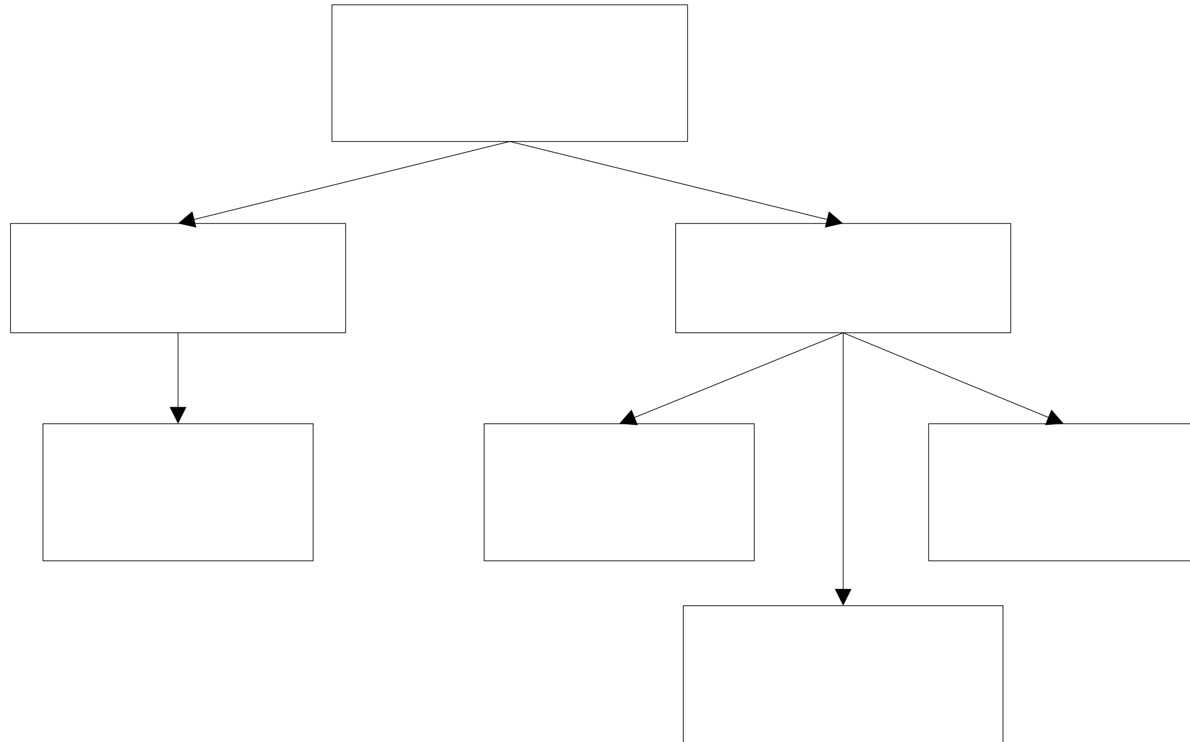
- What transition method will you use for the adoption of ASC 610-20?
  - Full retrospective adoption (i.e., recast all periods within the financial statements)
  - Modified retrospective application (i.e., apply to the most current period presented within the financial statements)
  - Undecided

Hedge Accounting

FASB Proposed Changes

Accounting for Derivatives Under ASC 815 (FAS 133)

Current Accounting



Accounting for Derivatives Under ASC 815 (FAS 133)

Current Accounting

Mark to Market

	Revenue
-	Expenses
+/-	Derivative gain/loss
=	Net Income

Hedge Accounting

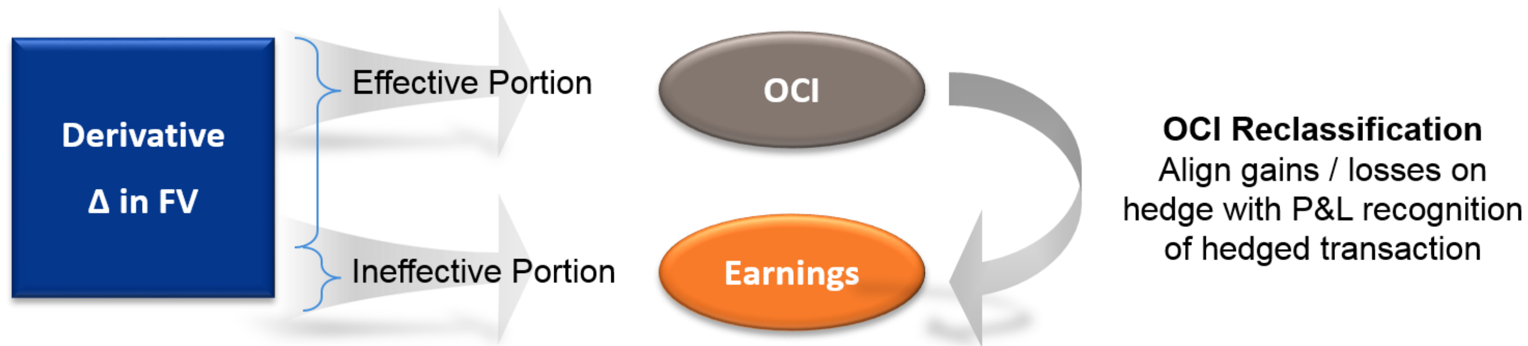
	Revenue
-	Expenses
=	Net Income

Derivative gains/losses deferred into OCI

Reclassified into earnings to align with the recognition of the associated hedged transactions.

Accounting for Derivatives Under ASC 815 (FAS 133)
Current Accounting

- Quantitative assessment test performed quarterly (unless shortcut applied)
- Ineffectiveness measured quarterly – reported in current period earnings



FASB Hedge Accounting Proposed Changes

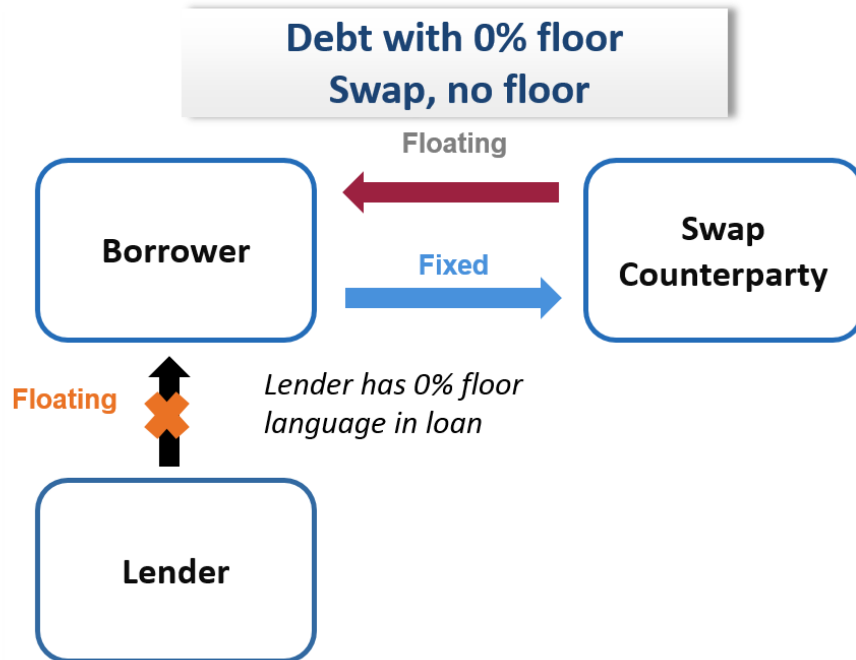
Relevant Proposed Changes

- Key Changes
  - Measuring and presenting ineffectiveness
  - Effectiveness testing requirements
  - Required timing of the inception quantitative effectiveness test
  - Prime, LIBOR, Fed Funds are all eligible hedge risks
  - More easily hedge commodity risk

FASB Hedge Accounting Proposed Changes

Example – 0% Floors in Loans

- Current standard market practice for lenders to insert 0% floors on LIBOR into loan agreements
- Accounting under current guidance
- Accounting under proposed guidance



**When true economic ineffectiveness still exists earnings volatility may still result*

FASB Hedge Accounting Proposed Changes

Adoption and Transition

- When are expected adoption dates?
  - Expect proposed guidance to be finalized in 2017
  - Early adoption beginning January 1, 2018
- What are the transition provisions?
  - Modified retrospective transition approach
    - New guidance only applied prospectively
    - Adjustment to retained earnings for prior period ineffectiveness

NAREIT Alert (December 14, 2015)

NAREIT Alert Important Industry Updates from NAREIT

December 14, 2015

On Nov. 23, the Financial Accounting Standards Board (FASB or Board) issued a proposal (the Proposal) that is intended to clarify the definition of a business. The objective of the proposal is to add further guidance that would assist preparers in evaluating whether a transaction would be accounted for as an acquisition of an asset or a business. This project is of particular interest to NAREIT members, as the project will revisit the definition of a business that was developed in Statement of Financial Accounting Standards (FAS) 141(R), Business Combinations. Under that guidance, the definition of a business was so broad that even the acquisition of a single investment property qualified as a business combination. As a result, acquisition costs incurred by a company in acquiring an investment property were required to be expensed pursuant to U.S. GAAP. Prior to FAS 141(R), acquisition costs were capitalized and amortized over the life of the acquired asset. If you are interested in participating in a NAREIT 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 Jan. 6, 2016. Comments on the Proposal are due to the Board by Jan. 22, 2016.

The Proposal includes a new framework to evaluate whether an acquisition qualifies as an asset acquisition or a business combination. The first step would be to apply a materiality threshold to the asset or assets acquired. If substantially all of the fair value of the gross assets acquired is concentrated in a single asset (or group of similar assets), the transaction would be considered an asset acquisition, and further evaluation would not be necessary. If the acquisition "fails" the substantially all test to qualify as an asset acquisition, the transaction would then be evaluated for whether it includes: 1) an input; and, 2) a substantive process that together contribute to the ability to create outputs. If both of these items are included in the transaction, the transaction would qualify as a business combination as opposed to an asset acquisition.

NAREIT believes that this proposed framework would largely address the industry's current concerns about U.S. GAAP requiring too many transactions to be accounted for as business combinations.

The Proposal would be applicable on a prospective basis for transactions that occur after the effective date. The FASB will establish the effective date after evaluating the comment letter feedback on the Proposal.

Contact

For more information contact Christopher Drula, Vice President of Financial Standards, at cdrula@nareit.com; or George Yungmann, Senior Vice President of Financial Standards, at gyungmann@nareit.com.

NAREIT Alert (June 23, 2016) 2

NAREIT Alert Important Industry Updates from NAREIT

June 23, 2016

On June 6, the Financial Accounting Standards Board (FASB or Board) issued a proposal (the Proposal) to clarify the scope of recently issued guidance on sales of *in-substance nonfinancial assets* (*e.g.,* real estate held in a legal entity) that was finalized in conjunction with the new *Revenue from Contracts with Customers* Standard (the Revenue Standard). Additionally, the Proposal would provide guidance for partial sales of nonfinancial assets (*e.g.,* real estate). The Revenue Standard and related amendments replaced the accounting guidance which previously applied to sales of real estate (*i.e.,* the former *FAS 66, Accounting for Sales of Real Estate (FAS 66))*.However, the Revenue Standard did not include a definition for the term *in substance nonfinancial assets* or guidance for how to account for partial sales of real estate.

The Proposal would "mark to market" all partial sales transactions as if the issuer sold its entire interest in the in-substance nonfinancial assets and therefore would require entities to measure the retained interest resulting from partial sales transactions at fair value. For example, if a REIT sold half of its 40% joint venture interest in a portfolio of real estate assets, it would recognize gain or loss in the financial statements as if it sold all of its interests in the joint venture. This treatment would represent a fundamental change from current U.S. GAAP. Under current guidance, the retained interest is measured at carry-over basis (*i.e.,* depreciated cost) and therefore the seller only recognizes gain or loss from the actual sale. Thus, the Proposal (if finalized) would trigger full gain or loss recognition attributable to the entire property even from partial sales of real estate.

NAREIT believes that the Proposal would be of particular interest of equity REITs that sell partial interests. If you are interested in participating in a NAREIT task force that will evaluate the Proposal and develop a comment letter, please contact Christopher Drula, NAREIT's VP of Financial Standards, at cdrula@nareit.com by June 30. The comment letter deadline is Aug. 5, 2016.

Background

The current scope of the nonfinancial asset guidance includes the transfer of *in substance nonfinancial assets.*However, the term *in substance nonfinancial assets* is not defined in U.S. GAAP. Thus, the Board is seeking to provide clarity for what is meant by this term. Additionally, the current nonfinancial asset guidance does not address partial sales of nonfinancial assets. NAREIT raised this issue previously in comment letters submitted to the Board, as well as in meetings with Board members. While FAS 66 provided prescriptive rules-based guidance for the partial sales transactions; the Revenue Standard does not specifically address these fact patterns.

The Proposal represents the second phase of a project that the Board added to its agenda in 2013. The objective of the project is to clarify the definition of a business by adding guidance to assist in the evaluation of whether a transaction should be treated as an acquisition (or disposal) of assets or acquisitions (or disposals) of businesses. The Board addressed the issues identified in the project in three phases:

- Phase 1 – The Board issued a proposal to clarify the definition of a business;
- Phase 2 – The Board issued the Proposal to (1) clarify the scope of recently issued guidance on sales of*in-substance nonfinancial assets* and (2) provide guidance on partial sales of nonfinancial assets; and,
- Phase 3 – In a future phase, the Board plans to discuss whether there are differences between the accounting for the acquisition and sale of assets and businesses that could be eliminated.

Scope of the Proposal

The Proposal would apply to the sale of all nonfinancial assets and *in substance* non-financial assets unless other guidance in U.S. GAAP would apply. Thus, the Proposal would *not* apply to the sale of businesses, equity method investments, or other revenue transactions. Given the FASB's related *Clarifying the Definition of a Business* Proposal, NAREIT believes that fewer real estate transactions will meet the proposed definition of a business combination, and therefore would be within the scope of the Proposal.

Proposed Definition of In-Substance Nonfinancial Asset

The Proposal would define an *in-substance nonfinancial asset* as an asset of a reporting entity that is included in either of the following:

- A contract in which substantially all the fair value of the assets (recognized and unrecognized) promised to a counterparty is concentrated in nonfinancial assets; or,
- A consolidated subsidiary in which substantially all the fair value of the assets (recognized and unrecognized) in the subsidiary is concentrated in nonfinancial assets.

Proposed Partial Sales Guidance

After executing a partial sale transaction, the Proposal would require an entity to measure its retained interest at fair value. This would result in full gain or loss recognition upon the sale of a nonfinancial asset (or in-substance non-financial asset). Under current U.S. GAAP, the retained interest is measured at its carry-over basis (*i.e.,*marking the retained interest to fair value and recognizing a gain or loss is prohibited). *This represents a fundamental change from existing U.S. GAAP.*

Proposed Effective Date

NAREIT understands that the Board is seeking to evaluate the comments received on the *Clarifying the Definition of a Business Proposal* concurrently with the Proposal, with the aim of aligning the effective dates with the Revenue Standard.

The Proposal would be effective for public companies in fiscal years beginning after Dec. 15, 2017, including interim periods within those years. The FASB would permit early adoption for fiscal years beginning after Dec. 15, 2016.

The Proposal would be effective for non-public companies in fiscal years beginning after Dec. 15, 2018, and interim periods within fiscal years beginning after Dec. 15, 2019. The FASB would permit early adoption for fiscal years beginning after Dec. 15, 2016.

Contact: Christopher Drula at cdrula@nareit.com or George Yungmann at gyungmann@nareit.com.

NAREIT Alert (October 14, 2016)

NAREIT Alert Important Industry Updates from NAREIT

October 14, 2016

FASB Issues Hedging Accounting Proposal

On Sept. 8, the Financial Accounting Standards Board (FASB or Board) issued a proposal (the Proposal) that would make targeted improvements to hedge accounting. The FASB's purpose in issuing the Proposal is to improve the financial reporting of hedging relationships in order to better portray the economic results of an entity's risk management activities in its financial statements. Additionally, the Proposal would simplify the application of the hedge accounting guidance in current U.S. Generally Accepted Accounting Principles (GAAP). Equity REITs and mortgage REITs that seek to qualify for hedge accounting in utilizing interest rate swaps or foreign currency swaps associated with debt instruments would be impacted by the Proposal. If you are interested in participating in a task force that will evaluate the Proposal and consider whether NAREIT should develop a submission, please contact Christopher Drula at cdrula@nareit.com by Oct. 20. Comments are due to the Board by Nov. 22.

Elimination of the separate recognition of periodic hedge ineffectiveness

The Proposal would eliminate the requirement in current GAAP to separately recognize periodic hedge ineffectiveness. Thus, the Proposal would require companies to present the entire change in the fair value of the hedging instrument in the same income statement line as the earnings effect of the hedged item. Current GAAP provides special hedge accounting only for the portion of the hedge deemed to be "highly effective" and requires an entity to separately reflect the amount by which the hedging instrument does not offset the hedged item, which is referred to as the "ineffective" amount.

Highly effective threshold to qualify for hedge accounting

In order to qualify for hedge accounting, companies would need to continue demonstrating that the hedging instrument is highly effective at achieving offsetting changes in fair value or cash flows.

Quantitative and qualitative assessment of hedge effectiveness

The Proposal would alleviate some of the ongoing requirements to demonstrate that hedges are highly effective. Under current GAAP, companies are required to perform initial and ongoing quantitative and retrospective assessments to qualify for hedge accounting. The Proposal would continue to require that companies perform an initial prospective quantitative test. However, the Proposal would allow companies to elect to subsequently perform only a qualitative (as opposed to a quantitative) assessment unless facts and circumstances change. This would represent a significant change from current GAAP, and would reduce the cost and administrative burden that companies endure to achieve hedge accounting on an ongoing basis.

Hedge documentation

The Proposal would continue to require that companies complete most of the hedge documentation at inception of the hedge. However, the Proposal would permit that the initial assessment be completed in conjunction with the quarter following the inception of the hedge relationship. Under current GAAP, the initial assessment must be completed at inception of the hedge.

Disclosure Requirements

The Proposal would modify disclosures required in current GAAP. The proposed modifications would include a tabular disclosure related to the effect on the income statement of fair value and cash flow hedges and would eliminate the requirement to disclose the ineffective portion of the change in fair value of hedging instruments. The proposed amendments also would require the following new disclosures:

- Disclosures related to cumulative basis adjustments for fair value hedges; and,
- Enhanced qualitative disclosures describing quantitative hedging goals, if any, set to achieve hedge accounting objectives.

Effective Date

The Board has not yet established an effective date for the Proposal. After the Board evaluates constituent input during the re-deliberations process, the Board will set the effective date.

Contact: George Yungmann at gyungmann@nareit.com or Christopher Drula at cdrula@nareit.com.

NAREIT Alert (January 9, 2017)

NAREIT Alert Important Industry Updates from NAREIT

Executive Summary

On Jan. 5, the Financial Accounting Standards Board (FASB or Board) issued a final standard (the Standard) that clarifies the definition of a business. The Standard's objective is to add further guidance that assists preparers in evaluating whether a transaction will be accounted for as an acquisition of an asset or a business.

The Standard is of particular interest to NAREIT members, as the Standard revisits the definition of a business that was developed in Statement of Financial Accounting Standards (FAS) 141(R), *Business Combinations*. Under existing GAAP, the definition of a business is interpreted so broadly that even the acquisition of a single investment property meets the definition of a business. Under today's accounting, transaction costs associated with business combinations are expensed as incurred.

> NAREIT believes that most acquisitions of investment property would qualify as asset acquisitions (as opposed to business combinations) under the clarified definition of a business in the Standard. Therefore, transaction costs associated with asset acquisitions will be capitalized, while these costs associated with business combinations will continue to be expensed as incurred.

Many REITs that are required to expense acquisition transaction costs under current GAAP, eliminate this expense in their calculation of a secondary FFO measure (*e.g.*, core FFO, adjusted FFO, normalized FFO.) Because NAREIT believes that the great majority of investment property acquisitions will qualify as asset acquisitions rather than acquisitions of businesses, this adjustment to NAREIT FFO will no longer be necessary.

The Standard will be applied on a prospective basis to transactions occurring as early as 10/1/16 (see further discussion below).

Some Important Details

Under current implementation guidance in GAAP, there are three components of a business: inputs, processes, and outputs. While an integrated set of assets and activities (set) that is a business usually has outputs, outputs are not required to be present for a transaction to be treated as a business. Additionally, all of the inputs and processes that a seller uses in operating a set are not required if a market participant can acquire the set and continue to produce outputs while integrating the acquired set with their own existing inputs and processes.

The "Substantially All" Fair Value Screen

If the "substantially all" screen is not met, the Standard requires that to be considered a business, a set must include (at a minimum) an input and a substantive process that together significantly contribute to the ability to create an output.

If the transaction does not include outputs (*e.g.*, real estate under development that has not generated revenues), the set will have an input (*e.g.*, real estate) and a substantive process only if it includes employees that form an organized workforce and an input that the workforce could develop or convert into output (*e.g.*, rental revenue). The organized workforce must have the necessary skills, knowledge, or experience to perform an acquired process. In performing this evaluation, a company would need to evaluate whether the acquired workforce is performing a substantive process. According to the Standard, a process is not critical if it is considered ancillary or minor in the context of all the processes required to create outputs.

If the transaction includes outputs, the set will have both an input and a substantive process that together significantly contribute to the ability to create outputs when any of the following are present:

- Employees that form an organized workforce that has the necessary skills, knowledge or experience to perform an acquired process that when applied to an acquired input is critical to the ability to continue producing outputs.
- An acquired contract that provides access to an organized workforce that has the necessary skills, knowledge, or experience to perform an acquired process is critical to the ability to continue producing outputs.
- The acquired process when applied to an acquired input significantly contributes to the ability to continue producing outputs and cannot be replaced without significant cost, effort, or delay in the ability to continue producing outputs.
- The acquired process when applied to an acquired input significantly contributes to the ability to continue producing outputs and is considered unique or scarce.

Real Estate Examples Illustrating Whether an Acquired Process is "Critical"

The Standard includes Real Estate examples that contrast transactions involving the acquisition of cleaning, security, and maintenance personnel (Case A, Scenario 2) with the acquisition of employees responsible for leasing, tenant management, and managing and supervising all operational processes (Case A, Scenario 3).

In Scenario 2, the transaction qualifies as an asset acquisition because the cleaning and security processes were not considered critical in the context of all the processes required to create outputs. Additionally, the cleaning and security processes could be easily replaced with little cost, effort, or delay in the ability to continue producing outputs. Further, the cleaning and security contracts are not considered unique or scarce (*i.e.*, these arrangements are readily available in the marketplace).

In Scenario 3, the transaction qualifies as a business combination because the set includes an organized workforce that performs processes that when applied to the acquired inputs (*e.g.*, land, building and in-place leases) are critical to the ability to continue producing outputs. Thus,

leasing, tenant management, and operational processes are critical to the creation of outputs.

Effective Date

For public companies, the Standard is effective for annual periods beginning after Dec. 15, 2017, including interim periods within those periods. All other companies would apply the Standard to annual periods beginning after Dec. 15, 2018 and interim periods within annual periods beginning after Dec. 15, 2019.

The Standard should be applied prospectively on or after the effective date. No disclosures are required at transition.

The Board provided companies with the option to early adopt the Standard. Companies can early adopt the Standard as of the beginning of a reporting period for which financial statements have not yet been issued. For example, if a REIT has not issued its 12/31/16 Form 10-K, the REIT could adopt the Standard for transactions that occurred after 10/1/16. Note that adoption in this fashion would result in similar transactions being accounted for differently within 2016 financial statements. From discussions with FASB Staff, NAREIT understands that REITs would be permitted to early adopt the Standard as of 1/1/17.

Contact: George Yungmann at gyungmann@nareit.com or Christopher Drula at cdrula@nareit.com.

NAREIT Alert (February 24, 2017)

NAREIT Alert Important Industry Updates from NAREIT

On Feb. 22, the Financial Accounting Standards Board (FASB or Board) issued a final standard (the Final Standard) that clarifies the scope of recently issued guidance on sales of *in substance nonfinancial assets* (*e.g.,* real estate held in a legal entity) that was finalized in conjunction with the *Revenue from Contracts with Customers* Standard (the Revenue Standard). Additionally, the Final Standard addresses the accounting treatment for partial sales of nonfinancial assets (*e.g.,* real estate).

Executive Summary

NAREIT believes that the Final Standard will be of particular interest to equity REITs that contribute a controlling interest in a real estate property to a joint venture. When a REIT transfers control of a property and maintains a retained interest in the property transferred, the Final Standard requires that the REIT report a full gain or loss as if it sold 100% of the property transferred and measure its retained interest at fair value. *This represents a fundamental change from existing U.S. GAAP.* Under current U.S. GAAP, gain or loss is recognized only on the interest transferred and the retained interest is measured at its carry-over basis.

Partial Sales

The Final Standard acknowledges that a partial sale of a nonfinancial asset or in substance nonfinancial asset can be structured in different fashions. A transaction can be structured such that an entity transfers a nonfinancial asset to a counterparty in exchange for a non-controlling interest in the legal entity to which the nonfinancial asset was transferred. A parent could also transfer ownership interests in a consolidated subsidiary that includes nonfinancial assets and retain a non-controlling interest in the former subsidiary.

The Final Standard clarifies that partial sales transactions within the scope of ASC 610-20 include contributions of nonfinancial assets to a joint venture or other noncontrolled investee. The Final Standard requires a company to recognize a full gain or loss on transfers of nonfinancial assets within the scope of ASC 610-20 to equity method investees.

The Final Standard requires a company to derecognize a distinct nonfinancial asset or distinct in substance nonfinancial asset in a partial sale transaction when it:

- Does not have a controlling financial interest in the legal entity that holds the asset in accordance with Topic 810, *Consolidation*; and,
- Transfers control of the asset in accordance with Topic 606, *Revenue from Contracts with Customers*.

Once a company transfers control of a distinct nonfinancial asset or distinct in substance nonfinancial asset, it is required to measure any non-controlling interest it receives or retains at fair value. The company is required to recognize a full gain or loss on the transaction.

If a company transfers ownership interests in a consolidated subsidiary and continues to hold a controlling financial interest, it does not derecognize the assets or liabilities, and accounts for the transaction as an equity transaction. Therefore, no gain or loss is recognized.

Scope

The Final Standard applies to all sales of nonfinancial assets and in substance nonfinancial assets, unless it meets one of the scope exceptions identified in par. 610-20-15-4, a through l.

Definition of In Substance Nonfinancial Asset

The Revenue Standard did not include a definition of an in substance nonfinancial asset. Therefore, the FASB included a definition in the Final Standard:

"An in substance nonfinancial asset is a financial asset promised to a counterparty in a contract if substantially all of the fair value of the assets (recognized and unrecognized) that are promised to the counterparty in the contract is concentrated in nonfinancial assets" (*e.g.,* real estate).

The Final Standard includes the following illustrative example that is relevant to the real estate industry (Example 1):

> Seller enters into a contract to transfer real estate, the related operating leases, and accounts receivable to Buyer. Seller

guarantees Buyer that the cash flows of the property will be sufficient to meet all of the operating needs of the property for two years after the sale. In the event that the cash flows are not sufficient, Seller is required to make a payment in the amount of the shortfall.

Seller concludes that the assets promised in the contract are not a business within the scope of Topic 810 on consolidation and are not an output of Seller's ordinary activities within the scope of Topic 606 on revenue from contracts with customers. In addition, assume that Seller concludes that substantially all of the fair value of the assets promised in the contract is concentrated in nonfinancial assets (that is, substantially all of the fair value is concentrated in the real estate and in-place lease intangible assets). Therefore, the accounts receivable promised in the contract are in substance nonfinancial assets. In accordance with the guidance in this Subtopic, all of the assets in the contract, including the accounts receivable, are within the scope of this Subtopic.

Seller concludes that the guarantee, which is a liability of Seller, is within the scope of Topic 460 on guarantees. Therefore, Seller would apply the guidance in paragraph 606-10-15-4 to separate and measure the guarantee as described in paragraph 610-20-15-9.

Seller's conclusions would be the same if it transferred the real estate, leases, and receivables by transferring ownership interests in a consolidated subsidiary. That is, Seller would still conclude that all of the assets in the subsidiary are nonfinancial assets and in substance nonfinancial assets within the scope of this Subtopic and the guarantee is within the scope of Topic 460.

When determining whether substantially all of the fair value of the assets promised to counterparty in a contract is concentrated in nonfinancial assets, cash or cash equivalents promised to the counterparty should be excluded from the analysis. Further, any liabilities assumed or relieved by the counterparty should not factor into the determination of whether substantially all of the fair value of the assets transferred is concentrated in nonfinancial assets.

Effective Date

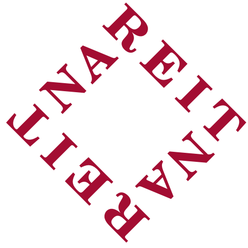
The Final Standard is effective at the same time as the new *Revenue from Contracts with Customers* Standard. Thus, the Final Standard is effective for annual periods beginning after Dec. 15, 2017 for public companies, including interim reporting periods within that reporting period. For all other entities, the Final Standard is effective for annual periods beginning after Dec. 15, 2018 and interim reporting periods within annual periods beginning after Dec. 15, 2019. All companies can early adopt the guidance for annual periods beginning after Dec. 15, 2016, including interim reporting periods within that reporting period.

Transition

Companies can elect to adopt the standard either:

- Retrospectively to each period presented in the financial statements; or,
- Retrospectively with a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year of adoption.

Contact: George Yungmann (gyungmann@nareit.com) or Christopher Drula (cdrula@nareit.com)



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January 21, 2016

Ms. Susan M. Cosper
Technical Director
File Reference No. 2015-330
Financial Accounting Standards Board
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P.O. Box 5116
Norwalk, CT 06856-5116
director@fasb.org

Delivered electronically

RE: Proposed Accounting Standards Update – *Business Combinations (Topic 805) – Clarifying the Definition of a Business*

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 – *Business Combinations (Topic 805) – Clarifying the Definition of a Business* (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 225 companies representing an equity market capitalization of $935 billion at November 30, 2015. Of these companies, 184 were Equity REITs representing

94.1% of total U.S. stock exchange-listed REIT equity market capitalization (amounting to $880 billion)[1]. The remainder, as of November 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 Board's objective

NAREIT supports the Board's objective in addressing constituent concerns that the definition of a business in current U.S. GAAP is applied too broadly, resulting in many transactions qualifying as businesses while purchasers view them as asset acquisitions. This phenomenon has been pervasive in the real estate industry since the implementation of FAS 141(R) where the acquisition of even a single property by a REIT is generally required to be accounted for as a business combination. Further, preparers and auditors have struggled to understand why the acquisition of an investment property is accounted for as a business combination, but treated as an asset disposition upon sale of the investment property (a sale of real estate).

What adds further complexity to the asset versus business determination is the difference in application by companies that report pursuant to U.S. GAAP and International Financial Reporting Standards (IFRS). Despite the fact that the words in GAAP and IFRS are identical, real estate companies across the globe that report under IFRS generally account for acquisitions of investment properties as asset acquisitions, while companies that report under U.S. GAAP account for the same types of transactions as business combinations. NAREIT appreciates the Board's efforts to address this divergence in application.

NAREIT Recommendation – Align the accounting guidance for business combinations with existing asset acquisition guidance

While NAREIT appreciates the Board's efforts in pursuing clarified guidance to address what constitutes an asset versus a business, NAREIT believes that the Board could achieve its objective in a much simpler manner. Rather than redefining what would qualify as a business, NAREIT strongly believes that the board should align the accounting guidance for business combinations with existing asset acquisition guidance. A major difference between business combinations guidance and asset acquisition guidance under today's GAAP is whether acquisition transaction costs are capitalized or expensed. NAREIT believes that eliminating this difference by requiring the capitalization of acquisition costs whether a transaction is considered an asset acquisition or a business combination would provide the following benefits to both the preparer and user community alike:

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[1] https://www.reit.com/sites/default/files/reitwatch/RW1512.pdf at page 21.

- Simplify accounting by eliminating a need for an evaluation of what constitutes an asset acquisition or a business combination;

- Help converge the accounting results for acquisitions of investment property as between IFRS and U.S. GAAP;

- Mirror the accounting for real estate acquisitions with economics of the transaction; and,

- Eliminate the need by financial statement users in the real estate industry to reverse the expensing of acquisition costs when evaluating the economic earnings prospects of real estate companies.

Other Comments

In the event that the Board decides to pursue the issuance of the Proposal, NAREIT recommends the following clarifications to the Proposal:

- Clarify the wording in paragraph 805-10-55-78 to include the italicized terms below:

  - Although the leases are at market *rates*, REIT concludes that the fair value of the in-place lease *intangible asset is* significant and that the fair value of the gross assets acquired is not concentrated in either the leases or the tangible assets.

    - Without these changes, the wording leads the reader to believe that the analysis would compare the fair value of in-place leases with the fair value of the operating property. This is a circular analysis, given that the fair value of the building is measured by the present value of cash flows to be received under in-place leases.

- Amend the criteria for the evaluation of similar asset types to include a comparison of the types of assets acquired with the acquirer's existing portfolio of assets.

  - For example, if a real estate company that owns and manages a portfolio of office buildings and, therefore has an operating platform focused on office buildings, acquires office properties to add to its portfolio, the acquisition should be accounted for as an asset purchase.

  - Further, some REITs do not own and operate a single asset type. NAREIT groups these REITs into the diversified sector (*e.g.,* a REIT that owns shopping malls, parking lots, and apartment buildings). Many times, these different types of properties are acquired together in single transactions. We believe that the acquisition of different types of assets should be accounted for as an asset acquisition to the extent that the transaction is consistent with the acquirer's business model. If the Board does not provide this clarification, the preparer may be left to debate with his or her auditor whether this acquisition represents similar

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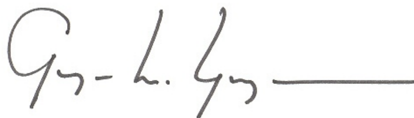
assets or multiple assets which could provide an uneconomic result that the transaction should be accounted for as a business combination (particularly noting that if acquired separately, they would be asset acquisitions).

- Add guidance that clarifies that the acquisition of multiple properties that are in various stages of development would still be considered similar assets.
  - Along the same lines as the preceding bullet, REITs can acquire a group of assets that are in various stages of development (*e.g.,* buildings under construction, vacant buildings, and operating properties). NAREIT recommends that the Board clarify that a transaction that includes properties at different stages of development would be considered similar in nature. The business purpose of acquiring the group of assets serves the same purpose – to add investment property to the company's current portfolio of investment properties. In our view, the economics of the transaction is more akin to an asset acquisition than a business combination.

NAREIT continues to support the FASB's *Clarifying the Definition of a Business* 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,



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REITS:
BUILDING
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August 5, 2016

Ms. Susan Cosper
Technical Director
File Reference No. 216-250
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, Connecticut 06856-5116
director@fasb.org

Delivered Electronically

Re: File Reference No. 2016-250, Proposed Accounting Standards Update – ***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***

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 *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* (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 All REITs Index, which covers both Equity REITs and Mortgage REITs. This Index contained 220

companies representing an equity market capitalization of $1.10 trillion at July 31, 2016. Of these companies, 179 were Equity REITs representing 94.5% of total U.S. listed REIT equity market capitalization (amounting to $1.04 trillion)[1]. The remainder, as of July 31, 2016, was 41 publicly traded Mortgage REITs with a combined equity market capitalization of $60.0 billion.

NAREIT Recommendation

NAREIT generally supports the Proposal assuming that, in most cases, real estate would not meet the revised definition of a business in the Board's *Clarifying the Definition of a Business* proposal. Thus, these real estate transactions would be within the scope of the Proposal.

We agree that the basis for derecognition should be a loss of control of an asset consistent with FASB Accounting Standards Codification (ASC) Topic 606, *Revenue from Contracts with Customers.*

At the same time, NAREIT requests that the Board consider scoping into the proposed standard sales of investments in real estate joint ventures where substantially all of the assets in the venture are investment properties. It seems to us that reporting the sale of a wholly-owned investment property differently than a sale of an investment in a real estate joint venture results in complexities for investors and other financial statement users. We have considered the Board's rationale for excluding equity method investments from the Proposal but believe that simplicity from the perspective of a financial statement user should be the primary factor in determining accounting standards when there may be multiple possibilities. The following example illustrates our concerns:

Company A owns a large portfolio of investment property. It decides to sell six office buildings *in a single package transaction*. Four of the buildings are wholly-owned and two are held in a joint venture. Company A holds a 50% non-controlling interest in the joint venture. The sale is to a joint venture in which Company A will own a 20% interest and will account for its investment under the equity method of accounting. Under the Proposal, the full gain on the four wholly-owned properties will be recognized and the 20% interest in these properties will be recorded at fair value. We believe that the sale of the partial interests will be reported under Topic 860, which would result in a *partial* gain being reported on the sale of the 30% interests in two properties and the 20% retained interest in these two properties would be reported at their carry-over basis.

Investors and real estate financial analysts will have difficulty understanding the logic in this required complex accounting, which results in full gain being recognized on the sale of part of the investment property assets in the transaction and partial gain being recognized on the other investment property assets sold in the same transaction.

[1] https://www.reit.com/sites/default/files/returns/FNUSIC2016.pdf.

Accordingly, we recommend that sales of investments in real estate joint ventures accounted for under the equity method, where substantially all of the assets in the venture are investment properties, be scoped into the Proposal.

Precedent set in SEC staff position on Reporting NAREIT-defined Funds From Operations

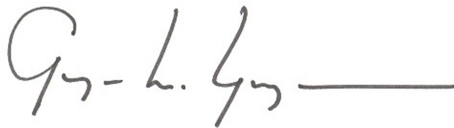
In 1991, NAREIT defined a non-GAAP performance metric that supplements GAAP net income. See Appendix I for the NAREIT Funds From Operations White Paper that fully describes the background, definition and use of this metric, which is widely recognized by investors in real estate investment trusts (REITs). In 2003, the SEC staff recognized FFO as a legitimate non-GAAP metric in the FAQ supporting Regulation G.

In 2011, at the request of NAREIT, SEC staff considered whether impairment write-downs of depreciated real estate should be excluded from FFO. The staff concluded that they would take no position as to whether FFO should exclude these impairment write-downs. NAREIT issued guidance to members for reporting FFO where the REIT records these impairment write-downs. Further, in January 2012, the SEC staff expressed a similar view with respect to impairment write-downs of *investments in joint ventures*, when the impairment is directly attributable to depreciable real estate held in the joint venture. NAREIT issued the Alert attached as Appendix II advising members of this further guidance with respect to the treatment of impairment write-downs in calculating FFO.

NAREIT looked through the entity structure at the underlying economics of the transaction in order to achieve more useful financial reporting and recommends that the Board do the same with respect to the derecognition of nonfinancial assets. NAREIT urges the Board to scope into the Proposal the derecognition of investments in real estate joint ventures where substantially all of the assets in the venture are investment properties.

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,



George L. Yungmann
Senior Vice President, Financial Standards
NAREIT

Christopher T. Drula
Vice President, Financial Standards
NAREIT

Appendix I

White Paper on Funds From Operations

April 2002

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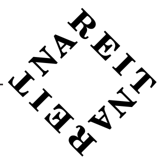


I. INTRODUCTION

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.

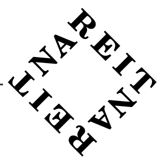
Since the introduction of the definition, the term has come to be widely used by REITs. In the view of NAREIT, this use (combined with the primary GAAP presentations required by the Securities and Exchange Commission) has been fundamentally beneficial, improving the understanding of operating results 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.

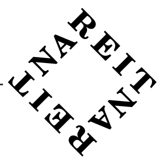
The following sections address the most important of the interpretive issues under the definition of FFO, along with NAREIT's views on them.

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

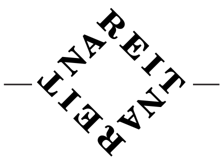
NAREIT's intent in the creation of FFO was to try to produce a measure of consolidated operating performance that is recurring in nature. Accordingly, in NAREIT's 1995 White Paper, the definition of FFO excluded items classified by GAAP as extraordinary or unusual, along with significant non-recurring 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;

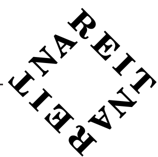
— FFO from discontinued operations;

— 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

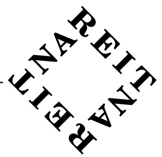
Thanks in some measure to a desire to use anticipated rather than historical results of operations in order to explain dividend policies, especially in initial public offerings, companies used their estimates of future FFO to justify anticipated dividend payouts in the descriptions of dividend policy 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.

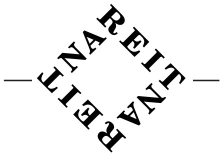
On April 26, 2001, NAREIT issued a National Policy Bulletin that more fully describes these "FFO White Paper Disclosures."

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.

January 6, 2012

NAREIT MODIFIES FFO DEFINITION TO ALSO EXCLUDE IMPAIRMENT WRITE-DOWNS OF INVESTMENTS IN *IN SUBSTANCE REAL ESTATE* INVESTEES UNDER CERTAIN CIRCUMSTANCES

In an Oct. 31, 2011, *SFO Alert* and a Nov. 4, 2011, *SFO Alert*, NAREIT issued guidance for reporting Funds From Operations (FFO) that reaffirmed NAREIT's view that impairment write-downs of depreciable real estate should be excluded from the computation of NAREIT FFO. This view is based on the fact that impairment write-downs are akin to and effectively reflect the early recognition of losses on prospective sales of depreciable property or represent adjustments of previously charged depreciation. Since depreciation of real estate and gains/losses from sales are excluded from NAREIT FFO, it is NAREIT's view that it is consistent and appropriate for write-downs of depreciable real estate to also be excluded.

Subsequent to issuing the guidance on Oct. 31, 2011, and Nov. 4, 2011, a number of NAREIT members asked if impairment write-downs of other assets should also be excluded from FFO. Of the fact patterns raised, NAREIT has concluded that the *only* impairment write-downs consistent with the concept of write-downs of depreciable assets or the early recognition of losses on sale of depreciable real estate are the write-downs of investments in affiliates (*i.e.*, joint ventures and partnerships), when there is clear evidence that the write-downs of the investor's investment in the affiliate have been driven by a measurable decrease in fair value of depreciable real estate held by the affiliate. NAREIT has concluded that these write-downs should be excluded from the FFO of the investor in the affiliate.

NAREIT has discussed this modification in the treatment of these specific impairment write-downs with SEC staff. The staff informed NAREIT that it expects that a REIT excluding these write-downs from FFO would include clear and detailed disclosure of how it determined that the write-down was driven by a measurable decrease in the fair value of depreciable real estate

held by the affiliate. The staff also informed us that they may request further clarification if the reasonable basis for this conclusion is not clear.

Further, NAREIT reminds members that the definition of FFO as modified excludes only impairment write-downs of depreciable real estate or of investments in non-consolidated investees that are driven by measurable decreases in the fair value of depreciable real estate held by the investee. This exclusion of impairment write-downs does *not* apply to impairment write-downs of other assets.

CONTACT

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No. US2017-01
January 6, 2017

At a glance

The FASB's new definition of a business will likely result in more acquisitions being accounted for as asset acquisitions.

FASB finalizes a new definition of a business

What happened?

On January 5, 2017, the FASB issued final guidance that revises the definition of a business. The definition of a business affects many areas of accounting (e.g., acquisitions, disposals, goodwill impairment, consolidation). According to feedback received by the FASB, application of the current guidance is commonly thought to be too complex and results in too many transactions qualifying as business combinations.

New guidance

When substantially all of the fair value of gross assets acquired is concentrated in a single asset (or a group of similar assets), the assets acquired would not represent a business. This introduces an initial required screen that, if met, eliminates the need for further assessment.

To be considered a business, an acquisition would have to include an input and a substantive process that together significantly contribute to the ability to create outputs. The new guidance provides a framework to evaluate when an input and a substantive process are present (including for early stage companies that have not generated outputs). To be a business without outputs, there will now need to be an organized workforce. The Board noted that outputs are a key element of a business and included more stringent criteria for sets without outputs.

Finally, the new guidance narrows the definition of the term "outputs" to be consistent with how it is described in Topic 606, *Revenue from Contracts with Customers*. Under the final definition, an output is the result of inputs and substantive processes that provide goods or services to customers, other revenue, or investment income, such as dividends and interest.

Transition

For public business entities with a calendar year end, the standard is effective in 2018. All other entities have an additional year. Early adoption is permitted.

The amendments can be applied to transactions occurring before the guidance was issued (January 5, 2017) as long as the applicable financial statements have not been issued. For example, a public company with a calendar year-end can apply the new guidance to transactions that occurred after its third quarter, but before filing of its 2016 Form 10-K.

Why is this important?

The changes to the definition of a business will likely result in more acquisitions being accounted for as asset acquisitions across all industries, particularly real estate, pharmaceutical, and oil and gas. Application of the changes would also affect the

accounting for disposal transactions. Refer to Table 9-1 in PwC's Business combinations and noncontrolling interests guide on CFODirect.com for a summary of the accounting differences between the acquisition of a business versus an asset.

The FASB's updated definition does not impact the SEC definition of a business used to determine whether historical financial statements and pro forma information is required in certain SEC filings.

What's next?

The new guidance is the first phase of a broader project. The second phase, expected to be finalized in early 2017, will clarify the guidance for partial sales and transfers of nonfinancial assets. In the third phase, the FASB is expected to revisit the accounting differences between asset and business acquisitions and disposals.

Questions?

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No. US2017-06
February 24, 2017

At a glance

New guidance clarifies what constitutes an "in substance nonfinancial asset" and changes the accounting for partial sales of nonfinancial assets to be more consistent with the accounting for a sale of a business.

FASB changes how to derecognize nonfinancial assets

What happened?

ASC 610-20 was issued as part of the new revenue standard. While the revenue standard primarily focuses on contracts with customers, ASC 610-20 was added to provide guidance for recognizing gains and losses from the transfer of nonfinancial assets in contracts with non-customers. The guidance issued by the FASB on February 22, 2017[1] clarifies when and how to apply ASC 610-20, in certain situations. The new guidance:

- Defines "in substance nonfinancial asset"
- Unifies guidance related to partial sales of nonfinancial assets
- Eliminates rules specifically addressing sales of real estate
- Removes exceptions to the financial asset derecognition model
- Clarifies the accounting for contributions of nonfinancial assets to joint ventures

Clarified scope

The new guidance clarifies that ASC 610-20 applies to the derecognition of nonfinancial assets and in substance nonfinancial assets unless other specific guidance applies. As a result, it will not apply to the derecognition of businesses, nonprofit activities, or financial assets (including equity method investments), or to revenue transactions (contracts with customers). The new guidance also clarifies that an in substance nonfinancial asset is an asset or group of assets for which substantially all of the fair value consists of nonfinancial assets and the group or subsidiary is not a business.

In addition, transfers of nonfinancial assets to another entity in exchange for a noncontrolling ownership interest in that entity will be accounted for under ASC 610-20, removing specific guidance on such partial exchanges from ASC 845, *Nonmonetary Transactions*.

As a result of the new guidance, the guidance specific to real estate sales in ASC 360-20 will be eliminated. As such, sales and partial sales of real estate assets will now be subject to the same derecognition model as all other nonfinancial assets.

Changes to accounting for partial sales

The new guidance will also impact the accounting for partial sales of nonfinancial assets (including in substance real estate). When an entity transfers its controlling interest in a nonfinancial asset, but retains a noncontrolling ownership interest, the entity will measure the retained interest at fair value. This is similar to the guidance on the sale of

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[1] Accounting Standards Update 2017-05, *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*

controlling interests in businesses. This will result in full gain/loss recognition upon the sale of a controlling interest in a nonfinancial asset. Current guidance generally prohibits gain recognition on the retained interest.

Transition

The amendments to the nonfinancial asset guidance are effective at the same time an entity adopts the new revenue guidance. Therefore, for public business entities (PBEs) with calendar year ends, the standard is effective on January 1, 2018. All other entities have an additional year to adopt the guidance. Early adoption is permitted beginning January 1, 2017 for calendar year end companies. While the timing of adoption needs to coincide with the adoption of the revenue standard, the transition method does not have to be the same. Transition can use either the full retrospective approach (i.e., applied to prior periods currently being presented) or the modified retrospective approach.

Why is this important?

The new guidance clarifies the application of the guidance in the revenue standard for the derecognition of nonfinancial assets, which will improve consistency. The new guidance is expected to impact all industries, but may particularly impact the real estate sector due to the elimination of the specific sales model for real estate and the requirement to recognize a full gain upon partial sales of real estate. While the accounting by joint ventures has not changed, entities contributing assets to joint ventures may also be impacted by the new guidance. In addition, given the FASB's recently revised definition of a business, more transactions will likely be treated as dispositions of nonfinancial assets (rather than dispositions of a business), which will increase the number of transactions subject to the new guidance.

What's next?

The new guidance is the second phase of a broader project. The first phase was completed in January 2017 with the release of ASU 2017-01, *Clarifying the Definition of a Business*. In the third phase, the FASB may revisit some of the remaining accounting differences between asset and business acquisitions and disposals.

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January 6, 2017

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In brief

The latest news in financial reporting

No. US2017-06
February 24, 2017

At a glance

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The FASB's new definition of a business

A comprehensive look at the new definition and its impact

No. US2017-01
January 31, 2017

What's inside:

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At a glance

On January 5, 2017, the FASB issued Accounting Standards Update 2017-01, which revises the definition of a business.

The changes to the definition of a business will likely result in more acquisitions being accounted for as asset acquisitions across most industries, particularly real estate and pharmaceuticals. The definition of a business also affects many other areas of accounting including disposals, consolidation, and segment changes.

Background

.1 Under the current business combinations guidance, there are three elements of a business: inputs, processes, and outputs. Outputs are not required to be present to meet the definition of a business. An entity needs to evaluate whether the set of assets and activities (a "set") is capable of being managed as a business by a market participant. If a set in a transaction does not include all of the inputs and processes that a seller used in operating that set, it can still qualify as a business as long as a market participant can replace the missing inputs and processes. While evaluating a transaction in this way aids in reaching consistent conclusions as to whether a business or a group of assets was acquired, this evaluation may result in transactions qualifying as business combinations when they are more akin to purchases of assets. Furthermore, the guidance does not specify the *minimum* inputs and processes required for a set to meet the definition of a business, which has added to its broad application. The FASB's revised definition of a business will result in fewer transactions qualifying as business combinations.

.2 The determination of whether a set is a business or a group of assets will impact the accounting for transactions related to that set. In a business combination, assets and liabilities acquired are generally recorded at fair value and goodwill is recognized for any excess consideration. In addition, in-process research and development and assumed contingencies are typically recognized and measured at fair value. Transaction costs are expensed and not included as part of the acquisition cost. In an asset acquisition, goodwill is not recognized, in-process research and development is expensed at the acquisition date if there is no alternative use, contingencies assumed are recorded only if probable, and transaction costs are generally capitalized.

.3 Another key difference is that there is a period of time, referred to as the measurement period, in which an entity can finalize the accounting for provisional amounts recorded in a business combination. The concept of a measurement period does not exist for asset acquisitions.

.4 While the definition of a business is written in the context of acquisitions, it also impacts the accounting in other areas, such as the accounting for dispositions, segment changes, and common control reorganizations, the determination and reassessment of distinct and separable operations for foreign currency transactions, lease classification upon an acquisition, and the assessment of variable interest entities.

.5 The FASB's updated definition does not impact the SEC's definition of a business, which is used to determine whether historical financial statements and pro forma information is required in certain SEC filings.

Key provisions

.6 The FASB's new framework will assist entities in evaluating whether a set should be accounted for as an acquisition of a business or a group of assets. It adds an initial screen to determine if substantially all of the fair value of the gross assets acquired is concentrated in a single asset or group of similar assets. If that screen is met, the set is not a business. The new framework also specifies the minimum required inputs and processes necessary to be a business. It removes the need to consider a market participant's ability to replace missing elements when all of the inputs or processes that the seller used in operating a business were not obtained.

.7 What qualifies as an input and process remains substantially the same as in the current guidance. While processes would typically be documented, the guidance clarifies that the intellectual capacity of an organized workforce could also qualify as a process. Administrative systems (e.g., billing, payroll) are typically not considered processes that significantly contribute to the creation of outputs.

.8 The new guidance narrows the definition of "outputs" to be consistent with how it is described in ASC 606, *Revenue from Contracts with Customers*. As a result, fewer sets will be considered to have outputs.

Screen test

.9 The guidance includes a new screen that directs the entity to determine whether substantially all of the fair value of the gross assets acquired is concentrated in a single asset or group of similar assets. If so, the set is not considered a business.

PwC observation:

The standard does not define what constitutes "substantially all." However, this term is used in other areas of GAAP (e.g., revenue, leases) and, while not necessarily a bright line, is typically interpreted to mean approximately 90%.

.10 Regardless of whether a set is a business or a group of assets, a reporting entity must determine the fair value of each asset acquired in order to allocate the consideration. As such, the new screen is not expected to add additional cost or complexity when evaluating an acquisition. However, the Board acknowledged that there could be additional costs to perform a quantitative analysis for a disposition.

.11 The initial screen may be performed qualitatively. The guidance includes an example of an acquisition of a license for a drug candidate and an at-market service contract. The at-market contract is qualitatively determined to have little or no fair value while, based on the significance of the license, it is clear that the threshold is met. In contrast, if a set includes multiple licenses for dissimilar drug candidates, and each has more than an insignificant fair value, the entity could qualitatively determine that the threshold is not met.

PwC observation:

If an entity does not apply the screen, but first evaluates a set under the more detailed framework, the screen may still need to be considered. If the framework indicates that the set is not a business, an entity need not evaluate the screen. However, when the framework indicates that the acquired set is a business, an entity should be comfortable that the acquired set would not meet the threshold to be considered an asset acquisition. An entity can evaluate the set in the most cost-effective manner.

Gross Assets

.12 For the purpose of the screen, there are several reasons why the fair value of the gross assets acquired is not necessarily the same as the consideration paid. For example, the denominator will exclude any liabilities assumed.

.13 Gross assets will also differ from consideration paid in a partial acquisition (i.e., it is impacted when there are noncontrolling interests and previously held interests). When a transaction results in control of a legal entity being obtained, even if less than 100% of the entity is acquired, total gross assets should be used in the screen. For example, 100% of the gross assets would be used as the denominator in the screen even though only a 60% controlling interest in the entity was acquired.

.14 In addition, gross assets should exclude cash and cash equivalents, deferred tax assets, and goodwill resulting from the effects of deferred tax liabilities. The Board noted that the tax form of the transaction and whether cash and cash equivalents were included should not affect the determination of whether the set is a business.

.15 Finally, the fair value of gross assets includes any consideration transferred in excess of the fair value of the net assets acquired (i.e., what would otherwise be recorded as goodwill in a business combination).

Single Asset

.16 The screen applies to a single asset or group of similar assets. A single asset includes any individual asset or group of assets that could be recognized and measured as a single asset under the business combination guidance (ASC 805). For example, ASC 805 allows certain complementary intangible assets with similar useful lives to be grouped as a single asset.

.17 The new guidance provides two scenarios in which separately recorded assets must be grouped into a single asset for the purpose of the screen.

- A tangible asset that is attached to another tangible asset should be considered a single asset. This includes an intangible asset representing the right to use a tangible asset (e.g., a building with an associated ground lease). To be considered attached, assets

cannot be physically removed and used separately without incurring significant costs. For example, land and a building would generally be recognized as separate assets in a business combination, but would be considered a single asset when performing the screen.

- In-place lease intangibles, including favorable and unfavorable intangible assets or liabilities, and the related leased assets should be considered a single asset (e.g., a building and an associated in-place lease intangible).

Similar Assets

.18 The screen can also be met if the fair value of the set is concentrated in a group of similar assets. Entities should consider the nature of the assets and the risks associated with managing and creating outputs when determining if assets are similar. If the risks are not similar, the assets cannot be combined for the screen. The Board indicated that when the risks in managing and creating outputs are dissimilar, the substantive processes required to manage and create outputs might need to be more advanced. As such, the determination of whether the acquired set constitutes a business should be made using the framework rather than the screen.

> **PwC observation:**
>
> Identifying similar assets based on the nature of the assets and their risk characteristics is an area that will require significant judgment. The guidance includes examples to illustrate how to make this evaluation.

.19 The following should not be considered similar assets for the purpose of performing the screen:
- A tangible asset and separate intangible asset
- Intangible assets in different major intangible asset classes (for example, customer-related intangibles, trademarks, in-process research and development)
- A financial asset and a nonfinancial asset
- Different major classes of financial assets (for example, accounts receivable and investments)
- Different major classes of tangible assets (for example, inventory and fixed assets)
- Assets within the same major asset class that have significantly different risk characteristics (for example, real estate investments that consist of residential and commercial properties)

The framework

.20 Under the new definition, to be considered a business, a set needs to have an input and a substantive process that together *significantly* contribute to the ability to create outputs. The guidance provides a framework to evaluate when an input and a substantive process are present (including for early stage companies that have not generated outputs). The guidance includes more stringent criteria for sets without outputs to be considered businesses.

PwC observation:

The Board eliminated the requirement to evaluate whether a market participant could replace any missing inputs or processes in determining whether or not a set qualifies as a business. However, the new guidance retains the requirement to evaluate whether the set is capable of being managed as a business by a market participant. Therefore, it is not relevant whether the seller previously operated the set as a business or whether the acquirer intends to operate the set as a business. The Board wanted to retain the requirement to evaluate the set from a market participant's perspective to prevent similar transactions from being accounted for differently depending on the buyer's intent.

.21 Even though individual processes that are used to create outputs may be insignificant on their own, entities should consider if they could be substantive in the aggregate.

.22 An organized workforce could be an input, a process, or both. For example, a consulting firm might only include employees (inputs) that utilize their intellectual capacity (a process) to generate outputs.

PwC observation:

While the guidance does not include a formal definition of an employee, we believe it would be reasonable to use the definition of an employee included in the FASB guidance on stock compensation (ASC 718). Therefore, an employee would be someone who will have an employer-employee relationship with the acquirer based on common law as a result of the acquisition.

The framework - outputs are not present

.23 When a set does not have outputs, in order to demonstrate an input and substantive process that together significantly contribute to the ability to create outputs, the set will need to include (1) employees that form an organized workforce and (2) an input that the workforce could develop or convert into outputs. When a set does not have outputs, the workforce needs to be actively contributing to the development of outputs. This is because without employees, there are inherent limitations on the processes that can be performed to create outputs.

.24 An organized workforce must have the necessary skills, knowledge, or experience to perform an acquired process that when applied to another input, is critical to the ability to develop or convert the acquired input into outputs. Depending on the nature of the process, the acquired workforce necessary to satisfy these requirements may consist of a small number of people (e.g., scientists working on a research and development project).

.25 Inputs that employees who form an organized workforce could develop or convert into outputs could include intellectual property that could be used to develop a good or service, resources that could be developed to create outputs, and access to necessary materials or rights that enable the creation of future outputs.

PwC observation:

Judgment will be required to determine whether the process performed by the organized workforce is critical to the ability to convert another acquired input into outputs. To make this judgment, the likelihood of producing an output if the acquired process was not present should be evaluated. If it is unlikely that the output would be created without the process, the process is likely critical to the ability to convert an input into outputs.

The framework - outputs are present

.26 A set will have outputs when there is a continuation of revenue before and after the transaction. However, the continuation of revenues does not on its own indicate that both an input and a substantive process have been acquired. When determining whether a process has been acquired, the presence of contractual arrangements that provide for the continuation of revenues, such as customer contracts, customer lists, and leases, would not be indicative of an acquired process and should be excluded from the analysis.

.27 The guidance includes the following examples of substantive processes, which when applied to an acquired input, significantly contribute to the ability to create outputs:

- Employees that form an organized workforce that has the necessary skills, knowledge, or experience to perform an acquired process that is critical to continue producing outputs. A process is not critical if, for example, it is considered ancillary or minor in the context of all of the processes required to continue producing outputs.
- An acquired contract that provides access to an organized workforce that has the necessary skills, knowledge, or experience to perform an acquired process that is critical to continue producing outputs
- The acquired process cannot be replaced without significant cost, effort, or delay in the ability to continue producing outputs
- The acquired process is considered unique or scarce

.28 The guidance includes examples of how to evaluate the set when outputs are present. In one example, a distributor acquires (1) distribution rights for a particular yogurt brand, (2) existing customer contracts, and (3) an at-market supply contract with the producer of the yogurt, but does not acquire any employees. In this example, the acquirer first determines that the set does not meet the the screen as the fair value will be assigned to multiple dissimilar assets (the license and the customer contracts). Since the set includes outputs through the continuation of revenues with customers, the acquirer evaluates the examples listed in paragraph .27 and determines that the set is not a business because it does not include an organized workforce and there were no acquired processes. Although it is likely that economic goodwill exists in this example as a result of revenue derived from future customers, this goodwill will be subsumed in the assets acquired.

PwC observation:

This example illustrates how the new guidance may result in a change in how entities evaluate transactions. Under current GAAP, entities might look to the in-place customer contracts that provide for the continuation of revenues and determine that the set includes both an input and a process (e.g., the distribution rights as an input and contractual provisions requiring minimum future delivery requirements as a process). Under the new framework, the existence of customer contracts are not part of the analysis of whether a substantive process has been acquired.

.29 It is not uncommon for various processes to be performed by third parties through contractual arrangements (e.g., asset managers). However, just because the set includes access to an organized workforce does not necessarily mean that the workforce is substantive. Similar to the framework for when outputs are not present, an entity will need to consider if the organized workforce accessed through a contractual arrangement is critical to continue producing outputs. For instance, an entity should consider the duration and renewal terms of a contract.

PwC observation:

An organized workforce can be an indicator of a substantive process. However, when outputs are present, an organized workforce is not required for the set to be considered a business. A substantive process can exist without an organized workforce (e.g., if the set includes an automated process through acquired technology or infrastructure).

The presence of more than an insignificant amount of goodwill

.30 When evaluating a set under the framework, the presence of more than an insignificant amount of goodwill may indicate that the acquired process is substantive. That is, if an entity is willing to pay an amount above fair value of the net assets included in the set, that may indicate that the set includes a substantive process. However, there could be scenarios (as in the yogurt distribution example above) in which there is economic goodwill but the set would not be a business unless an input and a substantive process are identified.

What's next

.31 For public business entities, the guidance is effective for financial statements issued for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. For all other entities, the amendments are effective for financial statements issued for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early adoption is permitted, including adoption in an interim period. Prospective application is required.

.32 The amendments can be early adopted and applied to transactions occurring before the guidance was issued (January 5, 2017) as long as the applicable financial statements have not been issued. For example, a public company with a calendar year-end can apply the guidance to transactions that occurred after its third quarter, but before the filing of its 2016 Form 10-K. If early adopted, the amendments must be applied to all transactions affected by the definition of a business (e.g., movements of a set between operating segments should be assessed to determine if the set meets the definition of a business, which could affect the allocation of goodwill).

.33 The guidance is the first phase of a broader project. The second phase, expected to be finalized in early 2017, will clarify the guidance for the derecognition of nonfinancial assets, including partial sales and transfers. As we expect fewer sets will qualify as a business under the new definition, the importance of the second phase of the project will be heightened as more sets will be assets and thus derecognized through the nonfinancial asset guidance. In the third phase, the FASB may revisit the accounting differences between asset and business acquisitions and disposals.

Questions?

PwC clients who have questions about this *In depth* should contact their engagement team. Engagement teams who have questions should contact the National Professional Services Group.

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