Accounting and Financial Reporting Updates

16 CPE Hours

IMPORTANT NOTE: In order to search this doucment, you can use the CTRL+F to locate key terms. You just need to hold down the control key and tap f on your keyboard. When the dialogue box appears, type the term that you want to find and tap your Enter key.

PDH Academy
PO Box 449
Pewaukee, WI 53072

www.pdhacademy.com
pdhacademy@gmail.com
888-564-9098

Accounting and Financial Reporting Updates

The purpose of this course is to inform the reader of the various changes to accounting and financial reporting affecting the accounting professional. Topics include a review of proposed FASB projects including those related to financial performance, leases, and financial instruments, practice issues involving the statement of cash flows, fair value reporting, pensions, the international convergence project, little GAAP, and more. The structure of the course is to encourage the reader to recall existing GAAP rules coupled with identifying, stating and outlining rules related to new and proposed pronouncements.

After reading the Section I course material, you will be able to:

- Identify some of the 12 recommended principles for the Comprehensive Business Reporting Model
- Recall the definition of free cash flow
- Recognize some of the key ratios used to analyze working capital
- Identify some of the symptoms of inefficiently managed working capital
- Identify some of the key differences in the claw-back provisions found in Sarbanes-Oxley and Dodd-Frank
- Recognize some of the key issues and changes facing company pension plans and their unfunded status
- Identify some of the key benefits and disadvantages of the principles-based system
- Identify some of the changes proposed to lease accounting including the impact on financial statements and key ratios
- Recognize the general structure of the FASB Accounting Standards Codification (ASC)
- Recognize some of the differences between IFRS for SMEs and IFRS
- Identify some of the GAAP rules for measuring and recording a deferred tax asset and related valuation account
- Identify some unusual transactions and how they are recorded on the statement of cash flows

After reading the Section II, you will be able to:

- Identify one of the criteria that must be met to treat a hosting arrangement as internal-use software
- Identify how to account for intangible assets under ASU 2014-18's accounting alternative
- Recall when an acquiree is permitted to use pushdown accounting under ASU 2014-17
- Identify the rules for accounting for goodwill for a nonpublic (private company)
- Recall one of the statements used to present the liquidation basis of accounting

Field of study:	Accounting
Level of knowledge:	Overview
Prerequisite:	General understanding of U.S. GAAP
Advanced Preparation:	None
Recommended CPE hours:	16
Course qualification:	Qualifies for both NASB QAS and Registry CPE credit based on a 50-minute per CPE hour measurement.
CPE sponsor information:	NASBA Registry Sponsor Number: 138298

Accounting and Financial Reporting Updates

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FASB Accounting Standards Codification (FASB ASC):

Effective July 1, 2009, the FASB implemented its *Accounting Standards Codification*™ (Codification). The *Codification* is the source of authoritative generally accepted accounting principles (GAAP) recognized by the FASB to be applied to nongovernmental entities. The Codification was effective for interim and annual periods ending after September 15, 2009. All previous level (a)-(d) US GAAP standards issued by a standard setter were superseded. Level (a)-(d) U. S. GAAP refers to the previous accounting hierarchy. All other accounting literature not included in the Codification are now considered non-authoritative. The Codification structure is significantly different from the structure of previous standards.

Within this course, the author references the new Accounting Standards Codification (ASC), Accounting Standards Updates (ASU), and in most cases also parenthetically retains the original FASB or AICPA pronouncement as a reference.

I. Latest Developments on the Accounting Front

A. Significant GAAP Changes in 2016 and Beyond

2015 should continue to be a very active year at the FASB as there are numerous new statements about to be issued. A key driver to the FASB's rapid-fire approach is its goal to accelerate the international convergence project so that U.S. companies will be in a position to adopt international accounting standards if the SEC mandates the use of international standards in the future. The author addresses the international FASB-IASB joint convergence project further on in this course.

Not all of the projects in the works are jointly issued by the FASB and IASB. Many of them are not part of the international standards project and are being developed and may be ultimately issued by the FASB alone. What is clear is that companies will have significant implementation issues as each of these new FASB statements is issued and the effective date of adoption nears.

The FASB's most significant projects in progress follow:

Major Project	What it will do
Accounting for Financial Instruments	Several changes: • Issued in January 2016: ASU 2016-1: Requires equity investments to be measured at fair value with the change recorded as income on the income statement. • Pending changes on impairment of financial instruments.
Leases	Final statement to be issued in the first half of 2016: Will Requirement companies to capital most leases with the concept of operating and capital leases eliminated.

FASB PROJECT SCHEDULE AS OF MARCH 2016		
F = final statement expected to be issued in 2016 **X = FASB expects to issue exposure draft or final statement after 2016**	**SCHEDULED ISSUANCE DATE**	
	2016	**Beyond 2016**
PROJECTS:		
Financial Instruments:		
Impairment	**F**	
Hedging		**X**
Interest Rate Disclosures		**X**
Leases	**F**	
PCC Issue No. 2015-01, Effective Date and Transition Guidance	**F**	
Financial Statements of Not-for-Profit Entities (Phases 1 and 2)		**X**
Disclosure Framework		**X**
Accounting for Goodwill for Public Business Entities and Not-for-Profits		**X**
Accounting for Income Taxes: Intra-Entity Asset Transfers		**X**
Clarifying the Definition of a Business		**X**
Consolidation: Principal versus Agent Analysis	**F**	
Statement of Cash Flows: Classification of Certain Cash Receipts and Cash Payments (EITF 15-F)		**X**
Financial Performance Reporting		**X**
Contingent Put and Call Options in Debt Instruments (EITF 15-E_	**F**	
Employee Share-Based Payment Accounting Improvements	**F**	
Simplifying the Transition to the Equity Method of Accounting	**F**	
Revenue Recognition- Identifying Performance Obligations and Licenses	**F**	
Recognition of Breakage for Prepaid Store-Value Cards (EITF 15-B)	**F**	
Simplifying the Balance Sheet Classification of Debt	**F**	
Effect of Derivative Contract Novations on Existing Hedge Accounting Relationships (EITF 15-D)	**F**	
Accounting for Goodwill Impairment		**X**
PRIVATE COMPANY COUNCIL:		
PCC Issue No. 14-01, Definition of a Public Business Entity (phase 2)	**F**	

B. Reporting Information About the Financial Performance of Business Enterprises

1. Financial Community's View of Financial Reporting and Disclosures

How does the financial community view the quality and importance of financial reporting and disclosures?

Background:

Over the past decade, the financial community has been fickle in conveying to the FASB, SEC and others the type of financial information it would like to see in financial statements and related disclosures.

First, there were the Enron and WorldCom frauds in the early 2000s, which created an onslaught of demand for further transparency, additional disclosures and the recording of off-balance sheet transactions. Investor demand for more information culminated with the passage of Sarbanes-Oxley Act of 2002. As history has shown, single, sizeable events, such as the Enron and WorldCom frauds, can result in the passage of bad law, as evidenced by the over-reaching provisions of Sarbanes-Oxley, which created a new oversight board (PCAOB), expansive auditing requirements, Section 404 compliance, and a host of extensive rules and regulations costing billions to implement and manage.

Interestingly, even though there were several sizeable frauds that occurred in the early 2000s, the expansive changes made by Sarbanes-Oxley were disproportionate to the satisfaction level of financial statement users. For example, financial statement users wanted some improvement with disclosures as they rated the quality of information as being good to average. Yet, Sarbanes-Oxley expanded various requirements as if the overall financial reporting system was broken, which it was not.

Thus, it appeared that the additional demands of Sarbanes-Oxley were made at the will of Congress and the SEC, within an over-reactive, politically charged climate.

Right after the passage of Sarbanes-Oxley, in 2003, AIMR did a survey to determine the extent to which portfolio and fund managers and securities analysts were satisfied with the quality of financial reporting and disclosures. At the time of the survey, the effects of the changes made by Sarbanes had not been felt. Therefore, one should treat these results as being part of a pre-Sarbanes survey.

The survey, conducted by AIMR, entitled *Global Corporate Financial Reporting Quality*, asked the following:

How do you rate the quality of the financial reporting and disclosures you receive?

Good to excellent	***45%***
Average	44%
Below average	7%
Poor	1%
No answer	3%
	100%

The survey further sought to determine the interrelation between the importance of financial information and disclosures, and quality of that information, by category. Only 45 percent of those surveyed rated the information they received in the pre-Sarbanes environment as either good or excellent.

The results of the survey suggested the following:

1. There was a *real disconnect between the importance of certain financial information and the perceived quality of that information*.

   a. In particular, the respondents suggested that the *quality of disclosures was generally poor* relative to their importance.

      For example, the survey suggested that overall, the importance of footnotes was either very or extremely important (85% of the respondents) while only 35% of those respondents stated that the overall quality of the footnotes was good to excellent.

2. Only 34% of the respondents noted that overall footnotes improved while 10% said they had not improved.

3. At the time of the survey, the top ten disclosures of most importance were:

	% very or extremely important
Off-balance sheet items	83%
Extraordinary, unusual, non-recurring charges	78%
Pension and other retirement benefits	76%
Contingencies, litigation, legal risks	73%
Explanation of accounting principles	72%
Revenue recognition criteria	72%
Costs capitalized versus expensed	70%
Segment reporting	71%
Forward-looking information	70%
Risk factors, sensitivity of assumptions	69%

A second study

As a further study on evaluating the financial reporting model, the Centre for Financial Market Integrity (CFA Institute) issued a report after Sarbanes-Oxley entitled *A Comprehensive Business Reporting Model, Financial Reporting for Investor*s. In its report, CFA outlined the comprehensive business reporting model that is important from the investor's perspective.

In its Report, the CFA outlined 12 principles for a comprehensive reporting model as summarized in the following chart:

12 Recommended Principles for a Comprehensive Business Reporting Model	
Principle	**Reason for Importance of Principle**
The company must be viewed from the perspective of a current investor in the company's common equity	The current common shareholder is the last to receive a share of the company's assets and earnings. The common shareholder must have complete, accurate information about all other claims that will be paid before it gets paid including potential risk exposures and possible returns.
Fair value information is the only information relevant for financial decision making	Currently, financial statements include some items reported at historical cost and others at fair value, under a mixed-attribute system. Decisions about whether to purchase, sell, or hold investments are based on the fair values of the investments and expectations about future changes in their values. Financial statements based on outdated historical costs are less useful for making such assessments.
Recognition and disclosure must be determined by the relevance of the information to investment decision making and not based upon measurement reliability alone	Financial information may be completely reliable if it is easily verifiable using one or more criteria. Yet, such information may not be relevant for financial decision making. For example, the purchase by a company of a major manufacturing facility 30 years ago at recorded cost is easily verifiable. However, such information is not useful or relevant for today's decision making.
All economic transactions and events should be completely and accurately recognized as they occur in the financial statements	The purpose of financial reporting is to convey the economic position of the company and changes in that position to investors. Reporting methods that omit or fail to reflect the economic essence of events and transactions as they occur, do not achieve the purpose of financial reporting. All activities that are currently off balance sheet must be recognized, including executory contracts.
Investors' wealth assessments must determine the materiality threshold	Under current practice, materiality is typically determined by the company or auditor using some arbitrary threshold such as 5 percent of an income statement or balance sheet number. Financial statements are prepared for investors who need information and who base their financial decisions upon it. The materiality threshold should be based on what will affect investors' decisions and not upon preparers' arbitrary assessments (e.g., 5% of net income or assets). These decisions should be based on both quantitative and qualitative factors. Example: A small amount of fraud committed by company managers would likely be considered highly material to investors in assessing the integrity of those to whom they entrust their assets.

Financial reporting must be neutral	Reporting of economic transactions and events should not be influenced by the outcomes of the financial reporting or the effects that the reporting may have on one or more interests. In the past, concern for outcomes has caused political forces to challenge standard setters. Example: During the stock option debate, those opposed to expensing stock options argued that expensing would reduce net income, causing companies that issue options to reduce the number of options granted to employees, making it more difficult to attract talented employees. Example: Pension accounting does not present fair value because of previous pressures placed on the FASB to water down its standards.
All changes in net assets must be recorded in a single financial statement: the *Statement of Changes in Net Assets Available to Common Shareholders*	Under present practice, changes in net assets are scattered throughout the financial statements in the income statement, cash flow statement, balance sheet and changes in stockholders' equity. Further, the netting and aggregation of transactions makes analyses of changes in net assets difficult. All changes in net assets should be reported clearly and understandably and in a single statement. Investors must now expend great effort to locate these changes and make use of them. Further, investors must resort to a great deal of analysis to determine the source and magnitude of many asset changes.
The *Statement of Changes in Net Assets Available to Common Shareholders* should include timely recognition of all changes in *fair values* of assets and liabilities	If investors are to be able to evaluate how the value of their investment is increasing or decreasing, they must be able to fully understand the change in fair value of the assets they hold and the obligations they have incurred. The clearest measures of a company's wealth-generating or consuming patterns are changes in the fair values of these assets and obligations. The Statement should also reflect the changes in fair value including remeasurements due to changes in interest rates. Delayed recognition of fair value, such as the unrealized gain or loss related to available-for-sale securities should be eliminated so that all gains and losses flow through the income statement.
The cash flow statement provides essential information and should be prepared using the direct method only	Under present practice, few companies use the direct method of presenting the operating activities of the statement of cash flows. A clear picture of the company's current means of generating cash flows, the patterns of those cash flows, and its effectiveness in producing cash is essential. The current cash flow statement format of most companies does not provide this information.

Changes affecting each of the financial statements must be reported and explained on a disaggregated basis	Today, most company financial statements are highly summarized and condensed. Aggregation of information with different economic attributes, different measurement bases, trends, and operations results in substantial loss of information.
Individual line items should be reported based on the nature of the items rather than the function for which they are used	Under current practice, information in financial statements are aggregated in major functional categories, such as cost of goods sold, and selling, general, and administrative activities. The forecasting of individual line items for use in valuation and other decisions requires that they be relatively homogeneous and represent a single economic attribute or an aggregation of very similar attributes. For example, labor cost, pension cost, materials cost, energy cost, etc.; that are part of cost of goods sold should be reported individually as each has very different economic characteristics, trends, and measurement bases.
Disclosures must provide all the additional information investors require to understand the items recognized in the financial statements, their measurement properties, and risk exposures	In current practice, disclosures vary widely in both quality and quantity. Investors must have sufficient supplementary disclosures to evaluate the numbers, including: • Financial reporting methods used • Models used for estimation and measurement • Assumptions used • Sensitivity analyses of point estimates • Information about risk exposures • Information explaining why changes in important items have occurred.

Now the disclosure overload

Be careful what you ask for…..

As you can see from the two reports previously discussed, in the wake of Enron and WorldCom, investors and third party users wanted more financial information and disclosures and they certainly received it.

During 2003 to 2014, there were several new accounting pronouncements issued in response to requirements of Sarbanes-Oxley, SEC and the FASB. Some of the pronouncements were issued in response to requirements of Sarbanes-Oxley, such as the issuance of FIN 46R and the consolidation of variable interest entity rules and the newly issued revenue recognition standard.

Now, after a decade of expanded disclosures and new GAAP standards, investors and third- party users are complaining that they are inundated with too many disclosures and far too much information. The result is that they want more quality, and less quantity of information.

Let's first look at some statistics based on a recently issued KPMG/FEI study:

a. In the 20 years since 1994, there have been more than 200 new GAAP documents issued in the form of Emerging Issues Task Force (EITF) consensuses, new GAAP statements, Accounting Standards Updates (ASUs), SEC Staff Accounting Bulletins (SABs), and Financial Reporting Releases, along with many interpretive guidance related to these documents.[1] In fact, a large number of those new standards have been issued during the period 2003 to early 2015.

b. The volume of new standards has accelerated since Sarbanes-Oxley Act with growing pressure placed on the FASB to "clean up" accounting standards, with particular interest in resolving GAAP for revenue recognition and off-balance sheet transactions.

c. The anticipated convergence with international standards has created an impetus for the FASB to accelerate new standards involving the FASB-IASB joint projects including leases, revenue recognition, financial instruments, among others.

d. The SEC's mandate that each financial statement disclosure be tagged in XBRL has resulted in the cost of each additional disclosure increasing.

A sample of those pronouncements issued from 2003 to early 2016, is noted in the chart below:

Selected Pronouncements Issued- 2003 to 2016	
Original Reference	**Pronouncement**
FIN 45	Guarantor's Accounting and Disclosure Requirements for Guarantees
FIN 46-R	Consolidation of Variable Interest Entities
FASB No. 158	Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans
FASB No. 157	Fair Value Measurements
FASB No. 123	Share-Based Payment (Stock Options)
FASB No. 159	Fair Value Option
FASB No. 141R and 160	Business Combinations and Non-Controlling Interests
FASB No. 161	Disclosures about Derivative Instruments and Hedging Activities
FASB No. 156	**Accounting for Servicing of Financial Assets**
FASB No. 166 and ASU 2009-16	Accounting for Transfers of Financial Assets
FASB No. 132	Disclosures About Pensions and Other Postretirement Plan Assets
ASU 2009-05, ASU 2009-12, and ASU 2010-06	Fair Value Measurements and Disclosures
ASU 2010-20	Disclosures about the Credit Quality of Financial Receivables and the Allowance for Credit Losses
ASU 2012-02	Intangibles—Goodwill and Other: Testing Indefinite-Lived Intangible Assets for Impairment
ASU 2013-04	Liabilities (Topic 405): Obligations Resulting from Joint and Several Liability Arrangements for Which the Total Amount of the Obligation Is Fixed at the Reporting Date (a consensus of the FASB Emerging Issues Task Force)

[1] *Disclosure Overload and Complexity: Hidden in Plain Sight*, KPMG and FEI, 2012.

ASU 2014-09	Revenue from Contracts with Customers (Topic 606)
ASU 2014-10	Development Stage Entities
ASU 2014-17	Business Combinations (Topic 805): Pushdown Accounting (a consensus of the FASB Emerging Issues Task Force)
ASU 2014-18	Business Combinations (Topic 805): Accounting for Identifiable Intangible Assets in a Business Combination (a consensus of the Private Company Council)
ASU 2015-01	Income Statement- Extraordinary and Unusual Items (Subtopic 225-20): Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items
Source: The Author	

The list of pronouncements identified in the previous chart is only a small sample of the total population of new pronouncements issued from 2003 to early 2016.

Take a look at any annual report of a public company and read the pages of footnotes. Any rational person will conclude that there is no shortage of disclosures. Are most of the disclosures meaningful to the end user?

One study suggests that the volume of disclosures has expanded, but not necessarily the quality. The study reviewed selected annual reports for the period 2004 to 2010. Updated information from 2010 through early 2016 has not yet been published although it is assumed that the results would show a similar pattern.

Consider the following results from the KPMG/FEI Report:[2]

1. Disclosures found in 10-k reports have expanded approximately 16 percent overall during the six-year period from 2004 to 2010, and footnote disclosure has grown 28 percent over the same period as noted in the following chart.

	Mean Increase 2004 to 2010
Volume of Form 10-K pages	16%
Volume of footnote disclosure pages	28%
Source: *Disclosure Overload and Complexity: Hidden in Plain Sight*, KPMG/FEI	

The pace of the increase in disclosures has been just as brisk from 2011 to 2015. Although not quantified, all indication is that the increase in the volume of disclosures for nonpublic entities is at least as high as that for public companies.

2. Over the six-year period 2004 to 2010, there was approximately a 50-percent growth in the volume of footnote disclosures related to pensions and other postretirement benefits.

[2] *Disclosure Overload and Complexity: Hidden in Plain Sight*, KPMG and FEI, 2012.

Take a look at the following excerpts from the survey that compared certain data from 2004 to 2010. (The survey did not expand into periods after 2010.)

Comparison- Number of Pages in Footnotes			
	Number of Pages		% increase
	2004	2010	
Archer Daniels Midland	20	42	110%
Wells Fargo	45	109	142%
Target	10	28	180%
Johnson & Johnson	19	27	42%
AT&T	25	40	60%
IBM	43	63	47%
Wal-Mart	12	23	92%
Source: *Disclosure Overload and Complexity: Hidden in Plain Sight*, KMPR/FEI, 2012, as modified by the author.			

Note: Footnote disclosures have grown at a rapid pace with particular expansion in the areas of pension and post-retirement benefits, fair value, financial derivatives and hedges. An important contributor to disclosure overload is increased complexity of the underlying transactions, investments, financial instruments, and relationships.

Financial statement user comments

1 The KPMG/FEI study states that financial statement users complain as to the quality of the disclosures and readability issue when trying to comprehend the information in the financial reports.

a. Many users believe that complexity in financial reporting confuses investors and therefore they cannot make optimal decisions.

b. Users have become concerned that the proliferation of required disclosures makes it difficult to decipher a company's performance and factors that drive performance.

c. Investors are concerned with longer and more opaque annual reports.

- More complex (longer and less readable) filings are associated with lower overall trading.
- There appears to be an association between report complexity and lower abnormal trading.
- Smaller investors reduce their trading when filings increase in length of pages.

Preparer comments

Many preparers of financial statements find the requirements for reporting financial instruments too complex. In fact, some preparers are concerned that the direction of the FASB and IASB toward principle-based standards will result in further confusion and complexity in disclosures.

Consider the following results from the same survey as they relate to preparer issues:

1. Preparers are concerned about the amount and speed of changes in regulations governing financial reporting.

    a. While there is some support for recent improvement in accounting for impairments, there is frustration that some standards are inconsistent, which makes it harder for preparers to see financial reports as a fair reflection of the business in question.

2. Some preparers believe that many of the disclosures are either unnecessary for their businesses or create confusion around the total remuneration for executives when they use complex reward mechanisms.

General conclusions of both users and preparers of financial statements

The study offers the following conclusions reached by both users and preparers:

1. Complexity of accounting standards and volume of mandated disclosures are the most significant contributors to the issue of disclosure complexity.

    - Fair value, derivatives and hedging are the most significant sources or causes of disclosure complexity under specific GAAP requirements.

2. Overall, SEC initiatives (e.g., the plain English initiative) to reduce disclosure complexity have not had much impact.

3. Most companies have not taken steps to reduce disclosure complexity in their financial statements.

4. Companies continue to include numerous disclosures (material and immaterial) in their notes.

5. Companies are reluctant to omit disclosures (other than those that are clearly immaterial), out of concern that the SEC or auditor will require the company to revise its reporting to include the immaterial item.

    - 61 percent are concerned that the SEC or other regulators will object to the removal of a disclosure, even if immaterial.

    - 56 percent are concerned that the external auditors will object to the removal of the disclosure, even if immaterial.

    - 71 percent say once a disclosure is included in notes, financial statement or public filing, it is rarely or never omitted from future financial statements or filings, resulting in an accumulation of excess disclosures over several years.

6. Companies *over disclose* to protect against potential litigation:

    - 73 percent say their company's disclosures are influenced by concerns over potential future litigation.

- Most companies stated that their inside or outside legal counsel does not significantly direct disclosure in some or all parts of public filings or footnotes to financial statements.

- 71 percent say that if legal counsel is significantly involved with disclosures, it is likely to involve risk factors.

7. Most respondents stated that the complexity of accounting standards and volume of mandated disclosures are significant contributors to disclosure complexity.

   - Almost all respondents stated financial reporting preparation time and information review time are impacted by expanded disclosure requirements.

   - Fair value and derivatives and hedging requirements is a primary source or cause of disclosure complexity.

   Note: With respect to complexity, not only has the volume of footnotes grown at a rapid pace, but the topics of disclosure have also become more complex. Such complex topics include new standards and disclosures about variable interest entities, derivative instruments, pensions and other post-retirement benefits and fair value. In fact variable interest entities and the financial reporting concepts that they embody only came into being within the last decade. The FASB's multiple attempts to issue guidance on variable interest entities illustrates that, even for these sophisticated and knowledgeable standards setters, this accounting and disclosure has been abnormally challenging.

8. Information presented on the face of the financial statements has a greater impact on users' understanding of the information than if provided in a footnote.

Recommendations from the study

The respondents developed the following recommendations to streamline disclosures without sacrificing important information.

a. The SEC should issue an interpretive release to address:

   - The permissibility of cross-referencing to avoid duplicate disclosures including business description, risk factors, accounting policies, litigation and other contingencies.

   - The manner of addressing immaterial items.

   Note that both the FASB and SEC have issued guidance that indicates that requirements need not be applied to immaterial items. Many registrants are concerned that any omission will lead to SEC staff comments and potential amendments to filings. One possible approach would be a single footnote that briefly identifies disclosures omitted due to immateriality.

b. Summaries of significant accounting policies and discussions of newly implemented or soon to be implemented accounting policies should not include a detailed description of patently immaterial matters.

c. Disclosures in the financial statements and elsewhere should make maximum use of tables and graphics and avoid the use of long textual discussions.

d. The SEC should move forward with its *21st Century Disclosure Project* and should consider rulemaking to permit companies to omit or incorporate by reference information included in other filings that continue to be available on the company's or SEC website.

e. The FASB should accelerate work on its Disclosure Framework project to establish a systemic approach to disclosure that properly balances disclosure considerations.

f. Disclosure of risk factors should be limited to company-specific unique risks and should not recite the obvious risks of the general environment.

Note: Risk factor disclosure in most periodic filings was observed to go much further than the rule, which made it difficult to determine factors that were truly matters for concern from those that were routine general risks. As a result of the volume of routine risk disclosures, readers are tempted to skim these factors and thus there is a greater chance that they will fail to read the uniquely risky factors.

g. Both public and private companies should be permitted to omit interim period disclosures concerning financial statement items that have not substantially changed since the end of the prior fiscal year.

h. The FASB and SEC should take various incremental procedures in consideration of cost-benefit analysis as a part of developing proposals for new accounting standards.

Note: In particular, the respondents believe that the FASB should consider any new disclosure requirements from the context of the overall current disclosure environment rather than considering disclosure from the perspective of each individual topic as it is addressed in standards setting. This macro disclosure consideration, together with more rigorous cost-benefit analysis and field testing of disclosures should be considered prospectively and retrospectively.

2. FASB Starts Up Financial Performance Reporting Project

In 2014, the FASB has announced that it is starting up its financial statement presentation project which stalled in 2011. The project has been renamed *Financial Performance Reporting Project.*

The objective of the project is to evaluate ways to improve the relevance of information presented in the performance statement (income statement). The project will explore and evaluate improvements to the performance statement that would increase the understandability by presenting certain items that may affect the amount, timing, and uncertainty of an entity's cash flows.

In July 2010, the FASB staff issued *Staff Draft of an Exposure Draft on Financial Statement Presentation,* which reflected the FASB's and IASB's cumulative tentative decisions on financial statement presentation at that time.

Key proposed changes identified in the Staff Draft included:

a. Financial statements would be functionalized and separated into *five main categories* as follows:

- Business section
- Financing section
- Income taxes section
- Discontinued operations section
- Multi-category transaction section

b. The *indirect method* of presenting the operating activities section of the statement of cash flows would be replaced by required use of the direct method.

c. The use of the term "*cash equivalents*" would be eliminated in the statement of cash flows and statement of financial position and replaced with the term "cash."

d. The statement of comprehensive income would replace the statement of income.

In 2011, the financial statement presentation project was one of the top priorities at the FASB. But, given the importance of other projects, including revenue recognition, financial instruments, and leases, the financial statement project was taken off the FASB's docket.

The FASB announced it was bringing the financial statement project back to life under the named *Financial Performance Reporting Project.* The plan is to bring the project back as a re-scoping of a research project.

Although the project is in its infancy, the direction of the changes being considered is significant and would dramatically change the way in which financial statements are presented. Moreover, the scope of the project is supposed to include both public and non-public entities, alike.

The FASB has directed the FASB Staff to focus on the following *two areas* within the scope of the project:

1. A framework for determining an operating performance metric, and

2. Distinguishing between recurring and nonrecurring or infrequently occurring items within the performance statement.

   In addition, the project will address potential related changes that may around in the following areas:

   - Additional disaggregation in the performance (income) statement
   - Transparency of remeasurements
   - Related changes to segment reporting, and
   - Linkages across the primary statements

Expect this project to gather momentum once the revenue recognition, financial instruments, and leases projects are issued in final form.

Changes in the financial statement format and presentation would have some obvious impacts as follows:

1. The cost of such a change would be significant.

a. Everything from textbooks to internal and external financial statement formats would have to be changed.

   - The change to the direct method alone would be costly.

2. There could be significant fluctuations in comprehensive income from year to year as more items are brought onto that statement than were not on the income statement before.

3. Contract formulas for bonuses, joint ventures, etc. that are based on GAAP net income would have to be rewritten.

4. Tax return M-1 reconciliations would differ.

Project update: At the January 20, 2016 FASB meeting, the project staff made a presentation of its research into the current practice of reporting functional and nature lines in the performance statement as well as considering how to disaggregate functional lines into certain nature components. This project is still in its infancy is will take several years to reach conclusion.

3. The Focus on Cash Flow, Working Capital and Other Financial Measurements

Furthering the scrutiny and mistrust of GAAP earnings, more analysts and investors are focusing on cash flow, working capital, and other financial measures other than accrual basis income in evaluating a company's financial performance. With the confusion over GAAP, third parties are focusing on other measures that they understand, such as cash flow.

Many analysts are using several key ratios and calculations that track cash flow and other financial measurements in relation to GAAP income. Those ratios and calculations are:

a. Free Cash Flow
b. Working Capital Ratios and Measurements
c. Core Earnings

Free cash flow

Free cash flow has become an important performance measurement used by financial analysts.

Although the formula for free cash flow can vary, typically it is based on the ratio of free cash flow to common equity.

Free cash flow is just that- the amount of cash flow that is free for common shareholders after accounting for fixed commitments such as capital expenditures and preferred stock dividends.

The formula typically used for computing free cash flow is as follows:

Free Cash Flow:	
Net income:	xx
Adjustments to reconcile net income to cash from operations:	
Depreciation and amortization	xx
Deferred income taxes	xx
Gain/loss on sale of assets	xx
Change in receivables	xx
Change in inventories	xx
Change in prepaid items	xx
Change in accounts payable and accrued expenses	xx
Net cash from operations (statement of cash flows)	***xx***
Less: Fixed items:	
Capital expenditures (net of dispositions)	(xx)
Preferred stock dividends	(xx)
Free cash flow	***xx***

Free cash flow can be further adjusted to reflect certain non-recurring items such as cash paid for acquisitions (net of cash received from divestitures), and restructuring and severance costs. Some companies and third parties shift certain items that are included in the operating activities of the statement of cash flows to investing or financing activities, and vice versa.

Although more third parties and analysts are focusing on cash flow as a measurement that is equally important to GAAP accrual basis income, what is becoming clear is that there are no standards for computing cash flow. In fact, GAAP does not define any formulas for computing cash flow except those presented in the statement of cash flows by ASC 230, *Statement of Cash Flows* (formerly FASB No. 95), such as those categorized in the operating, investing and financing activities sections, along with cash from operations. Therefore, concepts such as free or adjusted free cash flow and other cash flow variations will continue to be subject to alteration and manipulation until standards are adopted by the FASB, SEC or others.

Free cash flow and non-cash investing and financial activities

In computing free cash flow, a deduction is made for property, plant and equipment which are fixed obligations that must be incurred to feed continued growth. However, problems exist in calculating free cash flow when an entity has non-cash purchases of capital assets that are not displayed on the statement of cash flows. As a result, typically these non-cash items are not adjusted in arriving at free cash flows, thereby distorting the resulting free cash flow amount.

ASC 230, *Statement of Cash Flows* (formerly FASB No. 95), requires that non-cash investing and financial activities be excluded from the statement of cash flows and, instead, be disclosed.

Examples of typical non-cash include:

- Purchase of equipment by issuance of a note
- Establishment of capital leases
- Conversion of debt to equity

In these transactions, no immediate cash is expended even though the entity is obligated under the transactions.

Companies can "play games" in increasing their free cash flow simply by changing the way in which they make capital expenditures.

Example:
Company X has the following statement of cash flows:

Cash flow from operating activities	$2,000,000
Cash flow from investing activities:	
Capital expenditures	(3,000,000)
Cash flow from financing activities	3,000,000
Increase in cash and cash equivalents	$2,000,000

Free cash flow:	
Cash flow from operating activities	$2,000,000
Capital expenditures	***(3,000,000)***
Free cash flow	$(1,000,000)

Because the $3,000,000 of capital expenditures was made in cash and presented on the statement of cash flows, the capital expenditures are deducted in computing free cash flow.
Change the facts: Assume the company purchases the capital expenditures with debt.

Cash flow from operating activities	$2,000,000
Cash flow from investing activities:	
Capital expenditures	(0)
Cash flow from financing activities	3,000,000
Increase in cash and cash equivalents	$5,000,000

Supplementary disclosure:
Company purchased $3,000,000 of equipment under a long-term debt obligation.

Free cash flow:	
Cash flow from operating activities	$2,000,000
Capital expenditures	***(0)***
Free cash flow	$2,000,000)

Conclusion: Free cash flow increases from $(1,000,000) to $2,000,000 and does not reflect the non-cash capital expenditures of $3,000,000.

Note further that when the $3,000,000 of debt related to the capital expenditure is paid down, the principal payments are shown in the financial activities section and do not impact the free cash flow computation. Thus, no part of the non-cash transaction impacts free cash flow.

Observation: The previous analysis exposes the loophole that exists when an entity finances its capital expenditures. Under ASC 230, the expenditures are treated as a noncash transaction which is disclosed and not presented in the body of the statement of cash flows. In disclosing the noncash transaction, the capital expenditure is not deducted in computing free cash flow. Moreover, when the debt is repaid over time, the cash paid toward principal payments will be presented in the financing activities section and has no impact on free cash flow. The result is that none of the cash associated with the purchase of the capital expenditures is deducted in computing free cash flow. In the previous example, none of the $3,000,000 of capital expenditures ever impacts free cash flow.

Does it matter what type of noncash capital expenditure transaction is made?

There is a difference between how a capital expenditure is financed and its impact on free cash flow.

Consider the following three transactions:

1. Equipment is purchased through accounts payable that is outstanding at year end.
2. Equipment is leased through a capital lease.
3. Equipment is purchased through long-term debt.

Under all three transactions, the equipment purchased is presented as a supplementary noncash disclosure and is not deducted in computing free cash flow. Thus, there is no fundamental difference on the front end of the transaction.
However, the back end of the transactions differs profoundly.

When equipment is purchased through accounts payable, there is ultimately an impact on free cash flow. When the accounts payable is paid in the following period, the change in accounts payable is an adjustment to cash from operating activities, thereby affecting free cash flows. Thus, purchasing equipment with accounts payable does, in fact, ultimately result in the cash flow impacting free cash flow.

As for equipment purchased with long-term debt, or leased through a capital lease, there is no impact on free cash flows. That is, the capital expenditure related to the equipment purchase never impacts free cash flow. The reason is because when the long-term debt or capital lease obligation is repaid over time or in lump sum, the repayment is presented in the financing activities section of the statement of cash flows and does not impact free cash flow.

Georgia Tech Financial Analysis Lab Study

A study was published by Georgia Tech Financial Analysis Lab entitled, *Non-cash Investing and Financial Activities and Free Cash Flow*. The purpose of this Study was to consider the effect of companies that do not deduct non-cash capital expenditures in computing free cash flow.

The result is summarized in the following chart.

Free Cash Flow – Adjustments for Non-Cash Capital Expenditures						
Company	Operating cash flows	Capital expend.	Free cash flows, as reported	Non-cash capital Expend*	Adjusted FCF	% change in FCF
Safeway	$1,609,000	$(795,000)	$814,000	$(113,000)	$701,000	(14%)
Williams-Sonoma	209,000	(211,000)	(2)	(1)	(3)	(50%)
Albertson's	1,545,000	(1,022,000)	523,000	$(62,000)	461,000	(12%)
Pathmark Stores	90,000	(51,000)	39,000	(10,000)	29,000	(26%)
Maxwell Tech	150,000	(95,000)	55,000	(18,000)	37,000	(33%)
Flowers Foods	88,000	(44,000)	44,000	(55,000)	(11,000)	(125%)
BJ's Wholesale	200,000	(177,000)	23,000	(4,000)	19,000	(17%)
Plastipak Holdings	75,000	(99,000)	(24,000)	(7,000)	(31,000)	(29%)

* Non-cash expenditures presented as supplementary disclosure and not presented on the face of the statement of cash flows.
Source: *Non-cash Investing and Financing Activities and Free Cash Flow*, Georgia Tech College of Management, as modified by the author.

The Study illustrates that many companies are distorting their published free cash flows by not reflecting non-cash capital expenditures in the computation of free cash flows. For example, Safeway's operating cash flows are $1,609,000 while adjusted free cash flow (FCF) is only $701,000.

Because free cash flow is not based on GAAP income, no standards exist that require companies to adjust their free cash flow to include the adjustment for non-cash capital expenditures.

Free cash flow and incentive compensation

Due to the increase in the importance of free cash flow in analyzing financial performance, some companies tie their incentive compensation plans into free cash flow.

Most valuation models suggest that an increase in free cash flow ultimately translates directly into increases in stock price. Consequently, linking compensation plans to free cash flow is essentially the same as providing a nexus between income and compensation.

According to a report entitled *Free Cash Flow and Compensation: A Fashionable Fad or Something More,*[3] the following companies are a sample of those that have reflected free cash flow into their incentive compensation calculations.

[3] *Free Cash Flow and Compensation: A Fashionable Fad or Something More*? Georgia Tech College of Management.

Company	Basis for compensation plan
American Standards	Sales, earnings, free cash flow, etc.
Bausch & Lomb	Sales, earnings, free cash flow, etc.
Kraft Foods	Income growth, volume growth, free cash flow, etc.
Motorola	Operating earnings and free cash flow
Tyco	EBIT and segment free cash flow

Source: *Free Cash Flow and Compensation: A Fashionable Fad or Something More?* Georgia Tech College of Management.

Other companies, such as Newell, Washington Post, Weyerhauser, General Electric, and Comcast, included some form of cash flow in their incentive compensation formulas, but did not specifically mention free cash flow.

Working capital

All working capital ultimately leads to cash. In evaluating cash flow of a company, it is important to look at the flow of individual working capital components, namely trade receivables, inventories, and trade payables.

Four key ratios provide a thorough analysis of working capital. They are:

$$\text{Days Sales in Accounts Receivable} = \frac{\text{Trade receivables*}}{\text{Net sales}} \times 365$$

$$\text{Days Supply in Inventory} = \frac{\text{Inventory*}}{\text{Cost of goods sold**}} \times 365$$

$$\text{Days Payables Outstanding} = \frac{\text{Accounts payable*}}{\text{Cost of goods sold**}} \times 365$$

$$\text{Days in Working Capital} = \frac{\text{AR + Inventory – AP*}}{\text{Net sales}} \times 365$$

* Average numbers can also be used (beginning + ending balances/2).
** Purchases can also be used in place of cost of goods sold.
*** Another variation is to include purchases and cash operating expenses in the denominator.

Each of these above working capital ratios should be compared with the *best possible ratio.*

Example: If credit terms to customers are 30 days, and the number of days sales in receivables is 49 days, there is a 19-day spread between the best possible ratio (30 days) and the actual ratio (49 days).

How important is working capital to analysts and investors in their evaluation of a company?

The cost of tying up cash due to ineffective working capital management can be significant.

Because working capital flow ultimately leads to cash flow, analysts pay great attention to it as a measure of financial performance. In turn, companies are responding by increasing their focus on working capital management, particularly at year-end.

A study performed by REL Consulting Group that was published by CFO Magazine suggests that:

- Working capital is so important to third-party financial statement users, that companies have stepped up their effort to manage their working capital at year end through window dressing.

- One of the easiest ways to improve cash flow is to reduce the number of days in net working capital.

In the Study, REL performed working capital analysis on numerous companies in the fourth quarter versus the following first quarter of the past three years to determine if there was manipulation of working capital at year end.

The results were as follows:

1. There is a widespread pattern across industries that net working capital *drops dramatically in the fourth quarter* of the fiscal year, and *dramatically increases in the following first quarter* once the annual report has been published.

2. U.S. companies tend to leave too much "housekeeping" of their working capital to year end in terms of writing off bad debts and discarding obsolete inventory.

3. Companies continue to reward executives based on operating income and not working capital management.

   - The interest cost of holding excess working capital is not reflected in operating income.

Observation: The result of the survey suggests that management takes actions to reduce its working capital position at year end to maximize its cash position. Once year-end financial statements are issued, net working capital increases back to its normal level.

2015 REL Consulting Group Study: In 2015, a study on working capital[4] was published that assessed the working capital performance of the largest 967 U S. companies (based on sales) during the years 2005 to 2014. (2015 information has not been published.) The Study concludes that U.S. companies' working capital position is flat at about 33 days of working capital outstanding. There is about $1 trillion of excess working capital, which is defined as nothing more than excess cash tied up in working capital due to inefficiency in working capital management. (For purposes of the study, net working capital is defined as trade receivables plus inventory less trade payables.)

Following is a summary of the change in working capital from 2013 to 2014 (2015 data was not available):

[4] 2015 U.S. Working Capital Survey, REL Consulting (The Hackett Group)

2014 results: [967 Largest U.S. Companies]	2014	2013	Change in net WC	% change
Days in receivables	36	36	(0)	
Days in inventory	43	43	(0)	
Days in payables	(46)	(46)	(0)	
Days in net working capital	33	33	(0)	0%

% change 2014 vs. 2013	0%
% change 2013 vs. 2012	0%
% change 2012 vs. 2011	(3.0%)
% change 2011 vs. 2010	(3.0%)
% change 2010 vs. 2009	(3.0%)
% change 2009 vs. 2008	8.0%
% change 2008 vs. 2007	(6.0%)
% change 2007 vs. 2006	(1.0%)
% change 2006 vs. 2005	(2.0%)

Specific conclusions reached by the study include:[5]

1. Companies are cash rich with cash positions increasing by 74% from 2013 to 2014 to an aggregate cash balance of about $932 billion.

2. The ability to raise cash through cheap debt has reduced companies' incentive to release cash tied up in working capital. At the end of 2014, the top 967 U. S. companies had $1 trillion unnecessarily tied up in excess working capital, representing about 6 percent of U.S. GDP.

3. Days in working capital hovering between 39 and 33 days from 2009 to 2014.

   Note: In 2008, at the peak of the economy before the downturn, the number of days in net working capital was 35 days. From 2008 to 2010, net working capital increased significantly due primarily to the poor economy. In 2011 through 2014, the number of days in working capital became stable and ultimately settled at 33 days at the end of 2014.

4. Days in working capital improved slightly declining from 38 days in 2010 to 33 in 2014.

Prior to 2009, there had been continued effort by United States companies to reduce net working capital by implementing efficient systems to manage their working capital. In particular, there had been improvement in managing inventory as companies no longer stock piled inventories and were able to better match inventory supplies with product demand due to efficiencies in the supply chain. When the United States economy declined, those entities were able to effectively shave their inventory supply down to match lower demand. A similar situation occurred with manufacturing labor whereby entities were able to better match their labor supply with manufacturing demand. In doing so, there was little "fat" existing in the manufacturing labor resulting in a challenge for those same companies to find further cuts in their manufacturing labor. In essence, during the strong economic years of the early-to-mid

[5] 2015 U.S. Working Capital Survey, REL Consulting (The Hackett Group)

2000s, those entities had already implemented efficient cost cuts to the extent that there was no significant room for improvement.

To no surprise, with the deteriorated economy in 2009, the number of days sales in receivables increased from 35 days in 2008 to 39 in 2009, and ultimately came down and leveled off at 36 days in 2014. Once published, 2015 days sales in receivables is expected to be the same as 2014.

Another interesting statistic is that the top 1,000 United States companies continue to have cash tied up in excess working capital which was estimated at $1 trillion at the end of 2014. This excess working capital curtails companies from being able to expand and requires them to seek liquidity from outside sources. This cost of inefficient working capital is significant. Consider the cost of capital required to replace $1 trillion of excess working capital.

Given the tight financial markets, companies need to manage their working capital as they must gather additional net cash to subsidize the potential financing shortfall. With financing difficult to obtain or expand, the least expensive and available alternative is to squeeze the missing portion of required financing out of net working capital by reducing inventories, coercing or incentivizing customers to pay earlier, and by stretching payables.

Measuring collections of receivables

Historically, companies have used the number of days sales outstanding (DSO) as the primary gauge of credit-collection efficiency in connection with trade receivables.

As a reminder, DSO is calculated as follows:

$$\text{Days Sales in Accounts Receivable} = \frac{\text{Last three months ending total trade receivables}}{\text{Net sales for the quarter}} \times 30$$

Although DSO is typically useful in following trends in collections, it is not necessarily the only measure that should be used.

In particular, it is effective to look at both DSO and average days delinquent (ADD).

ADD reflects the average number of days invoices that are past due and is based on the following formula:

ADD = DSO – Best Possible DSO

Best Possible DSO expresses the best possible level of receivables under the most favorable conditions, with no delinquencies.

$$\text{Best possible days sales outstanding in accounts receivable (BPDSO)} = \frac{\text{Last three months ending current portion of trade receivables}}{\text{Net sales for the quarter}} \times 30$$

Example 1:

DSO = 45 days
Best possible DSO = 35 days
ADD = 45- 35 = 10 days

The ADD result means that customers were on average 10 days past due on their receivable balances.

Example 2:

Assume the following facts:

At December 31, 20X1, accounts receivable consist of the following:

AR at December 31, 20X1:	October 31	November 30	December 31	Three-month Total
Current	$700,000	$650,000	$750,000	$2,100,000
31-60	200,000	150,000	100,000	450,000
61-90	125,000	75,000	100,000	300,000
More than 90	60,000	50,000	40,000	150,000
	$1,085,000	$925,000	$990,000	$3,000,000

Net sales are $2,000,000 for the fourth quarter 20X1.

$$\text{DSO} = \frac{1{,}085{,}000 + 925{,}000 + 990{,}000}{2{,}000{,}000} \times 30 = 45 \text{ days}$$

DSO = 45 days

$$\text{Best possible DSO} = \frac{700{,}000 + 650{,}000 + 750{,}000}{2{,}000{,}000} \times 30 = 32 \text{ days}$$

Best possible DSO = 32 days

DSO	45
Best possible DSO	32
Average days delinquent (ADD)	13

Conclusion: The ADD is 13 days which means that customers were 13 days late on paying their receivables.

DSO and ADD can move in different directions

There are instances in which DSO and ADD can move in different directions for reasons other than efficiency of collections.

Example:

Assume to following:

	20X1	20X2
DSO	45	42
Best possible DSO	35	30
ADD	10	12

Conclusion: This is an example where DSO declines while ADD increases. When this occurs, the decline in DSO is likely to be due to factors other than collection efficiency.

For example, the fact that the Best Possible DSO declined may be a result of several factors not related to collection efficiency such as:

a. Changes in the receivable terms from net 35 to net 30. Such a change has nothing to do with collection efficiency.

b. Instituting an effective discount program such as changing from 1% to 2% discount in 10 days.

c. Eliminating confusion and smoothing order processing procedures to shorten the receivables cycle.

d. Tightening up sales personnel's willingness to extend payment terms to special customers.

e. Adopting stricter policies for receivable payment given up front as a result of changes from Sarbanes-Oxley.

In this example, the company's collections efforts have actually deteriorated from 20X1 to 20X2 even though DSO has declined from 45 to 42 days. The benchmark for perfect collections is Best Possible DSO which has declined from 35 to 30 days due to a change in the payment terms from net 35 to net 30. Thus, one would expect that DSO would decline by at least 5 days (from 45 to 40) just to retain the same level of collections quality in 20X2 versus 20X1. Yet this result did not occur as DSO declined by only 3 days (45 to 42 days) and ADD increased from 10 to 12 days.

Observation: Because most companies and their accountants and auditors typically use DSO as the only benchmark for collection efficiency, they are looking at a result that does not benchmark DSO against Best Possible DSO. Failure to do so means that a company's collection efficiency may actually be deteriorating even though DSO is declining. It is important that companies start using DSO and ADD in evaluating receivables collections.

What is the financial cost of having ADD?

Average Days Delinquent (ADD). means there is capital tied up in receivable balances and a related carrying cost thereto. To assist employees in understanding the cost associated with having too high an ADD, a company can translate the cost into a lost opportunity cost as follows:

Example:
Company X has the following monthly receivables information for 20X9.

Month	AR Balance (A)	DSO*	Best DSO	ADD*	% ADD/DSO (B)	ADD portion of AR (A x B)
January 1	$4,000,000	42	27	15	36%	$1,428,000
January 31	4,200,000	44	29	15	34%	1,431,000
February 28	4,400,000	46	30	16	35%	1,530,000
March 31	4,500,000	45	29	14	31%	1,395,000
April 30	4,400,000	41	28	13	32%	1,395,000
May 31	4,500,000	39	27	12	31%	1,385,000
June 30	4,700,000	46	29	17	37%	1,737,000
July 31	4,900,000	48	30	18	38%	1,838,000
August 31	3,800,000	45	29	16	36%	1,351,000
September 30	4,300,000	43	28	15	35%	1,500,000
October 31	4,100,000	42	28	14	33%	1,366,000
November 30	3,900,000	39	26	13	33%	1,300,000
December 31	4,200,000	41	27	14	34%	1,428,000
Average	**$4,300,000**					**$1,468,000**

* Number of days in Best DSO is computed using the current portion of receivables off the month's AR aging. Typically Best DSO will be less than the net terms (e.g., 30 days) due to incentive discounts such 2/10, net 30.

Assume further that the Company borrows on its working capital line of credit at an average rate of 5% in 20X9.

Conclusion: On average, the Company has $1,468,000 of excess receivables outstanding which represents that portion of receivables (ADD) in excess of the best possible balance outstanding.

The result is that the excess receivables of $1,468,000 costs the company the following in additional interest costs for 20X9.

$1,468,000 x 5% = $73,400 additional interest cost

Observation: Obviously, no company can achieve the Best Possible DSO level of receivables. Therefore, a company can build in a tolerable error that is given to the collections department and by which its performance is evaluated such as the following:

Acceptable receivables level	
Best possible DSO:	
Net 30 terms	30
Effect of discounts	(2)
Best possible DSO	28
Acceptable ADD	7
Acceptable DSO	35

4. Working Capital Management

Are there signs that a company has poor working capital management?

A report entitled *Improving Shareholder Value Through Total Working Capital*, by REL Consulting Group, emphasizes the importance of working capital management and the fact that analysts and investors need to evaluate the working capital efficiencies of the companies in which they have an interest.

In the Report, REL identifies symptoms that exist in companies with poor working capital management techniques. The following chart identifies those symptoms:

Symptoms of Inefficiently Managed Working Capital
Trade receivables:
• Bad debts are increasing
• Past due receivables (e.g., 90 days or older) are increasing
• The company is unable to collect the majority of past due amounts due to customer complaints
• Customers are paying short due to quality issues
• The company has imposed credit sanctions on its customers
• The predictability of the company's cash flow forecast is deteriorating
• The company requires additional staff to process a backlog of unprocessed invoices
• Receivables are growing disproportionately to sales
• Receivables staff morale is deteriorating due to being overworked and making collections calls
• The company has delays in closing the month end due to billing problems
• The company has month-end pressure to get as much sales and cash as possible
• Number of days in payables is lower than the number of days in receivables
Inventories:
• The company does not have detailed information of all inventories located at all points at the same time
• The company does not know the amount of its product that is being held by its top 10 customers
• The company does not know how much inventory it holds from its top 10 suppliers
• Customer service levels are low
• Sales and productions managers argue over product flexibility or availability
• The company is increasing its "safety stocks" in response to unreliable sources of supply and inter-company production

• The warehouse is running out of space despite flat or lower sales
• Inventory obsolescence and writeoffs are increasing
• The company's distribution network and its replenishment strategy have resulted in stocking the same slow-moving items in various warehouses
• Discontinued items clutter storerooms, warehouses, and the balance sheet
Payables:
• Interest payments to suppliers are increasing
• Payment disputes are increasing
• The company has a payment run each day or quite frequently
• The supplier list has expanded
• The same supplier delivers to different sites based on different terms
• There is no payment term "floor" that represents the minimum terms the purchasing department should obtain
• The company does not have an authorization procedure that demands approval for non-standard terms
• Vendors have imposed credit sanctions on the company
• Many of the non-cost-of-goods purchases are made outside the formal purchasing system
• ***Purchase discounts have declined (emphasized)***
Source: *Improving Shareholder Value Through Total Working Capital™ Management*, REL Consultancy Group

The push toward holding management accountable for working capital management

There is certainly a disconnect between profitability and working capital. Yet, the two are quite interrelated. Efficient working capital management can significantly improve not only cash flow but also profitability in several ways:

1. Excess cash from efficient cash flow management can be used to pay down debt and, in turn, minimize interest expense

2. Efficient trade receivable collection procedures can minimize bad debts

3. Efficient inventory management can reduce the amount of obsolescence

4. Excess cash generated from trade receivable and inventory management can allow a company to maximize purchase discounts.

Recently, companies have started considering cash flow-working capital management as a benchmark component used to compute management compensation.

One example is General Electric (GE) that uses performance share units (PSUs) to compute equity compensation in lieu of stock options. GE executives are given PSUs that vest in five years provided cash from operating activities increases at least 10 percent per year during the five-year period. Thus, GE, like other companies, links compensation to cash-working capital management.[6]

[6] *Compensation and Cash Flow*- CFO.com

Some of the practices that companies can implement to create a long-term working capital management program include:[7]

- Make cash flow improvement a strategic priority with visible senior management backing.
- Link cash flow performance and working capital management to compensation structure.
- Make cash flow one of the key metrics for performance management within operations and finance.
- Focus on lead time compression and increasing manufacturing flexibility.
- Standardize customer and supplier payment terms and control exceptions through an escalation process.
- Segregate customers and suppliers based on value and risk to support.
- Automate and eliminate high-volume, low-margin transactions to free up resources.

As suggested in the previous list of recommendations, cash flow and working capital management is becoming a key factor in compensation:

- More companies are using cash flow factors from the statement of cash flows to reward management rather than using only the statement of income.
- Many of the largest U. S.-based, publicly held companies use a cash-flow measurement to calculate short-term compensation, with the percentage continuing to rise.
- Cash flow-working capital management allows the company to focus on the balance sheet rather than the income statement.
- Corporate boards are motivated to use cash flow because GAAP income, EPS and revenue are subject to management's manipulation.
- With the FASB change to expensing stock options, companies have shied away from stock options as a form of compensation.
- Some companies are using a blend of factors in their executive compensation bonus plans, such as 50 percent of bonuses based on the income statement and 50 percent based on cash flow-working capital management.

[7] *U. S. Working Capital Survey*, REL

Core earnings

As a follow up to the FASB's financial reporting project, Standard & Poor's led the way in publishing performance data on the S&P 500 using a benchmark other than net income. More than one decade ago, Standard & Poor's created a research project with a goal of developing a standard measurement that would most effectively measure operating earnings, without the distortions on net income created by GAAP. The results of the research project were published in *Measures of Corporate Earnings.*[8]

The formula for core earnings used by S&P follows:

Computation of the S&P's Core Earnings[9]

Net income	$XX
Exclude:	
Non-recurring items:	
Discontinued operations	XX
Extraordinary items	XX
As reported income (used for EPS)	***XX***
Exclude:	
Goodwill impairment charges (1)	XX
Gains/losses from asset sales (2)	XX
Reversal of prior-year charges and provisions (5)	XX
Merger/acquisition related expenses (2)	XX
Litigation/insurance settlements and proceeds (2)	XX
Include:	
Employee stock option grant expense (3)	(XX)
Pension costs (4)	(XX)
Core earnings	***$XX***

(1) Goodwill impairment charges are non-recurring items that do not result in the generation of period revenue.
(2) Non-recurring items are excluded from core earnings such as gains/losses from asset sales, merger and acquisition expenses, and litigation/insurance settlements and proceeds.
(3) Stock options expense is recorded using external fair value method, rather than intrinsic method.
(4) Pension costs on defined benefit plans are adjusted to compute cost based on actual investment returns instead of expected returns.
(5) There is a reversal into income of portions of restructuring charges and other provisions booked in prior periods.

Standard & Poor calculates and reports core earnings on U. S. equities, including the S&P 500.

[8] Report published by Standard & Poor's
[9] *Measures of Corporate Earnings,* Standard & Poor

What is the impact of publishing core earnings for the S&P 500?

In general, there continues to be a significant difference between reported GAAP operating earnings per share and core EPS, with particular differences resulting from stock options, pensions and goodwill amortization.

Historically, the percentage of core EPS to operating EPS for the S&P 500 ranged from 80 to 92 percent from 2003 to 2015.[10] Entities that have high quality earnings typically have a relatively high percentage of core earnings to operating earnings which is conclusive that most of the earnings are convertible into cash and not merely a function of manipulation of GAAP. Conversely, a ratio of a company's core earnings to GAAP operating earnings that is less than 80 percent may indicate that the quality of earnings is poor and that GAAP income is not fully convertible into cash.

[10] S&P published core earnings per share, 2003-2015

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

1. Which of the following is correct as it relates to the current practice of determining financial statement materiality as noted in the report entitled, A Comprehensive Business Reporting Model:
   a. Materiality is typically determined by the investor or other third party using some arbitrary threshold
   b. Typically materiality is measured using a statistical, computed threshold
   c. The materiality threshold should be based on what will affect investors' decisions and not upon preparers' arbitrary assessments
   d. Materiality should reflect only quantitative factors

2. According to one study, if a company includes a disclosure in its notes, which of the following is correct:
   a. That disclosure usually has a shelf life of one year before it is replaced
   b. It is rarely omitted from future financial statements or filings
   c. That disclosure begins as a quantitative disclosure and is converted to a qualitative one in either the second or third year
   d. If it is an SEC company, typically a regulator will make the company change the disclosure

3. Which of the following is not a category or subcategory of financial statements proposed under the financial performance reporting project:
   a. Business section
   b. Financial section
   c. Income tax section
   d. Debt section

4. Which of the following is the FASB proposing would be the category of cash on the statement of cash flows:
   a. Cash equivalents
   b. Cash and cash equivalents
   c. Cash only
   d. Cash *and short-term investments*

5. Which of the following does not ultimately impact free cash flow:
   a. Collection of receivables
   b. Purchasing equipment through long-term debt
   c. Purchasing equipment with accounts payable outstanding at year end
   d. Payment *of preferred stock dividends*

6. The following formula is entitled _____*:*

$$\frac{\text{AR + Inventory – AP}}{\text{Net sales}} \times 365$$

   a. Days supply in inventory
   b. Days payable outstanding
   c. Days in working capital
   d. Days left in the sales cycle

7. One study indicated that at the end of 2014, U.S. companies _____.
   a. Had very little excess working capital
   b. Had about $1 trillion tied up in excess working capital
   c. Had the fewer days outstanding in accounts payable versus accounts receivable
   d. Had days in working capital increase from 2009 to 2014

8. How is Days Sales Outstanding (DSO) calculated:
   a. $\frac{Accounts\,receivable + Inventory - Accounts\,payable}{Net\,sales} \times 365$
   b. $\frac{Inventory}{Net\,sales} \times 365$
   c. $\frac{Last\,three\,months\,ending\,total\,trade\,receivables}{Net\,sales\,for\,the\,quarter} \times 30$
   d. $\frac{Last\,three\,months\,ending\,current\,portion\,of\,trade\,receivables}{Net\,sales\,for\,the\,quarter} \times 30$

9. The REL report, Improving Shareholder Value Through Total Working Capital, identified what symptom that exists in companies with poor working capital management techniques:
   a. Inventory obsolescence is decreasing
   b. Past due receivables are decreasing
   c. Suppliers deliver to other sites based on similar terms
   d. Vendors *have imposed no credit sanctions on the company*

10. How can working capital management significantly improve cash flow and profitability:
   a. Efficient accounts payable procedures can minimize bad debts
   b. Efficient inventory management can increase obsolescence
   c. Excess cash from efficient cash flow management can be used to establish more accounts
   d. Excess *cash generated can allow a company to maximize purchase discounts*

SUGGESTED SOLUTIONS

1. Which of the following is correct as it relates to the current practice of determining financial statement materiality as noted in the report entitled, A Comprehensive Business Reporting Model:
   a. Incorrect. Under current practice, materiality is not determined by the investor or other third party, but is typically determined by the company or auditor.
   b. Incorrect. In practice, materiality is typically determined using an arbitrary threshold such as 5 percent of income or a percentage of total assets, not a statistical, computed threshold.
   c. **Correct. The Report suggests that the materiality threshold should be determined through the eyes of the investor, for whom the financial information is issued. That threshold is based on what will affect investors' decisions.**
   d. Incorrect. The Report suggests that both quantitative and qualitative factors should be considered in determining materiality, and not based on an arbitrary quantitative threshold.

2. According to one study, if a company includes a disclosure in its notes, which of the following is correct:
   a. Incorrect. The Study does deal with shelf life of disclosures and does not suggest that such disclosures get replaced after one year. In fact, rarely does the disclosure get removed making the answer incorrect.
   b. **Correct. One key point noted in the Study is that once a disclosure in added to a notes, it is rare that the disclosure is omitted in future financial statements or filings. The result is that excess disclosures accumulate in the notes over several years.**
   c. Incorrect. There is no evidence that the disclosure converts to a qualitative version, making the answer incorrect.
   d. Incorrect. The Study did state that companies are concerned that an auditor or regulator will require a company to retain a disclosure. However, there is no evidence that a regulator will make a company *change a disclosure making the answer incorrect.*

3. Which of the following is <u>not</u> a category or subcategory of financial statements proposed under the financial performance reporting project:
   a. Incorrect. The business section is identified as one of the possible categories. According to the sample financial statements, the business section would consist of operating and investing transaction.
   b. Incorrect. The proposal would include a financing section. According to the sample financial statements, the financing section would include debt and financing transactions.
   c. Incorrect. The proposal would include an income tax section that would be reflective of activity related to all income taxes.
   d. **Correct. There is no debt section identified. Instead, debt activity would be part of the financing section making the answer correct.**

4. Which of the following is the FASB proposing would be the category of cash on the statement of cash flows:
   a. Incorrect. The term "cash equivalents" would be eliminated.
   b. Incorrect. Although cash and cash equivalents is a term used under the current statement of cash flows, the FASB does not recommend that it be continued.
   c. **Correct. The FASB wants to eliminate the term "cash equivalents" so that the statement of cash flows reconciles down to cash only.**
   d. Incorrect. Cash and short-term investments is not a category recommended by the FASB.

5. Which of the following does not ultimately impact free cash flow:
   a. Incorrect. Collection of receivables increases cash from operating activities which, in turn, affects free cash flow.
   b. **Correct. Purchasing equipment through long-term debt has no impact on free cash flow. Capital expenditure related to the equipment purchase never impacts free cash flow.**
   c. Incorrect. Purchasing equipment with accounts payable which is outstanding at the year end does, in fact, ultimately result in the cash flow impacting free cash flow. When the accounts payable is paid in the following period, the change in accounts payable is an adjustment to cash from operating activities, thereby affecting free cash flow.
   d. Incorrect. Preferred stock dividend payments are deducted from Net income to arrive at free cash flow. Thus the payments directly impact free cash flow.

6. The following formula is entitled _____:

$$\frac{\text{AR + Inventory – AP}}{\text{Net sales}} \times 365$$

   a. Incorrect. Days supply in inventory is inventory divided by net sales.
   b. Incorrect. Days payable outstanding consists of accounts payable divided by net sales times 365.
   c. **Correct. Days in working capital consists of the sum of the working capital components divided by net sales.**
   d. Incorrect. There is no formula for days left in the sales cycle.

7. One study indicated that at the end of 2014, U.S. companies _____.
   a. Incorrect. Companies had more than "very little" excess working capital, making the answer incorrect.
   b. **Correct. The REL working capital study showed that U.S. companies had about $1 trillion in excess working capital due to inefficient working capital management, making the answer correct.**
   c. Incorrect. In 2014, the number of days in payables was higher (46) than number of days in receivables (36) making the answer incorrect.
   d. Incorrect. Days in working capital decreased from about 39 in 2009 to 33 in 2014, making the answer incorrect.

8. How is Days Sales Outstanding (DSO) calculated:
   a. Incorrect. The presented formula is for computing Days in Working Capital, not DSO.
   b. Incorrect. The presented formula is for computing Days Supply in Inventory, not DSO.
   c. **Correct. The formula noted is the one to compute the Days Sales Outstanding (DSO).**
   d. Incorrect. The formula noted is the one for Best Possible Days Sales Outstanding in Accounts Receivable (BPDSO), not DSO.

9. The REL report, Improving Shareholder Value Through Total Working Capital, identified what symptom that exists in companies with poor working capital management techniques:
   a. Incorrect. A symptom that exists in companies with poor working capital management techniques, is an increase in inventory obsolescence which suggests excess inventory maintained over current demand for that inventory.
   b. Incorrect. An increase, not a decrease, in past due receivables unveils a weak collection policy.
   c. Incorrect. A poor technique is where the same supplier delivers to different sites based on different terms suggesting the company is not leveraging its collective volume to maximize terms and prices.
   d. **Correct. A symptom that exists in companies with poor working capital management techniques is that vendors have imposed <u>no credit restrictions</u> or sanctions on the company due to past due payments and concern that the company may be a credit risk.**

10. How can working capital management significantly improve cash flow and *profitability:*
   a. Incorrect. Efficient trade receivable, not trade payables, collection procedures can minimize bad debts.
   b. Incorrect. Efficient inventory management can reduce the amount of obsolescence, not increase it, making the answer incorrect.
   c. Incorrect. Excess cash from efficient cash flow management can be used to pay down debt and, in turn, minimize interest expense, not establish more accounts.
   d. **Correct. If an entity has efficient working capital management, that entity can use the excess cash to take advantage of maximizing purchase discounts, among other cash returns.**

C. Restatements and Other Financial Reporting Abuses

The public is inundated with information the financial press that focuses on the early warning signs of corporate reporting abuses. *The Wall Street Journal, Business Week, New York Times*, and other publications continue to deliver a weekly education to the unsophisticated investor. In this section, the author discusses a few of the obvious reporting problems that have been announced by the SEC and the financial press.

Restatements

In 2015, Audit Analytics published a report[11] comparing the number of financial statement restatements in 2014 with those in previous years.

Details from the report suggest:

1. The number of restatements in 2014 (831) represented a slight decrease from the 2013 level of 867. Overall, restatements during the period 2008 to 2014 declined considerably as compared with the levels for the period 2005 to 2007:

Restatements by year
831 in 2014
867 in 2013
851 in 2012
848 in 2011
836 in 2010
761 in 2009
930 in 2008
1,271 in 2007
1,842 in 2006
1,573 in 2005
937 in 2004

2. The average income adjustment per restatement was about $1.9 million, the lowest over the past eight years.

3. 59% of 2014 restatements had no impact on earnings.

4. The average number of days restated (the restatement period) was 496 days in 2014.

5. The average number of days to record and file the restatement was 4.54 days in 2014 a significant reduction from a high of 30 days in 2007.

6. The largest restatement was disclosed by a foreign company listed on a U.S. stock exchange.

[11] *Financial Restatements- A Fourteen-Year Comparison*, Audit Analytics (2015)

7. There was an average of 1.65 issues per restatement in 2014.

8. The top reasons for restatements noted in the report follow:

	% restatements
Debt-quasi debt	22%
Statement of cash flows	20%
Income tax issues- tax expense/benefit/deferral/other (FAS 109) issues	13%
Foreign, related party, affiliated, or subsidiary issues	12%
Expense (payroll, SGA, other) recording issues	12%
Revenue recognition	12%
Liabilities and payables	10%
Accounts receivable	10%
Inventory	8%

Note: In certain cases, there was more than one accounting issue for each restatement.

Source: Audit Analytics, 2015

Another report issued by Glass Lewis indicated that the number of restatements for companies audited by the Big Four was about half of those for companies audited by other auditors. Moreover, historically, smaller companies restate more often than larger companies, and those companies in the services and technology industries filed the most restatements.

So, what caused the decline in restatements from its peak in 2006 to 2014?

Restatements peaked in 2006, then gradually declined in 2007, 2008, before leveling off in 2009 through 2014. The slight uptick in restatements in 2010, 2011 and 2013 versus 2009 was not significant and should not be construed as an upward trend.

Although there is no evidence to support a conclusion, a consistent hypothesis is based on the following information:

- The decline in restatements from 2007 to the period 2009-2014, was a byproduct of improved internal control from companies implementing Section 404 of the Sarbanes-Oxley Act.

- For the past several years, most public companies have complied with Section 404 by rectifying their internal control differences and correcting errors that were found.

- Evidence of the impact of Section 404 compliance is identified by Glass Lewis in that the number of adverse opinions issued by auditors has declined by 78 percent over the past five years.

In addition, there are factors that contribute to continued restatements:

a. Auditors are being more demanding and assertive in requiring companies to make adjustments, and

b. Materiality thresholds are being reduced in fear of heightened scrutiny.

Another study suggested that the decline in restatements is directly linked to the rate of auditor turnover that declined in years 2009 through 2014, as compared with 2008. It is commonly expected that an auditor turnover indicates that there was an auditor dispute that may have led to a restatement and material weakness being uncovered in subsequent periods.

How long does the market punish companies that have restatements?

Since 2000, there have been several studies published that address the issue as to what happens when an entity restates its financial statements, focusing on two issues involving the market's punishment of a company's restatement:

How much does stock price decline after a restatement is published? and

How long does the decline occur?

Previously, studies had reached the following conclusions:

In one study[12] its author concluded the following:

- A restatement is generally considered bad news by the market.
- The market reacts quite negatively to a restatement by penalizing the stock price for the *three-day period* after the restatement announcement.
- Restated companies lose credibility in the marketplace as investors rate their earnings as being a lower quality after the announcement is made.
- Stock declines due to a restatement vary up to 10 percent depending on the type of restatement.

Another study suggested that:[13]

- The magnitude of the market reaction to restatement filings has not diminished with the increased frequency of restatements.
- How an entity discloses its restatement (with or without filing an 8K) suggests how the market will react to a restatement. A change in stock price and trading volume was significant if an entity filed the restatement in an 8K versus if it did not.

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[12] *A Review of Earnings Restatements* (Min Wu- New York University Stern School of Business)
[13] *Restatements: Investor Response and Firm Reporting Choices*, Plumlee and Lonbardi Yohn

Still another study[14] reached a conclusion that stock prices fell more sharply after a restatement when insiders of the company were on record for selling some of their stock during the restatement period. The theory is that insiders were aware of some internal issues that motivated them to sell their stock prior to a significant decline in stock price. Conversely, the fact that insiders purchased shares of company stock during a restatement period had the effect of mitigating the negative impact of the stock price decline.

Prior to 2014, the previously published studies concluded that stock price did decline after a published restatement but that the decline was relatively short-term, for only about 3 days.

That all changed in 2014 with the publishing of a new study.

In 2014, a study was published by the American Accounting Association, entitled, Is the Decline in the Information Content of Earnings Following Restatements Short-Lived?[15]

The purpose of the study was to determine whether investors punish companies for restatements. The study was based on an analysis of 1,200 restatements over a ten-year period, with 343 of the restatements due to a material fraud or irregularity.

The conclusions reached by the study are that:

- Once there is a *material restatement* for anything *other than an "honest error*," investors have a negative response to earnings statements made by that company for *close to three years* (11 quarters) from the date the restatement is announced.

  Note: The three-year period is much longer than all previous studies that suggested that the lack of investor response lasted only a few days.

- Companies with material misstatements saw their stock price decline an average of 7.2%.

- For all other restatements involving either an "honest mistake" and/or "immaterial amount," the decline in stock price was *only 1.8%* and the negative impact on investor response was *only one quarter*.

What should a company do to mitigate the effect of a misstatement?

There are several swift actions that a company can take to reduce the amount of stock price decline and time during which investor confidence is reduced.

- Removing the CEO or CFO, and/or external auditor, or the audit committee chairperson, regains investor confidence quicker, in as fast as the fourth or fifth quarter.

- Companies that execute payment of special dividends and offering share repurchases see a milder decline in stock price and for a shorter period of time.

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[14] Earnings Restatements Aren't Necessarily Stock-Price Poison, Brad Badertscher, University of Notre Dame

[15] Professors Xia Chen and Qiang Cheng, Singapore, and Alvis Lo in Boston, as published in *Investors Punish Material Restatements, Study Says*, Compliance Week (January 2014)

- A video announcement (rather than paper) made by the CEO taking full responsibility for the restatement resulted in a stock price decline of only 3% as compared with a drop of 26% when the company blamed another party.

- Increase in charitable giving helped to reduce the amount of decline in stock price.

Give back those bonuses when there is a restatement:

The *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the "Act") includes expanded requirements that companies have a clawback policy so that executives are required to pay back incentive compensation if there is a restatement of a public company's financial statements. The clawback provision of Dodd-Frank is discussed later in this section of the course.

Since 2002, Section 304 of the Sarbanes-Oxley Act has been the overall authority for companies to "claw back" executive compensation.

Section 304 states that certain officers (CEO and CFO) of a public company must return their bonuses related to a year for which there is a restatement of the company's financial statements due to a material noncompliance issue as a result of a *misconduct* with any financial reporting requirement under the securities law.

More specifically, Section 304 provides that if an issuer (public company) is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of *misconduct*, with any financial reporting requirement under the securities laws, the chief executive officer and chief financial officer of the issuer must reimburse the company for:

- any bonus or other incentive-based or equity-based compensation received by that person from the company *during the 12-month period* following the first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement, and

- any profits realized from the sale of securities of the issuer during that 12-month period.

In order for Sarbanes-Oxley's Section 304 clawback provision to apply, there must be two elements:

a. There must be a *misconduct*, and

b. There must be a *restatement*.

As to the companies that have had clawback provisions in their executive employment contracts, when there have been restatements, many companies have been reluctant to go after their executives to return bonuses due to several reasons including:

- There is a high cost of litigation and bad publicity, and

- The bad publicity may bring into question the terms and conditions of the employment contract.

Interestingly, the SEC did not prosecute a Section 304 case until 2007 even though Sarbanes-Oxley was effective in 2002. Since 2007, the SEC has ratcheted up its Section 304 cases. In recent years, the authority of Section 304 of Sarbanes-Oxley has continued to be tested in the courts in light of the high number of restatements.

Although the intent of Section 304 is clear, its application has led to situations in which challenges have continued to be made as to whether certain executives actually have to return their bonuses in the wake of their companies' restatements. In particular, executives have continued to take the position that their employment contracts that were consummated prior to the effective date of Section 304 should prevail and such contracts do not necessarily have a return of bonus requirement.

Also, both the courts and SEC have been inconsistent as to the scope of when Section 304 can be used for several reasons:

- There is a legal question as to whether the amount of compensation that must be returned is limited to the portion directly attributable to the misstated financial statements.

- Although it is clear that the SEC can use Section 304 to recover bonuses, there is ambiguity surrounding whether third parties can sue under Section 304.

- The term "misconduct" is not defined in Sarbanes-Oxley or within other securities statutes.

- An unresolved issue is whether the misconduct of an employee can trigger Section 304 against the CEO or CFO, even if the CEO or CFO had no knowledge of that employee's misconduct, and regardless of whether the CEO or CFO is charged with fraud or securities law violations.

Regardless of the requirements of Section 304 of Sarbanes or Section 954 of Dodd-Frank, companies are amending compensation policies to provide for the return of bonuses from both the executives and rank-and-file workers in the event of fraud, intentional misconduct, or material financial statement misstatements.

Consider the following statistics as noted in *Equilar's 2013 Clawback Policy Report*:

- 89% of Fortune 100 companies have publicly disclosed clawback policies, an increase from only 17.6% as far back as 2006.

- The majority of clawback policies focus on multiple recoupment triggers. Of the Fortune 100 companies that disclosed clawback policies, as grounds for recoupment of compensation:

  - 85.4% included materially inaccurate financial statements
  - 81.6% included ethical misconduct.
  - 71.8% included provisions containing both financial restatement and ethical misconduct triggers.

- Clawback policies still focus on top executives. Of clawback policies included in the analysis, 68% applied to key executives and employees

Below is a sample clawback policy by Express Scripts Holding Co. presented in its public disclosures:

> *"…. the Compensation Committee adopted a formal clawback policy that will be applicable for fiscal year 2013 reporting and beyond. Our policy applies to all current and former named executive officers and certain other executives (including the chief accounting officer) who received incentive based compensation following the effectiveness of the policy, and allows for recovery of incentive compensation payments based on restated financial results, regardless of whether misconduct was the cause of the restatement. The Compensation Committee retains discretion regarding the application of the policy. Once final rules are released regarding clawback requirements under the Dodd-Frank Wall Street Reform and Consumer Protection Act, we intend to review our policies and plans and, if necessary, amend them to comply with the new mandates."*

The SEC bullies executives- using Section 304 to retrieve bonuses

Prior to 2007, the SEC did not use Section 304 to recover bonuses. In fact, its first Section 304 case did not occur until 2007. Then, in 2008 through 2015, the SEC prosecuted Section 304 cases with vigor. In particular, recent SEC actions under Section 304 have involved officers who were not individually charged with fraud or securities law violations.

Recently, the SEC has been aggressively seeking recovery of compensation in cases in which the CEO or CFO was not accused of any wrongdoing.

Two cases illustrate the SEC's overly aggressive strategy:

- SEC v. Jenkins (*SEC v. Maynard L. Jenkins*, U.S. District Court of Arizona), and
- SEC v. Baker (*SEC v. Michael A. Baker et al*, U.S District Court of Texas)

In the first case, *SEC v. Jenkins*, the SEC took action against a former CEO of CSX Auto Corporation, Maynard Jenkins, to claw back more than $4 million of bonuses and stock profits allegedly earned while the company (but not the CEO) was committing accounting fraud. CSX had two financial statement restatements due to over-inflated revenue that were included in Form 10-K filings, both signed by the CEO. During the year following the filing of the 10-K forms, the CEO received bonuses and stock compensation. Subsequently, the SEC sought recovery of the CEO's $4 million of compensation and charged four former CSK executives with securities fraud, *even though the CEO was not charged*. What is most peculiar about the CSK case is that it represents the first case in which the SEC used the Section 304 clawback provision against an executive, even though individually he was not charged with fraud or other SEC violations.

The Jenkins case was ultimately settled by Mr. Jenkins returning $2.8 million of incentive-based compensation.

A second case, *SEC v. Baker*, involved the SEC's effort to claw back compensation from an executive who was not accused of any wrongdoing.

In SEC v. Baker, a federal district court in Texas upheld the SEC's right to seek the claw back of bonuses and other compensation from both the CEO and CFO of Arthrocare, in connection with that company's restatement of its financial statements. The restatements were due to alleged fraud by two senior vice presidents, but not against the CEO and CFO from whom the SEC sought recovery.

In the Baker case, the court confirmed that Section 304 of Sarbanes does not require the officer from whom the reimbursement is being sought to perpetrate the fraud or misconduct. Instead, the court stated that Section 304 *"requires only the misconduct of the issuer."*

Observation: Both the CSX and Baker cases have opened numerous legal issues. In particular, there is the question as to whether the SEC has the authority to deprive an individual of his or her compensation when he or she has not been charged with violating any law involving the earning of that compensation. Moreover, the risk that compensation might be clawed back might not encourage CFOs and CEOs to implement restatements. After all, why would an executive want to initiate a restatement if he or she is going to be forced to repay compensation earned during the restatement period and the one-year period thereafter!

The CSX and Baker cases are examples of several recent enforcement actions by the SEC that appear to be overly aggressive. Some commentators suggest that the SEC is merely setting an aggressive tone that is needed in financial markets that the public believes are laced with fraud and corruption.

Clawback provision under Dodd-Frank

Arguably, the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the "Act") embodies some of the most significant changes to corporate governance and financial regulations since the Great Depression. The Act includes many executive compensation and corporate governance provisions.

One example is a requirement that at least once every three years, public companies allow their shareholders to make a nonbinding vote related to the compensation packages of its named executive officers including any agreements the company may have with those officers.

Another key changes found in the Act is an executive compensation "clawback" provision.
Section 954 of the Act states:

> "The rules of the Commission (SEC)…..shall require each issuer to develop and implement a policy providing—
>
> (1) for disclosure of the policy of the issuer on incentive based compensation that is based on financial information required to be reported under the securities laws; and
>
> (2) that, in the event that the issuer is required to prepare an accounting restatement due to the *material noncompliance of the issuer with any financial reporting requirement* under the securities laws, the issuer will recover from any current or former executive officer of the issuer who received incentive-based compensation (including stock options awarded as compensation) during the 3-year period preceding the date on which the issuer is required to prepare an accounting restatement, based on the erroneous data, in excess of what would have been paid to the executive officer under the accounting restatement."

In essence, the Act requires the SEC to require public companies to implement and disclose a "clawback" policy. Under this policy, if there is an accounting restatement due to a material noncompliance with financial reporting requirements, the company would have to recover any incentive-based compensation (e.g., bonuses, etc.) from any current or former executive officer for the *three-year period* prior to the restatement period.

Such recovery of incentive compensation would be required regardless of whether the executive officer was involved in the misconduct that led to the restatement.

Does the clawback provision found in Dodd-Frank's Section 954 overlap with the Section 304 clawback provision in Sarbanes-Oxley?

There is a question as to whether the clawback provision found in Dodd-Frank is really necessary given the fact that Section 304 of Sarbanes already has a clawback provision.

When one looks close and compares the Section 954 Dodd-Frank clawback provision with the one found in Section 304 of Sarbanes Oxley, it is clear that Dodd-Frank's version is far more reaching and much more expansive than Section 304 of Sarbanes-Oxley.

Although the SEC regulations for the Dodd-Frank clawback provision have not been issued, here are the obvious differences between the two clawback provisions:

1. Section 304 of Sarbanes only applies to a CEO and CFO, while Section 954 of Dodd-Frank applies to "any current or former executive." Therefore, under Section 954, once an executive retires from a company, there is a potential clawback string that extends to that executive into retirement for the next three years.

2. Section 304 of Sarbanes requires that the misstatement be due to "misconduct" while Section 954 of Dodd-Frank does not require that there be any misconduct; only that there is a misstatement.

   Note: Section 954 applies when a company is "required to prepare an accounting restatement due to the *material noncompliance of the issuer with any financial reporting requirement."* Arguably, all reported restatements meet the "material noncompliance" threshold because only material adjustments are required to be made by GAAP. Thus, one of the fundamental problems with the Dodd-Frank clawback provision is that it does not require misconduct by anyone in order for it to apply.

3. Section 304 requires "any bonus or other incentive based or equity-based compensation" be repaid as well as any profits realized from the sale of securities of the issuer. Section 954 only requires the repayment of the amount of incentive-based compensation (including stock options) that exceeds what would have been paid under the restatement.

4. Section 304 applies to a twelve-month period while Dodd-Frank extends back three years from the year of restatement.

Comparison of Clawback Provisions Sarbanes Section 304 vs. Dodd-Frank Section 954		
	Sarbanes 304	Dodd-Frank 954
Employees at risk	CFO and CEO	Any current and former executives and officers
Type of compensation subject to clawback	All incentive-based and equity-based compensation	Excessive incentive-based compensation
Timeframe	One year following issuance of restated financial statements	Three years prior to the date on which the company was required to restate its financial statements
Level of misconduct	Misconduct required but not by CEO and CFO	No misconduct required. Only a restatement is required
Can a private party bring an action?	No	Not yet determined
Right of indemnification for clawback	Courts say "no", SEC unofficially says "no"	Not yet determined
Party responsible for clawback action	SEC	Company
Source: *Indemnification Risks,* The Corporate Board, as modified by Author.		

Observation: The Dodd-Frank clawback provision is far more mechanical than Section 304 of Sarbanes. Under Sarbanes, not only must there be a restatement, but there also must be misconduct associated with that misstatement. With Section 954 of Dodd-Frank, there is no "misconduct" threshold. Consequently, as a matter of fact, under Section 954, if a company restates its financial statements for any reason, it must recover any excess incentive-based compensation from its current and former executive officers. Although Dodd-Frank requires that the restatement represent "material noncompliance" an argument can be made that all required restatements represent "material noncompliance" with GAAP. Otherwise, such restatements would not be made due to immateriality.

As previously noted, 89 percent of Fortune 100 companies have clawback provisions in their executive compensation contracts. Most, if not all of them, have language that allows for a repayment of executive compensation when there is some sort of negligence or fraud on the part of the executive. The problem is that Dodd-Frank extends to situations in which an executive has done nothing wrong and for periods for which the executive may no longer be employed. The result is that an executive's clawback exposure under Dodd-Frank may certainly extend beyond the executive contract period.

What is the impact of Dodd-Frank's clawback provision?

Time will tell whether Section 954 of Dodd-Frank is overreaching or whether it actually improves executive behavior.

There are some early signs that the extreme nature of Section 954 is affecting executive recruitment.

1. Top executives are negotiating employment contracts that front load compensation into their base compensation and less into incentive-based pay (such as bonuses and options). The higher base compensation is exempt from the reaches of Section 954's clawback provision.

2. Executive recruiters are seeing a shift in executives from SEC companies to private companies to escape to risk associated with the long-arm of Section 954.

3. Executives and companies are structuring incentive-based compensation to be measured based on metrics that are not reportable and not subject to restatement.

4. Companies are structuring incentive-based compensation to be paid outside the three-year clawback period to make it easier to retrieve under a clawback claim.

5. Reluctance to restate. Both Section 954 and Sarbanes Section 304's clawback provisions are triggered only if there is a restatement. Because a restatement creates a clawback of compensation, executives might be motivated to look the other way in deciding whether a restatement is warranted.

Note: Section 954's clawback is triggered if incentive-based compensation is paid based on reporting financial information that has to be restated. If, instead, the compensation is based on another metric that is not as transparent, such as the number of widgets sold in Mexico, a restatement of financial information would not trigger a clawback because the metric would not be the subject of the restatement. Similarly, the incentive compensation can be measured using subjective information such as the average performance rating based on customer surveys, which would make any compensation not subject to clawback.

Should a company that records a restatement include the clawback recovery as part of the restatement entry?

If a public company is required to restate its financial statements, a part of that entry should include a receivable due from the executives for recovery of compensation under Section 954 of Dodd-Frank.

Example:

In 2016, Company X discovers a material error related to years 2013, 2014 and 2015 due to an accrual that was not recorded for each of the three years.

X is going to make an entry in 2016 to record the accrual and restate the financial statements for 2013, 2014 and 2015. Income for each of the three years will decrease significantly.

X has an incentive-compensation plan under which executives received sizeable bonuses for 2013-2015. Those bonuses were based on profitability.

Conclusion:

Assuming the error is material, it would satisfy the "material noncompliance" threshold under Section 954 of Dodd-Frank. The result is that X must clawback the bonuses from its executives including any executive that was employed during 2013-2015 and may no longer employed by the company in 2016.

Executive bonuses should be recomputed based on the restated income for 2013-2015 and the executives must repay the difference between the amount paid and the recomputed amount after the restatement.

The company makes the following entry in 2016, and restates the financial statements for 2013-2015:

Entry in 2016:

	dr	cr
Restatement adjustment 2013*	XX	
Restatement adjustment 2014*	XX	
Restatement adjustment 2015*	XX	
Accrual		XX
Executive clawback receivable**	XX	
Restatement adjustment 2013*		XX
Restatement adjustment 2014*		XX
Restatement adjustment 2015*		XX

* retained earnings
** The amount of executive compensation that would have to be repaid under Dodd-Frank.

The entry is made in 2016 with X restating each of the three year's financial statements to reflect the change. Tax effects are not considered in the above example but obviously current and deferred tax entries would be required.

Can an executive indemnification clause in his or her employment contract offset any clawback reimbursement?

Many executive employment contracts have provisions that reimbursement or indemnify the executive for any damages incurred during his or her employment unless due to fraud or gross negligence. The fraud or gross negligence threshold is likely to be a higher one than the thresholds that trigger clawback payments under both Sarbanes and Dodd-Frank. In fact, Dodd-Frank's clawback provision applies even if there though there is no wrongdoing by the executive.

The result is that under some employment contracts, if the executive is required to pay back compensation under the clawback provisions of Sarbanes or Dodd-Frank, that same executive could simply send a bill to the company to reimburse him or her for the clawback payment made.

Recently, several executives have tried to have their company reimburse them for clawback payments, under the indemnification clauses in their employment contracts.

To date, these executives have not been successful in the courts.

In one case, *Cohen v. Viray*, (DHB Industries Inc. case) (U.S. Court of Appeals, Second Circuit), an executive sought indemnification for any Section 304 clawback claims from a company, DHB Industries, Inc. as part of a settlement of a shareholder's derivative suit brought due to fraud, insider trading, and accounting violations. Under the settlement, the company agreed to indemnify both the CEO

and CFO for any penalties imposed by the SEC including any clawback of compensation under Section 304. Both the Justice Department and SEC objected to the indemnification provision.

The appellate court held that an indemnification of an executive's compensation under Sarbanes's Section 304 clawback rule violated Sarbanes-Oxley. The court ruled that reimbursing the executive for clawback payments cannot be permitted where it would effectively nullify a statute or common law. The court also stated that "it is well established that one cannot insure himself against his own reckless, willful or criminal misconduct." An overarching point made by the court is that if the indemnification clause were to prevail in reimbursing the executive, the individual would suffer no penalty at all.

The SEC's anti-indemnification stance

The SEC has publicly announced that it believes that using indemnification clauses to reimburse executives for clawbacks under both Sarbanes's Section 304 and Dodd-Frank's Section 954, is against public policy.

In fact, in recent settlement cases with the SEC, the SEC has insisted that the settling party agree not to seek reimbursement under any indemnification agreement for any amounts paid, including penalties. The SEC has yet to challenge reimbursement of legal fees or limit a company's obligation to pay for the defense for an executive in a Section 304 case.

Of course there are other ways to deal with this problem:

a. Some executives have sought protection from clawback claims by taking out "Side A" D&O insurance coverage even though some policies do not cover government investigations, fines or penalties, claims of fraud, or claims for disgorgement of personal profits, among other restrictions.

b. Other policies might limit coverage to legal and court costs to defend against a clawback claim, but not cover the clawback payment itself.

Status of SEC's final rules on Section 954

By now, the SEC was supposed to issue rules on how to implement Section 954 of Dodd-Frank pertaining to clawbacks.

SEC Commissioner Troy Paredes has stated concerns about Section 954 noting that some of its provisions were "troubling." In particular, the Commissioner gave the example of "an executive who has worked diligently and honestly at a company that has robust financial controls and top-notch procedures and systems but who may nonetheless have to pay back a considerable portion of his or her compensation if the company has to restate because of an accounting error."

Paredes further stated that Section 954 raises other "problematic" possibilities that may not be in the best interests of companies and their shareholders including:

- Will companies restructure compensation arrangements so that executives end up receiving less incentive pay that can be clawed back, but larger discretionary bonuses that are not explicitly linked to specific financial targets?

- Will executives now press for higher base pay to compensate them upfront for the risk that the incentive compensation they do receive may have to be forfeited in the future?
- How might a shift from incentive-based pay toward more guaranteed pay impact an executive's incentives?
- Will companies be discouraged from restating to avoid triggering the Section 954 clawback?

As of early 2015, the SEC has not issued final rules on Section 954 even though Section 954 is in effect.

D. The Gradual Demise of Company Pension Plans

In this section, the author addresses several key issues pertaining to pension plans segregated into the following:

1. Overview
2. The GAAP rules for defined benefit plans are covered by ASC 715
3. Single-Employer Plans
4. Unfunded multi-employer pension plans and the loaded pistol
5. The Pension plan assumptions manipulation game
6. State pension plans- an accident waiting to happen
7. Can companies afford to offer adequate pensions and other benefits in the future?
8. Who pays for the funding shortfalls in pension plans?
9. Trends in pensions and compensation
10. New defined benefit plan mortality tables
11. U.S. pension plans are moving from equities to bonds

1. Overview

Over the past two decades, the costs of maintaining defined benefit pension plans resulted in companies either freezing or eliminating defined benefit plans and replacing them with defined contribution plans or 401(k) plans. Defined contribution or 401(k) plans offer companies the opportunity to provide their employees with a retirement benefit, usually at a much lower cost, and with far greater flexibility for several reasons:

- With a defined contribution or 401(k) plan, a company can more accurately measure the amount of its pension cost because it is based on the amount contributed to the plan, as compared with the amount of the ultimate benefit paid as in the case of a defined benefit plan.

- In most defined contribution or 401(k) plans, a company can structure its contributions to be discretionary, thereby allowing it to reduce its pension contribution during weaker business cycles, and increase it during stronger cycles.

- With 401(k) plans, investment risk is shifted from the company to the employees as each employee is responsible for managing his or her investments.

Now, the next dramatic crisis in the U.S. markets may be the continued deterioration of U.S. defined-benefit pension plans. Despite a growing U.S. stock market, plans sponsored by corporate, as well as state and local pensions, are grossly unfunded. The recent decline in the U.S. stock market has made the

situation worse. The primary reason is one based on simple math: more benefits are being paid out of the plans than net assets going into those plans.

In January 2016, William Mercer announced that U.S. pension plan funded status for the S&P 1500 had improved by about $100 billion. In general, a higher discount rate reduced liabilities enough to offset longer actuarial lives of plan participants and declining stock market values.

The result is that at December 31, 2015, the pension deficit for the S&P 1500 was $(404) billion, while the deficit was $(504) billion at the end of 2014.

Although 2015 had a $100 billion improvement in funded status, the trend does not paint a positive picture for U.S. pension plans.

Any intellectually honest debate must acknowledge the following conclusions:

1 Pension liabilities are growing faster than the underlying pension assets.

2. On a long-term basis, even in years in which the stock market is on steroids, those asset value increases cannot offset the continued increases in pension liabilities.

These two conclusions are true for all defined benefit plans including single and multi-employer plans. It is a mathematical certainty.

Nevertheless, even with the introduction of 401(k) plans, many companies have retained their existing defined benefit plans by either freezing them or continuing to fund them for certain key employee groups such as those in upper management.

Before addressing these plans, let's take a look at a snapshot of where U.S. defined benefit plans fall as of 2015 regardless of what is published:

FUNDED STATUS- ALL U.S. PENSION PLANS			
Type of Plan	**Unfunded Liabilities 2015**		**% Funded Status**
	Low	High	
U.S. Corporate Plans:			
Multi-employer (union) plans	$400 billion	$500 billion	46-81%
Single-employer plans	500 billion	700 billion	50-75%
Public- state and local plans (1)	5 trillion	7 trillion	42-60%
Estimated total shortfalls	$5.9 trillion	$8.2 trillion	
(1) Data is based on several recent studies: The range of funded status and percentages varies due to the discount rates used and other assumptions. Sources: *Public Section Pensions: How Well Funded Are They Really*? Andrew G. Biggs, *State Budget Solutions*, July 2012, adjusted to 2015 and other publications.			

In looking at the previous chart, collectively there is a $5.9 trillion to $8.2 trillion unfunded pension liability across all sectors of private and public entities. The range exists because the "true" numbers require one to choose assumptions such as discount rates, expected rates of return, and other variants that significantly affect the unfunded liability. Most commentators, including the author, believe that the real unfunded liability is closer to the upper amount of $8 trillion due primarily to the fact that sponsors tend to use assumptions that understate pension liabilities. Regardless of whether the shortfall is $5.8 trillion or $8 trillion, the numbers are astronomical to the point that the plan sponsors (private or public) are in such a dire hole that there is no real way to get out without renegotiating pension contracts, which is typically impossible.

What does this mean for pension plans?

Defined benefit plans are being squeezed into extinction by the combination of stricter GAAP and accelerated funding required by Pension Protection Act of 2006 (PPA), all wrapped within a volatility marketplace. In essence, a large portion of the risk associated with whether a pension plan is under- or over-funded is outside the control of the sponsor company. In general, the sponsor company cannot control the key factors that drive the funded status of the plan: the fair value of the assets and the discount rate, both essentially driven by macro-market forces.

As of 2016, entities that have defined benefit pension plans face an uphill battle in trying to manage their underlying businesses and comply with funding requirements of their pension plans. Because the PPA requires more extensive funding of pension plans, companies with unfunded pension plans must reallocate critical cash flow resources from their core business operations to fund those plans.

Now it is easy to see why few companies are adopting new defined benefit plans and are instead offering either contributory or noncontributory 401(k) plans where the market risk does not rest with the sponsor company.

Most of the unfunded defined benefit pension plans exists within more traditional older manufacturing firms with large workforces and strong unions that previously negotiated generous retirement benefits. Examples are the airlines and automakers, which cannot shed their benefit obligations and are challenged to compete with newer and benefit-lighter companies and foreign companies that do not offer such benefits. One example is where, prior to their bankruptcy filing, older airlines such as United and US Airways had been burdened with large defined benefit plan obligations that newer rivals, such as Jet Blue and Southwest, do not have.

In addition to pension plans, many of the same companies have post-retirement benefit plans, most of which are grossly unfunded as compared with pension plans because post-retirement benefit plans are not subject to the funding requirements under ERISA. Thus, most companies fund such post-retirement benefits on a pay-as-you-go basis.

2. The GAAP rules for defined benefit plans are covered by ASC 715

The accounting for defined benefit plans is found in ASC 715, *Retirement Benefits Compensation* (formerly FASB No. 158, *Employer's Accounting for Defined Benefit Pension and Other Postretirement Plans)*. ASC 715 requires companies to record on their balance sheets the funded status of a defined benefit plan, measured as the difference between the fair value of plan assets and the pension benefit obligation. In issuing ASC 715, the FASB's goal was to provide greater transparency to pension

accounting by requiring companies to place the funded status of their pension plans on their balance sheet.

Under ASC 715, *Employers' Accounting for Defined Benefit Pension and Other Post-Retirement Plans*, the following rules apply to a business entity that sponsors one or more single-employer defined benefit pension plans:

1. Balance sheet:

   a. An accrual (liability) is recorded for pension cost:

   Example: Assume the following for the year:

Service cost	$200
Interest cost	100
Expected return on plan assets	(50)
Amortization of prior service cost	0
Amortization of (gain) or loss	0
Net periodic benefit cost	$250

Entry:		
Net periodic pension cost (income statement)	250	
Liability for pension benefits		250

   b. An additional liability or asset is recorded on the balance sheet for the funded status, measured as the difference between the fair value of the plan assets and the projected benefit obligation (PBO):

Fair value of plan assets	$100,000
Projected benefit obligation (PBO)	(110,000)
Funded status of plan (under) over	$(10,000)
Liability balance (after $250 entry)	$8,000
Additional liability recorded	2,000
Adjusted liability on balance sheet	$10,000

Balance Sheet
December 31, 20X1

LIABILITIES AND EQUITY:
Liability for pension benefit ****10,000***

Note: A portion of the liability relates to gains or losses and prior service costs or credits that arise during the period, but that are not recognized as components of net periodic benefit cost of the period. Examples include gains or losses, prior service costs or credits, and transition assets or obligations remaining from

the initial application, which are recorded as part of other comprehensive income and accumulated other comprehensive income on the balance sheet, net of the related tax effect.

3. Single-employer plans

For the past decade, a significant number of single-employer defined benefit plans have been unfunded. In the 1990s, many companies rode a wave of overfunded status due to record returns in the stock market coupled with the use of unrealistic plan assumptions. In the late 1990s, the tide turned and many plans shifted to unfunded status. Most of the shift was driven by the push toward requiring companies to use lower discount rates in valuing their benefit obligations along with softer stock market returns. There is also the fact that retirees are living longer than expected thereby putting pressure on employers to fund benefits over an extended period of time.

Following is a table that compares the funded status of the S&P 1500 between 2015 and 2014.

S&P 1500 Funded Status

	2014	2015
Fair value of plan assets	$1.886 trillion	$1.800 trillion
Pension obligations	2.390 trillion	2.204 trillion
Funded status	$(504) billion	$(404) billion
% funded status (assets as percentage of liabilities)	79%	82%

Source: William Mercer, January 2016

In looking at the above chart, the author wishes to point out a few key facts:

1. Despite volatile equity markets, the funded status improved from $(504) billion in 2014 to $(404) billion in 2015.

2. The total fair value of assets declined by about 5 percent (from $1.886 trillion in 2014 to $1.800 trillion in 2015) as the overall U.S. equity markets declined.

3. The pension obligations decreased from $2.390 trillion to $2.204 trillion.

That liability decrease was due, in part, to the change in two conflicting elements:

a. The liability decreased because there was an increase in the discount rate from about 3.81% in 2014 to 4.24% in 2015. That rate change was reflective of an increase *in the rate of high-quality corporate bonds.* As the discount rate increases, the liability decreases to account for a lower present value of pension obligations.

b. The liability increased because there was an increase in the liability to reflect a change in the longevity assumptions as plan participants are expected to live longer.

What happened in 2015 represents the continued battle that all defined benefit plans have. As retirees live longer, plans have pressure to drive the increase in asset values to pay for those additional benefit liabilities. Only higher interest rates can help reduce those liabilities to offset the increase in the longer retirement periods.

Quick GAAP overview

GAAP requires that the unfunded status of a defined benefit plan be recorded as a liability on the balance sheet. A hypothetical combined balance sheet of the S&P 1500 at December 31, 2015 would like this:

S&P 1500 Companies
Aggregate Balance Sheets
December 31, 2015

	(in billions $)
ASSETS:	
Deferred tax asset	***160***
LIABILITIES AND EQUITY:	
Liability for pension benefit	***404***
Common stock	XX
APIC	XX
Retained earnings	XX
Accumulated other comprehensive income (net of taxes)	***(244)***
Total stockholders' equity	XX

DIT asset: $404B x 40% = $160B
Accumulated other comprehensive income: $(404)B less DIT asset $160B = $(244)B.

At December 31, 2015, S&P 1500 companies were required to record an aggregate liability for the $(404) billion funded status shortfall. Most of the offset (debit) was recorded to accumulated other comprehensive income (equity), net of the tax effect. That $(404) billion of additional liabilities places a strain on those public companies when one takes into account that there is a corresponding reduction in stockholders' equity. Consider what happens to the debt-equity ratio of the various S&P 1500 companies when the debt numerator is increased by $(404) billion while the denominator is reduced by $(244) billion, net of the tax effect of $160 billion.

4. Unfunded multi-employer pension plans and the loaded pistol

Not only are single-employer plans in trouble, but the next U.S. taxpayer bailout may involve pension plans; namely multi-employer pension plans, mostly involving union employees.

A multi-employer plan is a pension or other postretirement benefit plan which has the following characteristics:

- There are two or more unrelated employers contribute, usually pursuant to one or more collective bargaining agreements

- Assets contributed by one particular employer may be used to provide benefits to employees of other participating employers since assets contributed by an employer are not segregated in a separate account or restricted to provide benefits only to employees of that employer

- Employers are *jointly and severely liability* for the plan obligations so that a shortfall in the plan may have to be funded by any and all of the employers, and

- The plan usually has a withdrawal or exit fee if an employer seeks to withdraw from the plan.

One of the most pervasive issues related to multi-employer plans is that employers are jointly liable for the plan liabilities. That means if one company fails to pay its obligations, the remainder employers must pay the shortfall. It is sometimes referred to as the "last man standing" principle. If there are five employers in a multi-employer plan and four are defunct, the fifth remaining employer is liable for the entire unfunded status of the plan.

Previously, the FASB issued ASU 2011-09, *Compensation- Retirement Benefits-Multiemployer Plans (Subtopic 715-80): Disclosures about an Employer's Participation in a Multiemployer Plan*, which requires companies to expand disclosures related to multi-employer plans in which the employer participates.

Credit Suisse report on multi-employer plans

Credit Suisse published a report entitled, *Crawling Out of the Shadows,* in which it evaluated the pension data of 1,354 pension plans of large and small to medium-cap U.S. companies.

Although the report is four years old, the conclusions reached are still relevant in 2016, and demonstrate chronic problems that exist with multi-employer pension plans.

The results were staggering:

1. Multi-employer plans cover approximately 10 million U.S. workers (7% of the workforce), and have been partially insured by the Pension Benefit Guarantee Corporation (PBGC).

2. Multi-employer plans were *$428 billion underfunded* (46% funded) with most of the underfunding belonging to companies outside the S&P 500.

    a. Based on the most recent Form 5500 filings, multi-employer plans reported an unfunded liability of only $(101) billion as compared with Credit Suisse's reconstructed liability of $(428) billion.

    b. The underfunding was heavily weighted in the construction, transports, supermarkets, and mining industries.

3. Companies could continue to be adversely affected by the extreme underfunding by increased contribution requirements, difficult labor negotiations, higher withdrawal liabilities, and weaker credit ratings.

4. Using the Form 5500 filings, multi-employer plans played games with the actuarial computations of plan funded status, using an average expected rate of return on assets of 7.5%, which is significantly higher than the actual return on investments.

    a. Plans have been using a discount rate to record the present value of their plan obligations that is significantly higher than the rate for high-quality corporate bonds, which is the required rate.

5. The pension shortfalls affected not only large cap companies, but also mid- to small-cap ones.

Credit Suisse recomputed the funded status of 1,354 of a total of 1,459 multi-employer plans that are insured by the Pension Benefit Guarantee Corporation (PBGC), by using the following assumptions:

- The pension liabilities and assets were computed at fair value instead of actuarial value.
- The discount rate used to compute the pension liabilities was 4.7% (return on high-grade corporate bonds), instead of 7.5% used in the actuarial computations.

Funded Status of Multi-Employer Plans
(Based on 1,354 sample)

	In billions	
	Reported Actuarial Basis (Form 5500)	Recomputed by Credit Suisse
Assets	$426	$360
Liabilities	(527)	(788)
Net position	$(101)	$(428)
% funded- per sampled plans	81%	46%
Estimated net position of all U.S. Multi-Employer Plans		**$(454)**

Source: Credit Suisse

When Credit Suisse recalculated the funded status of the selected multi-employer plans, the above-noted chart illustrates that the true funded status was a negative $(428) billion instead of the reported $(101) billion. Moreover, the percentage funded status was actually 46 percent and not the reported 81 percent.

The Pension Protection Act of 2006 established zones for evaluating the funded status of pension plans, using the following system:

Color Zone	**% Funded**	**Additional contributions**
Green (Healthy)	> 80% funded	None
Yellow (Endangered)	65-80% <u>or</u> the plan has an accumulated funding deficiency or is expected to have one during any of the next six years	*<u>Funding Improvement Plan</u>* required: • Must increase future contributions and/or reduce future pension benefit accruals to improve the plan's health, and • Funded status must improve by one third within 10 years
Orange (Seriously Endangered)	65-80% *<u>and</u>* the plan has an accumulated funding deficiency or is expected to have one during any of the next six years	*<u>Funding Improvement Plan</u>* required: • Must increase future contributions and/or reduce future pension benefit accruals to improve the plan's health, and • Funded status must improve by one fifth within 15 years
Red (Critical)	< 65% funded	*<u>Rehabilitation Plan</u>* required: • Must increase future contributions and/or reduce future pension benefit accruals to improve plan's health • Can also cut previously earned "adjustable" benefits (e.g., early retirement) • Plan must emerge from critical condition within 10 years
Source: Credit Suisse		

Credit Suisse reported that the top 10 multi-employer plans were significantly underfunded as compared with the reported funded status in their Form 5500 filings:

Top 10 Largest Multi-Employer Pension Plans Funded Status		
	Reported % funded (Form 5500)	Recomputed % funded (Credit Suisse) (Recomputed)
Central States, Southeast and Southwest Areas Pension Plan	63%	39%
Western Conference of Teamsters Pension Plan	89%	56%
Central Pension Fund of the IUOE & Participating Employers	86%	45%
Participating Employers National Electrical Benefit Fund	86%	47%
Boilermaker-Blacksmith National Pension Trust	80%	44%
1199 SEIU Health Care Employees Pension Fund	100%	50%
I.A.M. National Pension Plan	108%	58%
New England Teamsters & Trucking Industry Pension	52%	25%
Plumbers And Pipefitters National Pension Fund	68%	37%
Bakery & Confectionery Union & Industry International Pension Fund	87%	46%
Source: Credit Suisse based on Form 5500 Filings		

Funded Status- By Percentage				
% Funded	Zone	Per Form 5500 Filings	Recomputed (Credit Suisse)	% of plans
> 100%	(Green) Healthy	218	21	4%
90-100%		256	9	
80-90%		378	29	
65-80%	(Yellow and Orange) Endangered or Seriously Endangered	309	114	8%
55-65%	< 65% Red (Critical) Zone	116	246	88%
45-55%		50	425	
35-45%		13	371	
25-35%		4	112	
< 25%		8	25	
Rounding		2	2	
		1,354	1,354	
Source: Credit Suisse				

Observation: The previous chart illustrates that once the pension plan status of the sample plans was recomputed at fair value by Credit Suisse, only 4% of plans were in the Green Zone (healthy), while 88% were in the Red Zone (critical).

Hostess and the multi-employer defined benefit plan shortfall

The reader may recall the battle between Hostess brands and its unions, and the attempts for management and the unions to settle on a new contract.

What most people did not realize at that time is that there was no way that a deal could be struck under any circumstances.

Consider the following facts:

Hostess had:

- 12 unions, and 372 pieces of collective bargaining agreements
- 42 multi-employer plans involving 18,500 employees

Note: Approximately one third of the multi-employer plans to which Hostess contributed were among the most unfunded plans in the United States.

- $100 million of annual contributions to pension plans ($22 million into the Bakers union plan)

The Baker's union pension plan had a significant unfunded status:

Assets	$4 billion	
Liabilities	(7 billion)	
Unfunded status	$(3 billion)	
Plan activity:		
Contributions received annually	$155 million	(15% paid by Hostess)
Benefits paid out annually	(550 million)	
Annual shortfall	$(395 million)	
Participants in plan:		
Current retirees	70%	
Current workers	30%	

Conclusion: 30% of current workers pay for the benefits of 70% retirees.

With Hostess funding 15% of the contributions to the Baker's union pension plan, coupled with the annual shortfall in funding, there was no way that Hostess could continue to stay in the Baker's pension plan. Under the multi-employer plans, Hostess was jointly and severely liable for any unfunded plan status, which potentially exposed Hostess to the entire $3 billion shortfall. Moreover, if Hostess withdrew from the various pension plans, it would have been exposed to a $2 billion pension withdrawal liability.

There was no way that Hostess could have stayed in the pension plans and still survived!

The result was that Hostess filed Chapter 11 and used the protection of the bankruptcy code to shed most of its pension obligations.

In Chapter 11, Hostess:

- Saved $22 million per year in contributions to the Baker's pension plan
- Terminated all single- and multi-employer plans
- Eliminated $2 billion of withdrawal liabilities for 42 multi-employer plans
- Shifted the burden of its single employer plans (2,300 employees) on to the Pension Benefit Guarantee Corporation (PBGC)
- Shifts the burden of its multi-employer plans (covering 16,000 employees) onto other employers and a portion to PBGC. Those other employers included Kraft Foods, Safeway Stores, Kroger, and BBU, among others, and
- Eliminated its private equity owners potential exposure to the unfunded pension liabilities, as those owners were deemed passive investors.

  Note: In recent years, private-equity funds have effectively used bankruptcy to eliminate pension withdrawal liabilities in cases involving Friendly's Ice Cream, Eddie Bauer, Hostess (discussed above), and Delphi Automotive.

5. The pension plan assumptions manipulation game

Defined benefit plans are unfunded based on use of distorted assumed rates of return. For more than a decade, companies and their actuaries have artificially underreported pension liabilities by using a discount rate that is inflated.

If a company wishes to manipulate its funded status, all it has to do is *change three fundamental assumptions* used in the calculation of the pension liability:

- Discount rate used to present value the pension liability
- Expected rate of return on assets which reduces pension cost
- Compensation growth rate

The general rule is:

a. The higher the discount rate and expected rates of return, the lower the pension liability and lower the pension cost.

b. The lower the compensation growth rate, the lower the pension liability and lower the cost.

Therefore, if you want to understate pension liabilities and pension cost, here is what you do:

- Use a higher discount rate
- Use a higher expected rate of return
- Use a lower compensation growth rate

Here is why:

The discount rate is used to compute the present value of the projected benefit obligation. Several of the components of the pension cost used to record the current accrual to the pension liability are measured based on either the discount rate or expected rate.

They are:

- Service cost
- Interest cost
- Expected return on plan assets

The service cost reflects a compensation growth rate so that if that rate is reduced, the service cost recorded to pension cost and the corresponding pension liability is reduced.

Take a look at the following table:

Components of Pension Cost			
Component of Net Periodic Cost Recorded to Pension Liability	**Increase (Decrease)**	**Definition**	**Rate Used**
Service cost	$XX	Amount by which the pension obligation increases as a result of employee service during the current year Compensation growth rate is reflected in the service cost Benefits x discount rate	Discount Rate (DR)
Interest cost	XX	Amount by which the benefit obligation increases due to passage of time Beginning PBO x discount rate	Discount Rate (DR)

Expected return on plan assets	(XX)	Expected amount of returns generated by plan assets during the accounting period. Determined based on historical returns Beginning FV of assets x Expected Rate of Return	Expected Rate of Return (ERR)
Amortization of prior service cost	XX	The portion of cost related to plan adoption or amendment	NA
Amortization of (gain) or loss	XX	Changes in assumptions, actual versus expected return on plan assets, etc.	NA
Net periodic benefit cost (current year accrual)	$XX		

Following is a T account that illustrates the effect of these three rates on the projected benefit obligation (PBO):

PROJECTED BENEFIT OBLIGATION (PBO)

		Beginning PBO balance	XX
Expected return on plan assets [Beg FV-assets x ERR]	XX	Service cost accrual [Benefits x DR]*	XX
		Interest [Beg PBO x DR]	XX
		= ENDING PBO BALANCE	XX

ERR = expected rate of return
DR = discount rate
* includes compensation growth rate

Therefore, the way to minimize the pension liability:

Component of Cost	**Action**	**Impact on PBO**
Service cost	Use higher discount rate Use lower compensation increase assumption	Lower Liability
Interest cost	Use higher discount rate	Lower Liability
Expected Rate of Return on Assets	Use higher expected rate of return	Lower Liability
OVERALL IMPACT		**LOWER PBO LIABILITY**

What is the definition of the discount rate and expected rate of return?

The discount rate is used to present value the benefits and compute the pension liability, referred to as the projected benefit obligation.

The expected (long-term) rate of return is used to compute a portion of annual pension cost and actually reduces total pension cost.

ASC 715 defines these rates as follows:

Discount rate: is the rate used to measure the projected benefit obligation, and the service and interest cost components of net periodic pension cost.

ASC 715 states that:

- The discount rate shall reflect the rate at which the pension benefits could be effectively settled, which is the rate of return needed on a bond investment made today to fund future benefit obligations.

- The discount rate is determined *at the measurement date*.

- An employer may use the current rates of return on *high-quality fixed-income investments* currently available whose cash flows match the timing and amount of expected benefit payments.

The rate of return on *high-quality fixed-income investments* consists of the rate of return on AA and AAA corporate bonds, which maturities that match the pension obligation payouts.

Typically, rates of returns on AA bond funds with maturities ranging from 10-20 years are used.

Examples of funds include:

- Merrill Lynch U.S. Corporate AA 15 years +fund
- Merrill Lynch U.S. Corporate AA/AAA 10 years fund
- Citigroup Pension Liability Index Fund

- The objective of selecting assumed discount rates is to measure the single amount that, if invested at the measurement date in a portfolio of high-quality debt instruments, would provide the necessary future cash flows to pay the post-retirement benefits when due.

- The determination of the assumed discount rates is *separate from* the determination of the expected return on plan assets whenever the actual portfolio of plan assets differs from the hypothetical portfolio of high-quality fixed income investments (AA and AAA rated corporate bonds).

Note: ASC 715 makes the following observations related to the selection of the discount rates. The objective of selecting a discount rate is to measure the single amount that, if invested at the measurement date in a portfolio of high-quality debt instruments, would provide the future cash flows necessary to pay the pension benefit obligations when due. Notionally, that single amount would equal the current market value of a portfolio of high-quality zero coupon bonds whose maturity dates and amounts would be the same as the timing and amount of the expected future benefit payments. Because cash inflows would equal cash outflows in timing and amount, there would be no reinvestment risk in the yields to maturity of the portfolio.

However, in other than a zero coupon portfolio, such as a portfolio of long-term debt instruments that pay semiannual interest payments or whose maturities do not extend far enough into the future to meet expected benefit payments, the assumed discount rates (the yield to maturity) need to incorporate expected reinvestment rates available in the future. Those rates shall be extrapolated from the existing yield curve at the measurement date. Assumed discount rates shall be reevaluated at each measurement date. If the general level of interest rates rises or declines, the assumed discount rates shall change in a similar manner

Expected (long-term) rate of return: is the interest rate used to compute the expected return on plan assets, which is a reduction in pension cost.

ASC 715 states that:

- The expected rate of return shall reflect the average rate of earnings expected on the funds invested or to be invested to provide for the benefits included in the projected benefit obligation.

- Appropriate consideration should be given to the returns being earned by the plan assets in the fund and the rates of return expected to be available for reinvestment.

Let's address each of the rates:

Discount rate:

GAAP requires the discount rate used to compute the projected benefit obligation (PBO) to be based on the current rate of return on *high-quality fixed-income investments* consisting of the rate of return (yield) ranging between AA- and AAA-rated corporate bonds. Because AA-rated bonds have a higher yield, typically most companies use a higher AA-rate, which minimizes the pension benefit obligation.

Following is a chart the compares the average discount rate used by SEC companies with the range of yields that was being generated for AA- and AAA-rated bonds in the same year.

Annual Discount Rates Versus Bond Returns

End of the Year	Discount Rate Used for Pension Funds (a)	Returns on AA and AAA- Rated Bonds (c.)
2015	4.22%	3.9% (b)
2014	3.81%	3.7% (b)
2013	4.83%	4.6% (b)
2012	4.02%	3.6%
2011	4.79%	4.4%
2010	5.44%	5.5%
2009	5.82%	5.7%
2008	6.35%	5.8%

(a) Milliman 100 Pension Funding Index
(b) Moody's Aaa Bond Yield December of each respective year.
(c.) Blend of rates based on Merrill Lynch AA 15-year, AA/AAA 10-year, and Citigroup bond index funds.

Observation: In the previous chart, the discount rate used in 2009 to 2010 was relatively close to the range of rates actually generated on AA and AAA-rated corporate bonds. Then, in 2011 and 2012, there was a spread in which the discount rate used was slightly higher than the rate of return on bonds. In fact, in 2012, the rate used (4.02%) was higher than the actual AA/AAA bond rate of 3.6%. Similarly, the discount rates for 2014 (3.81%) and 2015 (4.22%) were higher than the rates of return for bonds of 3.7% and 3.9%, respectively.

So, why didn't companies use a higher discount rate of around 4.22% in 2015?

For those companies that used a higher rate, the incentive is obvious in that the higher rate results in a lower liability.

One might conclude that a small elevation in the discount rate (4.22% versus 3.9%) is insignificant. However, that person would be wrong if he or she were to know the impact a small increase in the discount rate has on the amount of the liability.

The general rule is that for every one percent increase in the discount rate, the pension liability drops by about 15 percent. Yes, that's right; 15 percent with a corresponding reduction in pension cost for a portion or all of that reduction.

If the rate increase is only .32% (4.22% versus 3.9%), the result is a potential reduction in the liability of about 5 percent. A company with a $1 billion pension liability can reduce that amount by $50 million with a corresponding reduction in pension cost.

So now the reader can understand that if a company can increase its discount rate by a small fraction, it can significantly understate the pension liability.

The argument for using a risk-free rate such as the 10-year Treasury rate

The discount rate used to measure pension liabilities is supposed to be the rate that would be generated if the entity hypothetically purchased a risk-free asset at the measurement date, and generated enough investment return to fund future pension payouts. Because pension obligations are guaranteed, the liability is risk-free so that, in theory, the investment purchased at the measurement date should also be a risk-free asset.

If the risk-free rate were the valid rate, the rate of the 10-year U.S. Treasury would be used which would result in rates as follows:

Date	U.S. Treasury Rate 10 years
December 31, 2015	2.27%
December 31, 2014	2.17%
December 31, 2013	3.03%
December 31, 2012	1.91%
December 31, 2011	1.97%
December 31, 2010	3.39%
December 31, 2009	3.73%

The reason cited by the FASB and others as to why a risk-free discount rate is not used to compute the pension liability, is because there is risk that exists between maturities. That is, it is virtually impossible to match maturities of U.S. Treasuries with the cash requirements to fund pension obligations. Therefore, as each investment were to mature, there would be risk associated with being able to repurchase the investments at the same interest rates. Thus, the investments required to be purchased at the measurement date could not be purchased without having some interest-rate risk. Consequently, using a risk-free discount rate would not be realistic because an entity would not have the ability to purchase U.S. Treasuries with maturities that identically match the due dates of the pension obligation payments.

Expected rate of return

To recap, the expected rate of return is the interest rate used to compute the expected return on plan assets, which is a reduction in pension cost.

ASC 715 states that:

> *"The expected rate of return must be reflect the average rate of earnings expected on the funds invested or to be invested to provide for the benefits included in the projected benefit obligation."*

In determining the expected rate of return, consideration must be given to the mix of actual investments and their returns.

Companies have an incentive to keep the expected rate of return as high as possible. The higher the rate, the higher the expected return on plan assets which reduces the PBO and pension cost.

Comparison of ERR to Actual Rate of Return, By Year

End of the Year	Expected Rate of Return (ERR) Used for Pension Funds	Actual Rate of Return
2015	7.5%	1.9%
2014	7.5%	9.9%
2013	7.5%	11.2%
2012	7.5%	11.7%
2011	7.8%	5.9%
2010	8.0%	12.8%
2009	8.1%	14.0%
2008	8.1%	(18.8)%
2000 to 2014 average (a)		6.0%

Source: Milliman 100 Pension Funding Index, *2014 Corporate Pension Funding Study*, December 2015

(a) Published average return for 2000 to 2012, adjusted by the author to reflect the effect of 2013-2015

Notice from the previous chart that the average ERR used by U.S. pension funds was about 7.5% in 2015 while the actual return for that year was only 1.9%. That would suggest that the expected rate of return was actually too low. Moreover, even though the average ERR for 2015 was 7.5%, more than 50% of the entities used an ERR of 8% to 9%.

However, ASC 715 states:

> *"The expected rate of return must be reflect the average rate of earnings expected on the funds invested or to be invested to provide for the benefits included in the projected benefit obligation."*

That means that the ERR must be the rate of return that the plan expects to earn *over a long period of time*, taking into account the mix of investments in the plan on the measurement date.

Although the ERR used in 2015 was around 7.5%, one must look closer to reach a conclusion that the 7.5% rate might actually be too high, not too low.

a. The actual rate of return on assets for the U.S. plans was only 6.0% from 2000 to 2015, well below 7.5%.

b. The 2015 rate of return of 1.9% was reflective of a deterioration in the U.S. stock market.

c. In order to justify a 7.5% expected (long-term) rate of return, an entity would have to have a heavy weighting of investments in equities and higher-risk investments.

From one survey, it appears that the typical investment mix followed by most of the major U.S. pension plans in 2015 was:

Equities	40%
Fixed income (bonds, etc.)	40%
Other investments	20%
	100%

Source: Milliman 100 Pension Funding Index, *2015 Corporate Pension Funding Study*

That means a company that uses an expected ERR of 8% to 9% is assuming that the long-term return that will be generated on a long-term basis will be 8% to 9% based on the 40%-40%-20% blend of assets.

What are other countries using for ERRs?

A survey of expected rates of return used by pension plans in other countries indicates that United States companies use ERRs that are significantly higher than other countries.

Consider the following list based on 2015 data.

Expected Rates of Return By Country

Country	ERR Used in 2015 Pension Plans
Canada	5.57%
Germany	3.92%
Japan	2.69%
Netherlands	3.22%
Switzerland	2.75%
UK	5.74%
United States	**6.99%**

Source: *2015 Global Survey of Accounting Assumptions for Defined Benefit Plans*, Towers Watson

What the above chart shows is that U.S. pension plans are using expected rates of return that are significantly higher than those used by any other major country. A higher expected rate of return understates the pension liability.

Other manipulations- growth rate on compensation

As the author stated at the beginning of this section, if a company wishes to manipulate the funded status of its pension plan, all it has to do is change *three fundamental assumptions* used in the calculation of the pension liability:

- Discount rate used to present value the pension liability
- Expected rate of return on assets which reduces pension cost
- Compensation growth rate

The author has already discussed the discount rate and expected rate of return. The last assumption that can be altered is the compensation growth rate.

When a company computes the service cost component of total pension cost, it must reflect into computation any growth in compensation that affects the pension payout.

If a company wants to keep its pension benefit obligation down, one way is to reduce the growth rate of compensation that is reflected in the computation of the service cost component of pension cost that is recorded as part of the pension liability.

One average, companies include an average salary increase of about 2 to 5 percent per year in the computation of the service cost component. If, instead, the assumption only reflects a 1 percent increase, the service cost component and, in turn, pension liability would be reduced. Although it is impossible to truly estimate the compensation growth rate over a long period of time, in general, a rate of 2 to 5 percent is consistent with what most companies should be using in their pension computations.

Recap on manipulating pension liabilities

Because the assumptions reflected in the compensation of pension liabilities of a defined benefit plan are quite subjective and can dramatically change the overall outcome, it is imperative that any stakeholder in a pension plan evaluate the key assumptions used in measuring the pension liability and funded status.

GAAP requires that a company disclose the discount rate, expected rate of return, and compensation growth rate.

Using 2015 market information, those rates should have rates that are in the following ranges:

Assumption	Typical Range of Acceptable Rate
Discount rate	3.5% to 4.0%
Expected return on assets	Not greater than 7%
Compensation growth rate	2 to 5%

If a company's disclosure of its pension plan assumptions deviates from those noted in the above table, there is a question as to whether appropriate pension plan assumptions have been followed.

Impact of longevity on pension liabilities

So far, the author has explained that companies are manipulating the discount rate and expected rate of return to keep the pension benefit obligation (PBO) down. If this is the case, why are pension liabilities increasing?

Companies may be trying to keep pension liabilities down by keeping both the discount rate and expected rate of return high, but that action is simply not enough.

A key reason for the increase in pension liabilities is that life expectancy is increasing. The longer the life expectancy of pension retirees, the greater the benefits that will have to be paid out and in turn, have to be present valued to compute the pension benefit obligation.

Life expectancy at birth has risen from about 65 years in 1950 to more than 76 years now. Life expectancy will surpass 90 years by year 2100.

Using a recent actuarial table, a future retiree who is currently age 50 will live until 81, while in 1996, that same male would have been expected to live until age 77. That means there are an additional 4 years of pension benefits to be paid to that one employee, and that additional cost must be reflected in the pension liability, on a present value basis.

That trend is going to continue. Consequently, regardless of the growth of pension assets, defined benefit pension plans are going to be a challenge to make fully funded. The math of having too many pensioners living too long makes it virtually impossible for companies to be able to keep their defined benefit pension plans solvent.

Pray for inflation and an increase in interest rates

Pension plan trustees are concerned that lower interest rates coupled with pensioners living longer, will bankruptcy their defined benefit plans. And the truth is that they could be correct.

The good news is that in the next few years, when the Federal Reserve stops artificially pushing rates down, the effects of the Fed's quantitative easing (e.g., printing money) may translate into higher inflation and interest rates. If that happens, the under-funded status of many of the U.S. pension plans could be reversed in one swoop simply because the discount rate increases. Consider that if interest rates rise significantly, so will expected rates of return and discount rates. With higher rates, pension liabilities will be reduced so that the funded status may become positive. Until interest rates rise, it will be virtually impossible for most pension plans with unfunded status to reverse themselves.

6. State pension plans- an accident waiting to happen

The state pension plan saga continues and the story does not get any better.

According to a report from State Budget Solutions, issued in November 2014, state employee retirement plans are in big trouble.

a. The report notes that through 2013 plan years, all 50 state plans:

- Are underfunded by a total of $4.7 trillion
- Have a funded ratio is 36%
- Have a shortfall averaging $15,000 per capita

b. The breakout of the funded status all 50 state plans is as follows:

Total assets	$2.7 trillion
Plan liabilities	(7.4) trillion
Shortfall- underfunded	$(4.7) trillion

c. The numbers are far worse than the previous year's numbers of $4.1 trillion underfunded with a funded status of 39%.

d. The report measured pension liabilities by market valuation using a 15-year Treasury rate of 2.74% instead of expected rates of return used by pensions that are in the 7-9% range.

Note: Using the states' own erroneous assumptions, the unfunded liabilities were only $1 trillion instead of $4.7 trillion.

e. A summary of the worst states follows:

Largest Shortfalls- State Pension Plans					
State	**Actuarial Assets**	**Market Liability***	**Funding Ratio**	**Unfunded Liability**	**Unfunded Liability Per Capita**
Alabama	$29,419,597	$94,436,581	31%	$65,016,984	$13,450
Alaska	$9,830,274	$39,700,280	25%	$29,870,006	$40,639
Arizona	$31,866,927	$90,652,039	35%	$58,785,112	$8,871
Arkansas	$21,504,868	$61,485,975	35%	$39,981,107	$13,512
California	$476,133,354	$1,230,182,696	39%	$754,049,342	$19,671
Illinois	$95,040,320	$426,619,820	22%	$331,579,500	$25,740
New York	$238,027,500	$545,959,988	44%	$307,932,488	$15,670
Texas	$190,832,179	$486,932,011	39%	$296,099,832	$11,196
Ohio	$152,370,215	$441,974,046	34%	$289,603,831	$25,028
New Jersey	$86,122,541	$286,272,593	30%	$200,150,052	$22,491
Florida	$131,680,615	$315,080,836	42%	$183,400,221	$9,380
Pennsylvania	$85,215,151	$267,049,559	32%	$181,834,408	$14,235
Michigan	$57,209,849	$193,562,650	30%	$136,352,801	$13,779
Massachusetts	$42,974,758	$147,019,968	29%	$104,045,210	$15,545
TOTALS- ALL 50 STATES	**$2,679,831,466**	**$7,416,319,293**	**36%**	**$4,736,487,827**	**$15,052**

* Market value based on use of 15-year Treasury rate of 2.734%

Source: State Budget Solutions, November 2014

GASB made changes to rules for public pensions

In June 2012, GASB issued Statement 68, *Accounting and Financial Reporting for Pensions*, to make some changes to the pension rules for public pension plans.

The rules were effective in *fiscal years beginning after June 15, 2014*.

GASB 68 made the following changes to public pension plans:

a. It requires governments that participate in defined benefit pension plans to report in their statement of financial position the funded status (projected benefit obligation less the fair value of assets).

b. It requires immediate recognition of annual service cost and interest on the pension liability and immediate recognition of the effect on the net pension liability of changes in benefit terms.

   1) Other components of pension expense will be recognized over a closed period that is determined by the average remaining service period of the plan members (both current and former employees, including retirees).

c. Discount rate: GASB 68 provides for use of a blended discount rate to compute the present value of the projected benefit obligation:

   The discount rate is a blend of two rates:

   - Expected rate of return, and
   - Yield on tax-exempt 20-year bonds

   The discount rate is computed as follows:

   1) Use a long-term *expected rate of return* for that portion of the plan assets that is expected to be secured by plan assets.

   Example: If 60% of the pension liability is expected to be funded by plan assets, 60% of the expected rate of return should be used to compute the discount rate.

   2) Use a yield or index rate on *tax-exempt 20-year, AA-or-higher rated municipal bonds* for that portion of the pension liability that is not expected to be secured by plan assets.

   Example: If 40% of the pension liability is expected not to be funded by plan assets, 40% of the yield on tax-exempt bonds should be used to compute the discount rate.

d. It requires employers to present more extensive disclosures and required supplementary information.

Observation: The changes that GASB 68 made have a significant effect not only on state and local governments, but also on any institutions (colleges and universities) that participate in state pension plans. Such institutions have to record their share of the state pension plan liability.

As to the two discount rates, under GASB 68, the overall discount rate declines because of the use of the two rates. To the extent that the plan has assets to fund the PBO, the higher expected rate of return will be used. The excess PBO, for which there is not expected to have plan assets to pay for the benefits, a lower rate based on the 20-year AA or higher rated municipal bond will be used.

Example: Assume the Town of Brokesville has a funded status of 50% (fair value of assets/PBO).

Assume the current rate on 20-year AA-rated municipal bonds is 3.5% and that the expected rate of return on plan assets is 8% based on the existing investment mix.

Conclusion: Under GASB 68, 50% of the pension liability is discounted using the 8% expected long-term rate, as that is the portion of the liability for which there will be sufficient pension assets to pay for plan obligations. The remainder 50% is discounted using the AA-rated municipal bond rate of 3.5%.

8%	x	50% =	4.00%
3.5%	x	50% =	1.75%
		Weighted discount rate	5.75%

Although a rough calculation, the discount rate (which, under previous GASB rules, would have been based on the expected rate of return of 8%), declines to about 5.75%. That decline of greater than two percent would significantly increase the pension liability, but is far short of the discount rate that should be used based on an AA-rated bond which is about 3.5% in the previous example.

7. Can companies afford to offer adequate pensions and other benefits in the future?

The trend is toward companies offering more modest pension and retirement plans in the future as the cost to maintain them is simply too great.

According to the PBGC:[16]

- Defined benefit plan terminations were 83 in 2014 as compared with 111 in 2013. There were only 67 terminations back in 2008.
- The number of employees enrolled in defined benefit plans covered by the PBGC has gradually declined from year to year to about 40 million in 2014.
- Now, only 7% of private sector employees are part of defined benefit plans, down from 62% in 1980.

A short time ago, the AICPA published the results of a survey conducted of more than 3,000 members in both publicly and privately held companies. The results:

- 74% of respondents stated that U. S. companies cannot continue providing employees with pensions that adequately cover their retirement years.
- 54% indicated that the erosion of benefits would hurt recruiting and retention efforts.
- 57% believe rising healthcare costs are the biggest barrier to a company's ability to offer pension benefits.
- 30% stated the pressures to compete in the marketplace outweigh the pressures to provide retirement benefits.
- 65% of respondents offer 401(k) plans with matching contributions.

[16] Source: PBGC, *2014 Annual Management Report*, November 2014

- 59% believe that Americans need to educate themselves about retirement savings strategies.

8. Who pays for the funding shortfalls in pension plans?

Take your pick:

a. The U.S. Government as part of a bailout
b. The Pension Benefit Guaranty Corporation (PBGC)
c. State and local taxpayers
d. All three of the above

With $6 to 8 trillion of pension liability shortfalls related to single and multi-employer corporate plans, and state and local plans, it is doubtful that the related sponsors will be able to fund these shortfalls.

For corporate plans, the first line of defense in funding deficient pension plans (including multi-employer and single-employer plans) is the Pension Benefit Guaranty Corporation (PBGC).

The Pension Benefit Guaranty Corporation (PBGC) bails out defunct defined benefit pension plans, including single- and multi-employer plans. But who will bail out the PBGC? For the past few years, the PBGC has had negative funding positions and significant exposure for future bailouts. Nevertheless, Congress will likely have to subsidize the PBGC in the next few years.

Part of the problem is that the PBGC only guarantees benefits up to about $13,000 per employee, per year, which is not enough to fund most of the overall shortfalls.

	September 30 (In billions)	
PBGC Status:	2014	2015
Assets	$90.0 B	$87.7 B
Liabilities	(151.8) B	(164.0) B
Net position	$(61.8) B	$(76.3) B
Possible exposure	$184 million	$238 million

Source: PBGC, *2015 Annual Management Report*, November 2015

At September 30, 2015, the PBGC had exposure to fund potentially defunct pension plans in the amount of $238 million, consisting of $218 million related to single-employer plans, and $20 billion related to multiemployer plans.[17] Those amounts do not reflect future claims that could occur from grossly underfunded plans that are categorized in the red zone.

A large portion of the $184 million of possible exposure was concentrated in the manufacturing and transportation industries.

[17] *2015 Annual Management Report*, Pension Benefit Guarantee Corporation, November 2015

On one side, the PBGC is simply not receiving the cash flow needed to function as fewer plans are available to pay it fees. On the other side, companies, in particular those in older established, union-based businesses, have learned how to play the bankruptcy game as a method to eliminate two burdens; one is union contracts and the other is the large unfunded pension obligations. Upon filing bankruptcy, companies can shift a portion of the pension shortfall to PBGC with no recourse. Classic examples of such strategies have previously occurred in the airline industry.

The U.S. Government to the Rescue?

There is no surprise that Congress has been lobbied by the various unions for Congress to approval a bailout of the pension liabilities for multi-employer plans. Since most of the multi-employer plans involve union employees, the union lobbies are extensive. There have been several bills proposed in Congress that would provide for the U.S. taxpayer to fund or guarantee the funding of the multi-employer plan deficits after the PBGC pays its share of the losses. To date, nothing has passed. Similar discussions exist with public plans.

In addition, Congress may be required to bail out the PBGC for other shortfalls related to single-employer plans.

Consider a rough computation of the total unfunded obligation that could exist with multi-employer plans along with the PBGC, that could require U.S. taxpayer bailout:

Multi-employer plans:	(in billions)
Funding deficiency $(428) billion x 88% in the Red Zone	$(377)
Total potential exposure	$(377)
Assets in PBGC	88
Net exposure to bailout	$(289)

In looking at the above table, a few observations:

- If one considers that portion of the multi-employer plans that is in Red Zone status (88% have a funded status of less than 65%), the net potential exposure to bail out the plans could be $377 billion.

- The PBGC has only $88 billion of assets as of its 2015 financial statements to pay for $377 billion of potential losses, leaving the PBGC short by about $(289) billion. Add to that number any potential shortfall in single-employer plans.

The result is that the PBGC has insufficient assets to pay for exposure to losses and may have to be bailed out by Congress.

What about public pension plans?

The largest shortfall of defined benefit pension plans actually rests with state and local pension plans, which have a shortfall of about $5 to $7 trillion. There is simply no way that the state and local governments will be able to fund $5 to 7 trillion. Don't be surprised if state and local municipals seek a bailout of their plans from Congress.

9. Trends in pensions and compensation

The recent cutback in defined benefit pension and postretirement plan benefits is part of a larger trend toward a reduction in overall compensation and employee benefits. In general, companies are looking for ways to trim overall compensation costs.

Consider these statistics:[18]

a. 25 million people will leave the work force through 2020.

b. The average age of a U.S. worker exceeds age 41, with more than 20% more than age 55.

c. The median age will increase to 43 by 2020, with more than 25% expected to be older than age 55. At that time, baby boomers will be between the ages of 56 and 74.

Note: To put the age in perspective, the average age of a U.S. worker was only 34 in 1980.

With a soft economy, companies are taking specific action toward reducing employer retirement plan benefits thereby shifting that benefit to employee IRAs.

One report stated that total retirement benefits from all U. S. employer retirement plans decreased from 7.8 percent of pay in 2002 to approximately 6 percent in 2015 with a continued downward trend.[19]

The U. S. shift away from company pensions toward IRAs

Over the past decade, there has been a dramatic shift away from defined benefit employer-sponsored retirement plan toward 401k plans and further shift toward employee funding of IRAs.

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[18] *Monthly Labor Review*, Bureau of Labor Statistics, December 2015
[19] Watson Wyatt

Based on the most recently published information, assets in retirement plans of non-governmental employees are approximately at the following levels:

Assets in Retirement Plans for Non-Governmental Employees

Plan type	2015 assets in plans*	2015 %	1996 %
	2015		
IRAs	$7.3 trillion	44%	31%
401(k)-defined contribution plans	6.5 trillion	39%	36%
Defined benefit plans	2.8 trillion	17%	33%
	$16.6 trillion	100%	100%

Source: 2015 information: *The U. S. Retirement Market, Investment Research Institute*, December 2015.
1996 information: Flow of Funds Report, Federal Reserve.

* Consists of third quarter 2015 data.

There has been a continued shift from defined benefit plans to 401(k) plans and, in turn from 401(k) plans to individual IRA accounts. This move in assets from corporate-related accounts to individual accounts is a trend because companies have to cut ever-growing employee benefits. As presented in the previous table, the highest percentage of assets in retirement funds lies in IRAs (44%) with defined benefit plans having the smallest percentage (20%). This shift is profound when compared with the percentages in 1996 when the percentages were equally divided among the three types of plans. Clearly, the shift to IRAs is a prime example of companies having to reduce higher retirement costs from the entity to the individual responsibility.

The same trend is occurring with other employee benefits. With respect to health insurance, companies are being forced to shift more of the financial burden onto employees. A survey published by Mercer Human Resource Consulting asked this question to employers about health care costs:

How is your company responding to rising health care costs?

Higher co-payments	64%
Increase deductibles	61%
Increase employee contribution to premiums	60%
Health savings accounts/reimbursable plans	45%
Wellness/disease prevention programs	40%
Switch providers for lower rates	39%
Disease-management programs offered	18%
Reduce scope of coverage	12%
Purchase health care jointly with other businesses	8%
Use more contract labor to avoid cost	7%

Notice that the first three responses represent a shift in the financial burden to employees. The above survey does not reflect the impact of Obamacare which is likely to further reduce benefits provided by employers.

Will employees have enough to retire?

Unfortunately, regardless of the type of pension plan used by retirees and prospective retirees, there is a significant shortfall in the amount of pension assets as compared with what individuals will require in the future to retire.

Consider the following some of which is provided by the Employee Benefits Research Institute:

- The average employee contributes 6.4% of his or her paycheck to a 401(k), much less than 10% minimum that is recommended.

- Boomers and Gen Xers have an aggregate retirement income shortfall of $4.3 trillion.

- Shortfall is defined as: Amount needed to retire, less amount in savings and social security benefits.

10. New defined benefit plan mortality tables

In October 2014, the Society of Actuaries (SOA) released new mortality tables found in RP-2014 and a new mortality improvement scale referred to as MP-2014. These new tables directly impact company defined benefit plan liabilities.

According to SOA, the new mortality tables are based on about 10.5 million life-years of exposure and more than 220,000 deaths, submitted from a total of 123 private and public/federal pension plans

The mortality assumptions currently used to value most retirement programs in North America were developed from data that are more than 20 years old (UP-94 and RP-2000), which are based on mortality experience with base years of 1987 and 1992, respectively

The new mortality tables reflect expanded life expectancies which will be reflected in actuarial computations of plan obligations.

The results of the new tables follow:

1. Life expectancies of 65-year olds in the United States have increased from:

   - 84.6 years to 86.6 years for men, and
   - 86.4 years to 88.8 years for woman.

2. The effects of the new tables follow:

   For companies with significant defined benefit pension and OPEB obligations, longer life expectancies will probably significantly increase the plan obligations.

- An average of two years of future benefit payments will have to be added to the plan obligation liability on sponsor financial statements.

Note: The immediate income statement effect will be minimal. GAAP permits the adoption of the new tables to be recognized in other comprehensive income (OCI) and be amortized into net income over several years.

- Plan sponsors will most likely use the revised mortality tables in developing 2014 assumptions affecting benefit obligations and contributions.

Note: ASC 715-30-35-42 and 715-60-35-72 require that the best available information be considered as of the measurement date including using the best estimate when using assumptions, including life expectancy.

"Each significant assumption used shall reflect the best estimate solely with respect to that individual assumption."

- If the new tables are used to calculate the plan sponsor's benefit costs and obligations, they should also be used for the plan's financial statements.

- The IRS did not reflect the new tables in its minimum funding standards for 2014 and 2015 but is expected to consider the new estimates when setting minimum funding standards for plans beginning in 2016.

3. The new mortality assumptions and longer life expectancies will likely result in the following:

- Higher contribution requirements
- Benefit restrictions
- Lower balance sheet funded status (assets minus liability will be lower)
- Higher lump-sum payouts
- Higher PBGC variable rate premiums

Must companies use the new mortality tables in computing plan obligations for GAAP financial statements?

Not necessarily.

U.S. GAAP does not require a plan sponsor to use a particular mortality table so that sponsors ultimately make the decision as to which assumptions they use in their financial statements to measure a plan's defined benefit obligation and net periodic benefit cost.

Instead, plan sponsors make their own decisions with respect to assumptions used for their financial statements as long as they use the "*best estimate*" available.

That said, most plan actuaries, accountants and auditors choose to use the actuary tables, in particular the newly issued RP-2014, because it represents the most recently issued mortality information available.

For pension funding purposes, although the IRS did not include the new RP-2014 information in its tables for 2014 and 2015, the IRS is expected to reflect it in its tables for 2016. Therefore, for GAAP purposes, some companies may try to hold onto the old (and less expensive) actuary tables through 2015 plan years based on the argument that they do not want to use the new tables until the IRS uses them in 2016.

For many actuaries, accountants and auditors, they may not want to wait until 2016 and may force their clients to use the new tables starting in 2014 plan years.

In February 2015, the AICPA issued a Technical Practice Aid (TPA) entitled, *Section 3700, Pension Obligations .01 Effect of New Mortality Tables on Nongovernmental Employee Benefit Plans (EBPs) and Nongovernmental Entities That Sponsor EBPs*, to address the applicability of the new mortality tables to sponsors of pension plans.

Technical Practice Aid (TPA) entitled, *Section 3700, Pension Obligations .01 Effect of New Mortality Tables on Nongovernmental Employee Benefit Plans (EBPs) and Nongovernmental Entities That Sponsor EBPs*

[February 2015]

Inquiry: Nongovernmental EBPs and nongovernmental entities that sponsor EBPs (sponsoring entities) incorporate assumptions about participants' mortality in the calculation of the benefit liability for financial reporting purposes. Professional associations of actuaries occasionally publish updated mortality tables and mortality improvement projection scales (collectively referred to as mortality tables for purposes of this Technical Question and Answer) to reflect changes in mortality conditions based on recent historical trends and data. Established actuarial companies also may develop mortality tables based on other information and assumptions.

For financial reporting purposes, how and when should nongovernmental EBPs and nongovernmental sponsoring entities consider these updated mortality tables if their financial statements have not yet been issued at the time the updated mortality tables are published?

Reply: Nongovernmental EBPs and nongovernmental sponsoring entities should consider the specific requirements of generally accepted accounting principles (GAAP), **which require the use of a mortality assumption that reflects the <u>best estimate</u> of the plan's future experience for purposes of estimating the plan's obligation** as of the current measurement date (that is, the date at which the obligation is presented in the financial statements).

In making this estimate, GAAP requires that all available information through the date the financial statements are available to be issued should be evaluated to determine if the information provides additional evidence about conditions that existed at the balance sheet date.

FASB Accounting Standards Codification (ASC) 855-10-55-1 specifies that information that becomes available after the balance sheet date (but before the financial statements are available to be issued) may be indicative of conditions existing at the balance sheet date when that information is a culmination of conditions that existed over a long period of time.

Updated mortality tables are based on historical trends and data that go back many years; therefore, the existence of updated mortality conditions is not predicated upon the date that the updated mortality tables are published. Management of a nongovernmental EBP or a nongovernmental sponsoring entity should understand and evaluate the reasonableness of the mortality assumption chosen, even when assisted by an actuary acting as a management's specialist, and document its evaluation and the basis for selecting the mortality tables it decided to use for its current financial reporting period. A management's specialist is defined in paragraph .05 of AU-C section 500, *Audit Evidence* (AICPA, Professional Standards), as an individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.

Many defined benefit pension plans present plan obligations as of the beginning of the plan year, as allowed under FASB ASC 960-205-45-1. Although this presentation is before the balance sheet date, it represents a measurement of an amount that is presented in the financial statements that should reflect management's *best estimate* of the plan's mortality and other assumptions. The assumptions used to estimate the plan's obligation should be evaluated based on all available information through the date the financial statements are available to be issued, including determining whether updated mortality conditions existed as of the date the obligation is presented in the financial statements (that is, the beginning of the year).

Auditors are required to evaluate the competence, capabilities, and objectivity of a management's specialist; obtain an understanding of the work of that specialist; and evaluate the appropriateness of that specialist's work as audit evidence for the relevant assertion. Considerations may include evaluating the relevance and reasonableness of significant assumptions and methods used by that specialist. Refer to paragraphs .08 and .A35–.A49 of AU-C section 500 and the "Using the Work of a Specialist" section in chapter 2, "Planning and General Auditing Considerations," of the AICPA Audit and Accounting Guide Employee Benefit Plans, for further guidance. In addition, the auditor is responsible for evaluating subsequent events under AU-C section 560, *Subsequent Events and Subsequently Discovered Facts* (AICPA, Professional Standards). That section requires the auditor to obtain sufficient appropriate audit evidence about whether events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements are appropriately reflected in those financial statements in accordance with the applicable financial reporting framework. [Issue Date: February 2015.]

SEC wants the new mortality tables used in 2014 and beyond

Although GAAP does allow a plan sponsor to choose its plan assumptions as long as they are the *best estimates* available, the SEC has been a bit more forceful and letting companies know they expect those companies to use the new mortality tables.

In his remarks made in December 2014 during the 2014 AICPA National Conference on Current SEC and PCAOB Developments, the SEC's T. Kirk Crews made the following comments:

> *"Given plan sponsors have historically utilized the SOA's mortality data and that data has been updated, the [SEC] staff does not believe it would be appropriate for a registrant to disregard the SOA's new mortality data in determining their best estimate of mortality. Finally, management should consider the guidance in Subtopic 715-20) and disclose the impact of mortality to the extent it results in a significant change in the benefit obligation"*

Those comments suggest that the SEC expects SEC companies to use the new tables in applying its "best estimate" of mortality assumptions.

What was the impact of the using the new mortality tables on 2014 pension plans?

Think about it. If an entity uses the new mortality tables for 2014, they are adding an average of 2 years of pension payments in the computation of their pension obligations.

That amount is likely to be significant.

- Tower Watson noted that it estimates that the funded status of the 400 largest U.S. company pension plans *declined by $72 billion* as a result of using the new mortality table assumptions in 2014.

- Overall funded status of the top 400 companies declined from 89% to 80% due to mortality table changes and a decline in interest rates.[20]

As to individual companies, some had more significant impacts on their liabilities than others:[21]

- General Motors pension liability increased by $2.2 billion due to mortality table changes, out of an overall increase of $3.6 billion.

- AT&T's pension and retirement-benefit obligations increased by $1.5 billion in 2014.

- Kimberly-Clark's pension obligations increased by about $2.5 billion.

- General Electric estimated that the new mortality assumptions could cause its retiree obligations to increase by $5 billion.

- Dow Chemical Co.'s pension liabilities increased by $750 million stemmed from new mortality table estimates.

In addition to the increases in obligations due to use of the new mortality tables, for 2014 plan years, companies experienced additional pension obligations due to a decline in interest rates. Thus, for 2014, U.S. companies with pension plans incurred sizeable deterioration in their funded status due to a one-two punch created by use of the new mortality tables coupled with a decline in interest rates.

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[20] Longer Lives Hit Companies With Pension Plans Hard- Firms' balance sheets will have to reflect higher costs, Wall Street Journal, February 2015

[21] Long lives pinching pension plan funds, Bloomberg News, February 2015

11. U.S. pension plans are moving from equities to bonds

As previously discussed in the last section, pension liabilities are increasing in part, because interest rates (and thus discount rates) have declined.

One reason for the decline is that the AA and AAA-rated bond interest rates have decreased. Moreover, the overall discount rates are declining because sponsors no longer wish to hold such a high percentage of assets in risk equity investments.

Thus, the shift is moving toward bonds and, consequently, a lower discount rate. A lower discount rate yields a higher pension obligation.

Companies are increasing their holdings in long-term bonds for several reasons:

- With bonds they can more closely match returns with future pension commitments.
- Bonds offer less risk from the volatility of the stock market.
- Sponsors are anticipating that bonds will offer a higher interest rate in the future if the Federal Reserve follows up on its warning that it is likely to increase interest rates.

For the first time since 2003, large pension funds hold more bonds than equities.

- The 50 largest pension plans in the S&P 500 invested 43% of their assets in bonds and 37% in stocks last year.
- In 2013, the split was 42% in debt and 41% in equities the year before, according to a new report from Goldman Sachs Asset Management. [22]
- In 2003, pensions held only 30% in bonds versus 61% in equities.

[22] Yield Watch: Corporate Pensions Shift to Bonds, CFO Journal, WSJ, April 2015, based on a report issued by Goldman Sachs Asset Management

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self - study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

1. What may have been a primary reason for the decline in restatements from 2006 to the period 2009-2014:
   a. Implementation of international accounting standards
   b. Auditors were less assertive in requiring companies to make adjustments
   c. Materiality thresholds were increased in fear of heightened scrutiny
   d. Sarbanes-Oxley's Section 404

2. According to the Min Wu study, how does the market reacts to a restatement. By _____
   a. Being indifferent with no change in stock price
   b. Penalizing the stock price for the three-day period after the announcement
   c. Reacting as though the company has gone bankrupt
   d. Reacting positively to the company's ability to make changes

3. Which of the following does Sarbanes's Section 304 clawback provision apply:
   a. CEO
   b. All current executives
   c. All managers and executives
   d. All executives current and retired

4. Harry is the CEO of a public company. A controller of the company committed fraud resulting in a restatement. Harry was not charged with fraud. Based on the results of recent court decisions involving Section 304 of Sarbanes-Oxley, which is the likely result of whether Harry's bonuses can be clawed back:
   a. Because Harry did not commit fraud, Harry will not have to pay back his bonuses
   b. Harry will likely have to pay back his bonuses
   c. There has been no recent court decisions to deal with this issue
   d. Harry is not only going to pay back the bonuses, but he will have to go to prison for up to 30 years

5. With defined benefit pension plans:
   a. A company can more accurately measure the amount of its pension cost
   b. A company can structure its contributions to be discretionary
   c. Investment risk is shifted from the company to the employee
   d. The amount of its pension cost is based on the amount of the ultimate benefit paid

6. Which of the following is a result of ASC 715 (formerly FASB No. 158):
   a. It changes the rules for defined contribution pension plans
   b. It requires companies with defined benefit plans to record on their balance sheets a portion of the plan liabilities
   c. It introduces greater transparency of plan disclosures
   d. It addresses whether postretirement benefit trusts should be consolidated

7. According to the Credit Suisse report on multi-employer plans, which of the following is the conclusion reached:
   a. Multi-employer plans continue to be overfunded due to a strong stock market
   b. Multi-employer plans are slightly underfunded by about 10 percent
   c. Multi-employer plans are grossly underfunded at about a 46 percent level
   d. Multi-employer plans became overfunded in recent years due to significant changes in actuarial assumptions

8. If an entity's pension plan is 86 percent funded, which color zone does the plan fall into as defined by the Pension Protection Act:
   a. Yellow
   b. Green
   c. Orange
   d. Red

9. Which of the following is a way in which an entity can reduce the pension liability of a defined benefit pension plan:
   a. Use a higher discount rate
   b. Use a higher compensation growth rate
   c. Use a higher actual rate of return
   d. Use a lower expected rate of return

10. Which of the following is an example of an investment which can be used as the discount rate for measuring the projected benefit obligation:
    a. Rate of a U.S. Treasury instrument
    b. Rate for a AA-rated corporate bond
    c. Rate for a junk bond

SUGGESTED SOLUTIONS

1. What may have been a primary reason for the decline in restatements from 2006 to the period 2009-2014:
   a. Incorrect. With few exceptions, U.S. companies have not adopted international accounting standards, making the answer incorrect.
   b. Incorrect. Auditors were actually more, not less, demanding and assertive in requiring companies to make adjustments.
   c. Incorrect. Actually, materiality thresholds were reduced, not increased, in fear of heightened scrutiny.
   d. **Correct. A possible reason for the decrease in restatements after 2007 was that companies implemented Section 404 of Sarbanes-Oxley and rectified internal control issues that existed prior to 2007. The benefit of the Section 404 implementation apparently has carried to the years after 2007.**

2. According to the Min Wu study, how does the market reacts to a restatement. By _____:
   a. Incorrect. The market is not indifferent and actually looks at a restatement negatively.
   b. **Correct. The market reacts quite negatively to a restatement by penalizing the stock price for the *three-day* period after the restatement announcement.**
   c. Incorrect. The Study does not make any correlation between a restatement and the impact of a company going bankrupt.
   d. Incorrect. According to the recent Min Wu study, a restatement is generally considered bad news by the market, not good news.

3. Which of the following does Sarbanes's Section 304 clawback provision apply:
   a. **Correct. Sarbanes's Section 304 applies to either a CEO or CFO.**
   b. Incorrect. Sarbanes's Section 304 only applies to a CEO or CFO, and not to all current executives.
   c. Incorrect. Managers and executives, other than the CEO and CFO, are not subject to Section 304, making the answer incorrect.
   d. Incorrect. *Section 304 does not apply to all executives and does not apply to retired parties.*

4. Harry is the CEO of a public company. A controller of the company committed fraud resulting in a restatement. Harry was not charged with fraud. Based on the results of recent court decisions involving Section 304 of Sarbanes-Oxley, which is the likely result of whether Harry's bonuses can be clawed back:
   a. Incorrect. Recent cases have held that any misconduct within the company means that the CEO and CFO will be subject to the Section 304 clawback provisions.
   b. **Correct. Any misconduct in the company will result in the CEO and CFO paying back their bonuses. Since the controller committed fraud, Harry will likely have to pay back his bonuses.**
   c. Incorrect. There have been several recent decisions including the SEC v. Jenkins case, making the answer incorrect.
   d. Incorrect. *Section 304 deals with civil payments and not criminal issues.*

5. With defined benefit pension plans:
   a. Incorrect. With a defined contribution or 401(k) plan, not a defined benefit plan, a company could more accurately measure the amount of its pension cost because it is based on the amount contributed to the plan.
   b. Incorrect. A sponsor of a defined benefit plan has fixed, measured contributions required with no discretion to those payments. To the contrary, most defined contribution or 401(k) plans allow a company to structure its contributions to be discretionary, thereby allowing it to reduce its pension contribution during weaker business cycles and increase it during stronger cycles.
   c. Incorrect. Investment risk remains with a company that sponsors a defined benefit plan. Alternatively, with 401(k) plans, investment risk shifts from the company to the employee as each employee is responsible for managing his or her investments.
   d. **Correct.** ***With defined benefit pension plans, the amount of its pension cost is based on the amount of the ultimate benefit paid, discounted back to the current year.***

6. Which of the following is a result of ASC 715 (formerly FASB No. 158):
   a. Incorrect. ASC 715 does not apply to defined contribution pension plans.
   b. Incorrect. The FASB statement requires a company to record the funded status of the plan on the balance sheet. It does not require that a portion of the plan liability be recorded.
   c. **Correct. The Statement introduces greater transparency of plan disclosures on the sponsor's balance sheet by including the entire funded status on the balance sheet.**
   d. Incorrect. ASC 715 has nothing to do with postretirement benefit plans or trusts. ASC 715 addresses the accounting for retirement plans only. Thus, the answer is incorrect.

7. According to the Credit Suisse report on multi-employer plans, which of the following is the conclusion reached:
   a. Incorrect. Multi-employer plans are underfunded by about $428 billion making the answer incorrect.
   b. Incorrect. Multi-employer plans are not slightly underfunded by about 10 percent. Instead, they are significantly underfunded by far greater than 10 percent, aggregating an unfunded status of about $428 billion.
   c. **Correct. According to Credit Suisse, multi-employer plans are grossly under-funded at about a 46 percent funded level, which places them in a dangerous funded status zone.**
   d. Incorrect. Multi-employer plans have been underfunded for several years and continue to be underfunded. There is no evidence that changes in actuarial assumptions contributed to the underfunded status.

8. If an entity's pension plan is 86 percent funded, which color zone does the plan fall into as defined by the Pension Protection Act:
   a. Incorrect. Yellow is between 65% and 80% funded status.
   b. **Correct. Green zone occurs at a funded status of more than 80 percent, making the answer correct.**
   c. Incorrect. Orange, like yellow, occurs between 65% and 80% funded status, making the answer incorrect.
   d. Incorrect. Red occurs at less than 65% funded status which is far less than the 86% level in the example.

9. Which of the following is a way in which an entity can reduce the pension liability of a defined benefit pension plan:
   a. **Correct. Use of a higher discount rate results in a lower pension liability being calculated.**
   b. Incorrect. Using a lower, not higher, compensation growth rate results in a lower pension liability because future benefits estimated to be paid will be lower.
   c. Incorrect. The actual rate of return does not affect the pension liability calculation.
   d. Incorrect. Use of a higher, not lower, expected rate of return results in the periodic pension cost being lower. A lower periodic pension cost results in a lower pension liability accrual.

10. Which of the following is an example of an investment which can be used as the discount rate for measuring the projected benefit obligation:
   a. Incorrect. The rate of a Treasury instrument is synonymous with a risk-free rate of return. GAAP does not provide for using the risk-free rate of return for measuring the pension obligation.
   b. **Correct. The rate used is that of a high-quality fixed-income investment which includes either an AA or AAAA-rated corporate bond.**
   c. Incorrect. The rate should be that of a high-quality corporate investment, which does not include the rate of a junk bond.
   d. Incorrect. An overnight repo is not a high-quality fixed-income investment, making the answer incorrect. Moreover, an overnight repo is a short-term investment which does not match the term of the pension liability.

E. You Need Principles to Use Principles-Based Accounting

As each new joint FASB-IASB standard is implemented, U.S. GAAP is moving closer to a principles-based accounting system that deviates from its traditional rules-based system.

At the heart of a recent debate is whether a principles-based accounting system should replace the more concrete, yet inflexible, rules-based approach. For years, the accounting profession has been criticized for its "black and white" approach to setting rules. In some instances, quantitative thresholds and rules have replaced logic. The result is that in recent instances, companies have "technically" satisfied GAAP's rules even though the substance of the transaction was contrary to the rules-based form.

One high-profile example took place more than a decade ago with Enron and its application of the special-purpose entity (SPE) rules for deciding whether certain off-balance sheet entities should have been consolidated by Enron. Under the SPE rules, (which subsequently have been replaced by the variable interest entity (VIE) rules under FIN 46R (ASC 810)), a company (Enron) was not required to consolidate certain off-balance sheet entities as long as it satisfied a 3% outside equity threshold. With its eye on the 3% rule, Enron structured agreements to ensure that the 3% was satisfied. At 3.1% Enron would not have to consolidate certain off-balance sheet entities, but at 2.97%, it would. In fact, one particular Enron off-balance sheet entity had an outside equity percentage of 2.97%. Can you imagine making a decision to consolidate an entity whereby at 2.97%, the entity is not consolidated, while at 3% it is? The 3% SPE threshold is an excellent example how a rules-based system's use of bright-line thresholds can distort the substance of transactions.

Now, let's change the facts. Originally, the FASB established the 3% rule for SPEs to define the minimum threshold at which an entity could obtain financing by itself without outside assistance. Assume that instead of the 3% rules-based threshold, a more qualitative, principle-based concept was used. That concept might look like this: "An entity must consolidate an off-balance sheet entity if that entity is not self-sustaining regardless of what the percentage threshold is." In essence, the 3% "rule" is replaced with a "principle" that is used to determine when to consolidate an off-balance sheet entity. Would a principles-based GAAP work and could it be applied in practice? Another example is capital leases which are based on a set of rules found in ASC 840 (formerly FASB No. 13). Specifically, ASC 840 provides the "rules" for capitalizing a lease if any one of four criteria is met.

Perhaps the best parallel of a rules- versus principles-based system is the Internal Revenue Code. Tax law consists of the principles, while the rules are found in the regulations, rulings, etc. Imagine operating under the Internal Revenue Code relying solely on the law (code) without the rules (e.g., regulations, rulings, etc.). The system would be impossible to interpret, and interpretations of the law would be quite subjective and difficult to apply.

In 2002, Congress passed the Sarbanes-Oxley Act, which required the SEC to conduct a study on the adoption of a principles-based accounting system by United States SEC companies.

In July 2003, the SEC finalized its study of a principles-based system and issued *SEC Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System.*

The conclusion reached by the Study is that the adoption of *objectives-oriented, principles-based accounting standards* in the United States would be consistent with the vision of reform that was the basis of the Sarbanes-Oxley Act.

Unlike a pure principles-based system, an *objectives-oriented, principles-based system* has certain attributes as follows:

1. In applying a particular standard in practice, accountants and auditors focus the accounting and attestation decisions on fulfilling the accounting objective of the standard. This minimizes the opportunities for financial engineering designed to evade the intent of the standard.

2. Each standard is drafted with objectives set by an overarching, coherent conceptual framework meant to unify the accounting system as a whole.

3. The objectives-oriented approach has exceptions which are contrary to a pure principles-based system.

4. The objectives-oriented approach has bright-line tests, which are contrary to a pure principles-based system.

5. The objectives-oriented approach articulates the class of transactions to which they apply and contain sufficiently detailed guidance so that preparers and auditors have a structure in which to determine the appropriate accounting for company transactions.

An objectives-oriented, principles-based system would provide both benefits and additional costs.

Benefits: An objectives-oriented, principles-based system would:

1. Improve the meaningfulness of financial information for investors with respect to complex business transactions

2. Better align professional incentives of management with investor's interests by holding management responsible for the economic substance of transactions

3. Increase the informativeness of financial statements under certain conditions

4. Enhance quality, consistency, and timeliness of standard setting because a principles-based system is faster to implement and maintain, and

5. Provide a vehicle to make U.S. standards closer to international standards which are already on a principles-based system.

Costs: An objectives-oriented, principles-based system would:

1. Increase the cost of accounting and auditing services:

    - More time would be spent communicating with the SEC, PCAOB, boards, and management on GAAP.

    - Insurance carriers may have to charge higher malpractice premiums due to the perceived greater exposure to liability.

    - Accounting firms would have to hire better talent to interpret a principle-based system.

    - Additional resources would be required to interpret standards.

2. Increased litigation risk

Can a principles-based system work?

The author believes a hybrid system, such as the objectives-oriented, principles-based system could work, if appropriate implementation guidance were given. However, a pure principles-based system will never work. Accounting without a rules-based system is gray, not black and white. A system based on gray, nebulous rules is subject to dispute, confusion, and ambiguity. It also lacks consistency. Consider two companies in the same industry. Using principles-based accounting, one company interprets the timing of revenue recognition in one manner, while the other interprets it in another. Both entities reached their conclusions correctly based on valid assumptions. Yet, the system results in two entities within the same industry, with the same information, reaching different conclusions about how to recognize revenue. The result is a lack of consistency within the same industry.

Let's also consider the impact of a principles-based system on auditors and accountants in litigation. It is difficult enough trying to defend and define the complex accounting rules under which accountants and auditors now practice. Imagine what would happen without accounting rules and how one could explain to a lay jury, conclusions reached using a principles-based approach.

Finally, the only way a principles-based system could ever work is if it operates within a universally ethical foundation. Although most accountants and their clients do follow an ethical compass, there are simply too many external forces and pressures that could persuade companies, and even their auditors and accountants, to interpret principles in one direction versus another. Such a result would mitigate the benefits expected to be derived from a principles-based system.

The rules-based system is not perfect, but it is the only one in which we can apply accounting on a consistent basis across industries.

Arguments For and Against Principles-Based Accounting System	
Rules-Based System	**Principles-Based System**
Advantages	**Disadvantages**
• Objective- easier to defend in litigation.	• Subjectivity and judgment without rules to define thresholds places greater litigation risk on accountants and auditors.
• Can be applied with reasonable level of ethics and professional judgment. Requires less skills of judgment.	• Requires high degree of ethics and exercise of professional judgment.
• Easier to enforce.	• More difficult to enforce.
Disadvantages	**Advantages**
• Much more complex and detailed.	• Less onerous, detailed and complex than the present "rules-based" "check-the-box" system.
• More difficult for accountants and auditors to stay current with rules-based system.	• Easier for accountants and auditors to stay current with a principles-based system.
• Fosters form over substance mentality for accounting.	• Fosters substance over form mentality for accounting.
• More difficult for U. S. system to converge with international standards under a rules-based system.	• Easier for the U. S. rules to converge with less rules based international standards.

Observation: The author believes a pure principles-based system is doomed for failure in the United States. The first test case of a principles-based system occurred with the FASB's issuance guidance on variable interest entities in ASC 810, *Consolidation* (formerly included in FIN 46R). When it was first issued, the Interpretation was broad-based, confusing, and lacked adequate examples (rules). The confusion was so rampant that the FASB had to issue or propose eleven FASB Staff Bulletins (FSB) to the original FIN 46. Finally, the FASB scrapped the first Interpretation and replaced it with a new Interpretation. Even after the issuance of the revised interpretation, few accountants have any idea how to apply the Interpretation because of the lack of specific "rules." Moreover, many of the new proposed standards involving leases, revenue and financial instruments are joint FASB-IASB statements that are based in a principles-based system.

F. International Accounting Standards Convergence

Its looks like the effort to force U.S. companies to adopt international standards (IFRS) is essentially dead. After more than a decade of effort, the SEC has given up on its previous goal of having one set of international accounting standards. Simply put, U.S. investors and stakeholders do not want it.

Background

During the past decade, a new set of International Financial Reporting Standards (IFRS) was adopted in Europe. Presently, United Kingdom companies are governed by the International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB). Effective in 2005, all companies listed on European stock exchanges (approximately 8,000 total) adopted international standards.

As of 2016:

- Approximately 122 countries require or allow their companies to adopt the new international standards including the U.K., Australia, Japan, and New Zealand.

- To no surprise, Cuba, Iran and Egypt have rejected international standards.

- More than 12,000 companies are now using IFRS worldwide.

The United States has not adopted IFRS and it now looks like it will not happen in the foreseeable future.

The first step: The IASB-GAAP agreement to converge standards

In 2002, both the IASB and FASB signed the "*Norwalk Agreement*" under which they agreed that convergence of both standards into one set of global standards is important. Both organizations included a convergence project into their agendas. At that time, the goal was for United States companies (including closely held entities), to adopt IFRS, rather than the other way around.

Under the Norwalk Agreement, both sides agreed to move toward to:

- Remove differences between existing U.S. and IFRS (in the short-term convergence project), and

- Converge future programs, either through joint or concurrent projects (long-term convergence project).

A key difference between U.S. GAAP and IFRS is that *IFRS standards are less rules-based and more principles-based*. As discussed previously in this segment, the difference between the two concepts (rules versus principles) is pervasive and requires a dramatic change in the approach to accounting. According to the IASB, the IFRS are principles-based standards that depend more on subjective determination and judgment of companies and their auditors in determining whether a transaction "faithfully represents" the economics of the transaction. In fact, the entire codification of the IFRS fits into one volume as compared with the multiple volumes of information that encompass U.S. GAAP. The result is that there is a great diversity in accounting and auditing under the IFRS system as compared with U.S. standards.

The IASB-FASB convergence project has had *two phases.*

Phase one- short-term convergence project: Phase One was completed and removed a variety of small, individual differences between U.S. GAAP and the IRFS that were not within the scope of other major projects.

a. The short-term convergence project was limited to those GAAP issues that both sides could resolve in the short-term.

b. The FASB issued three statements that were included within the short-term convergence project.

Phase two- joint and concurrent (long-term) projects: Phase Two, which is still in progress, consists of both organizations either working jointly or concurrently on larger more complex projects that include:

- Revenue recognition
- Stock options
- Consolidations and off-balance sheet entities
- Financial performance reporting
- Leases

Phase two was established so that both the FASB and IASB could ultimately convergence accounting standards is a more seamless fashion.

The short-term convergence project

FASB:

In implementing the short-term project, he FASB took steps toward modifying U.S. GAAP to be consistent with IASB GAAP by issuing three statements to revise existing U.S. GAAP. Those three GAAP standards were issued as follows:

a. *ASC 250, Accounting Changes and Error Corrections* (formerly FASB No. 154): Eliminates the use of the cumulative effect of an accounting change for implementation of a voluntary accounting change, replacing it with a required restatement of financial statements, applied retroactively.

b. *ASC 845, Nonmonetary Transactions* (formerly FASB No. 153): Eliminates the use of a book-value approach to account for the exchange of similar productive assets (e.g., real estate exchanged for real estate) in situations in which the transaction does not have commercial substance.

c. *ASC 330, Inventory* (formerly FASB No. 151): Amends the language in ARB No. 43 to be consistent with IAS 2, with respect to inventory costs.

IASB:

On the other side, as part of the short-term project, the IASB has issued a series of statements that cleaned up international standards to not only converge with the FASB, but also as part of the overall international standards convergence that took place.

The following chart presents the framework of the FASB-IASB short-term convergence project and long-term international standards project.

Move Toward International Standards-
FASB-IASB's Norwalk Agreement

FASB Changes Existing GAAP

Changes toward IFRS:

- ASC 250: *Accounting Changes and Error Corrections* (formerly FASB No. 154)
- ASC 845: *Nonmonetary Transactions* (formerly FASB No. 153)
- ASC 330: *Inventory* (formerly FASB No. 151)

Short-Term Convergence Project

IASB Pending Changes-Existing Accounting Standards

Changes for IFRS:

- Presentation of FS
- Inventories
- Accounting Changes in Estimates, Errors
- PP&E
- Leases
- Foreign Exchange Rates
- Related Party Disclosures
- Consolidations
- Investments
- Joint Ventures
- EPS
- Investment Property
- Financial Instruments

Changes toward FASB:

- Non-Current Assets Held for Disposal-Disc. Operations
- Contingent Liab./Assets
- Termination Benefits
- Government Grants
- Income Taxes

FASB-IASB Long-Term Project
Major Long-Term Projects-Joint

• Revenue Recognition • Consolidations • Financial Instruments • Leases	• Financial Statement Presentation • Statement of Comprehensive Income • Reporting Discontinued Operations • Balance Sheet Offsetting

How is the convergence working?

It appears that the adoption of international standards has worked for all nations *other than the United States*.

At its inception, critics stated that the project was doomed for failure for numerous reasons including the political and cultural differences between the FASB and IASB. Yet, it appears that the IASB has been successful at expanding the application of IFRS and eliminating many of the standards differences between the FASB and IASB, even without the U.S. committing to the adoption of international standards.

Consider the following:

1. Since its inception, the IASB has been able to convince more than 122 countries (at least 25 of them in the E.U.) to adopt one set of international standards. The U.S. is not one of those countries.

2. In a relatively short period of time, both the FASB and IASB adopted new standards that reflect the other side's existing standards, even though the United States has not committed to adopting IFRS.

Presently, the FASB has issued three statements that amend U. S. GAAP under the short-term convergence project and has many standards about to be issued under its long-term convergence project.

The following chart summarizes the status of the convergence of standards as of early 2016:

Status of FASB- IASB Convergence Project		
Project	Influencing party	Status
Short-term project:		
Nonmonetary exchanges	IASB	Completed
Inventories	IASB	Completed
Voluntary accounting changes	IASB	Completed
Long-term project:		
Fair value measurement	FASB IASB	Completed
Statement of comprehensive income	FASB IASB	Completed
Balance-sheet offsetting	FASB IASB	Completed
Accounting for financial instruments	FASB IASB	Pending high priority
Leases	FASB IASB	Pending high priority
Revenue recognition	FASB IASB	Issued and being amended
Consolidation: Policy and Procedures	FASB IASB	Pending
Reporting discontinued operations	FASB IASB	Completed
Insurance Contracts	FASB IASB	Pending
Financial Statement Presentation	FASB IASB	Pending
Earnings per Share	FASB IASB	Not active
Income Taxes	FASB IASB	Pending
Postretirement Benefit Obligations including Pensions (Phase 2)	FASB IASB	Not active
Emissions Trading Schemes	FASB IASB	Not active
Financial Instruments with Characteristics of Equity	FASB IASB	Not active
Conceptual Framework Project	FASB IASB	Pending
Source: FASB		

Both the FASB and IASB have announced that their goal is to prioritize the completion of three major projects: revenue recognition, leases, and financial instruments. Thereafter, all bets are off and the joint-project activity is likely to subside considerably.

Following is a quick analysis of what is going on at the IFRS front.

U. S. and international support to move toward global acceptance of IFRS

2009 and 2008 were years that created the impetus for IFRS to replace U.S. GAAP, while 2010 through early 2016 was a time period during which the IFRS effort stalled.

In November 2008, the SEC issued a document entitled, *Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers* (the "Roadmap").

The Roadmap represented the first time that the SEC had embraced the possibility that U.S. issuers (SEC companies) ultimately would be required to adopt IFRS.

Specifically, the Roadmap outlined seven milestones that had to be met for the U.S. to move toward acceptance of IFRS.

The SEC noted in its Roadmap that beginning with filings in 2010, the SEC would permit early use of IFRS by a limited number of U.S. issuers if companies used IFRS as the basis of financial reporting more than any other set of standards.

In its Roadmap, the SEC stated that by June 2011, it would assess whether the seven milestones had been achieved. If so, the SEC would decide whether to proceed with rulemaking that would require U. S. issuers to use IFRS beginning in 2014. In February 2010, the SEC moved the 2014 date to 2015.

In 2009, through a series of speeches, the SEC reaffirmed its commitment to assess the IFRS by 2011.[23] Yet, in 2010, it appeared as if the SEC was wavering on its 2011 decision date as well as the ultimate 2015 implementation date. In particular, in a 2010 speech, the then SEC Chairperson, Mary Schapiro stated that it would take a minimum of four years to adjust to IFRS if the SEC decided to require use of IFRS. Moreover, Ms. Schapiro noted that the SEC was not committed to a decision date of 2011.[24]

What was the hold up in requiring use of international standards by U.S. companies?

Although the convergence had steam in the mid-2000s, its impetus has dwindled in part to a change in direction at the SEC with a different commissioner and administration.

There are other considerations that might be affecting the decision not to converge:

1. The cost to change would be significant:

    a. U.S. companies would be required to adopt International Financial Reporting Standards (IFRS).

    b. Accounting systems would have to be changed to capture revised IFRS data.

    c. U.S. accountants, auditors, actuaries, and other parties would be required to receive extensive education and training in IFRS versus U.S. GAAP.

2. IFRS may not be better than the current U.S. standards:

    a. There are certain standards within IFRS that are not acceptable to many U.S. companies such as IFRS's disallowance of the use of LIFO inventories.

    b. Much of IFRS is based on a principles-based system while the U.S. GAAP is generally based on a rules-based system which is more litigation proof.

    c. The amount of authoritative literature in IFRS is small relative to the volumes of U.S. GAAP, particularly with respect to industry-specific guidance.

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[23] For example, October 2009 speech by James Kroeker, SEC Chief Accountant.

[24] Speech by SEC Chairman, Mary Schapiro, AICPA National Conference on Current SEC and PCAOB Developments, Washington, D.C., December 2010.

The following chart summarizes some of the key differences between U.S. GAAP and international standards:

Key Differences- U.S. GAAP and IFRS		
Element	Treatment under IFRS	Treatment under U.S. GAAP
LIFO inventory	Does not permit use of LIFO	Permits use of LIFO
Impairment of long-lived assets	Uses a one-step approach	Uses a two-step approach
	Permits companies to reverse impairment losses back to the amount of the basis when the reason for the impairment no longer exists	Does not permit a reversal of impairment losses
Property plant and equipment	Permits a company to evaluate its property, plant and equipment as long as the entire class is revalued	Does not permit such a revaluation
	Requires use of component depreciation in certain cases where the individual components can be separated and there are significant differences in the useful lives of the components	Permits, but does not require, use of component depreciation
Uncertain tax positions	Uncertain tax positions are not specifically addressed by IFRS	The tax benefit of a tax position is recognized only if it is more likely than not that the position will be sustained upon examination
Revenue recognition	IFRS guidance on revenue recognition is limited	Has significant guidance on revenue recognition albeit scattered throughout GAAP
R&D	IFRS permits development costs to be capitalized if certain criteria are met, while research costs must be expensed	Requires R&D costs to be expensed in most cases
Disclosures	More extensive disclosures exist due to principles-based standards	Less extensive disclosures exist due to rules-based standards
Source: Author		

Because IFRS is a principles-based system, the amount of authoritative literature for IFRS is small relative to the volumes of GAAP. Additionally IFRS has minimal industry-specific guidance, while GAAP has an abundance of industry guidance.

Gradual decline in support for international standards- 2012 to 2016:

Starting in 2012, the support for forcing U.S. companies to adopt international standards started to wane.

On July 13, 2012, the SEC published a report entitled, *Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers- Final Staff Report.*

Although the Report *did not reach any conclusions* about whether U.S. companies should adopt IFRS, the SEC Staff did state the following:

1. The vast majority of participants in the U.S. capital markets *do not support* the adoption of IFRS by U.S. companies.

2. There needs to be substantial support for exploring other methods of incorporating IFRS that might demonstrate the U.S.'s commitment to the objective of one single set of high- quality, global accounting standards.

3. The IASB standards are generally perceived to be *high quality* by the global financial reporting community. However, there continue to be areas that are underdeveloped (e.g., the accounting for extractive industries, insurance, and rate-regulated industries). By comparison, U.S. GAAP also contains areas for which guidance is in need of continued development (e.g., push-down accounting and government grants), but the perception among U.S. constituents is that the "gap" in IFRS is greater.

4. The SEC Staff believes that enhancements should be made to the IASB's coordination with individual country accounting standard setters and the IASB's funding process.

5. The Staff further stated that investors agree that companies should not be permitted to adopt IFRS early, as it would compromise comparability with U.S. companies applying U.S. GAAP.

Note that the SEC Staff report did not address whether U.S. public companies should have the option to adopt IFRS on a voluntary basis.

Throughout 2013 and 2014, the SEC has made several speeches in which it has addressed the international standards issue. Yet, as of 2015, the SEC still has not made a decision as to whether SEC companies should be required to adopt international standards.

2015-2016- Put a fork in the convergence project- it is done!

Although the FASB and IASB have several significant joint projects in the works, including revenue recognition, recently issued FASB statements demonstrate that the two bodies are issuing standards with greater independence from the other.

Consider, for example, the FASB made several tentative decisions with respect to its financial instruments project, that differ from the approach being proposed by the IASB.

- The FASB retained certain existing requirements for embedded derivative features in hybrid financial assets.

- The FASB's impairment of financial instruments approaches differ from the IASB's method, and

- The FASB's proposed credit loss model for financial instruments recognizes loan losses earlier than the IASB's proposal.

In its document entitled *Strategic Plan, U.S. Securities and Exchange Commission, Fiscal Years 2014-2018* (Draft for Comment), all indications are that the SEC is not moving in the direction of international convergence.

In the document, the SEC states:

> *"The SEC will continue to work closely with its regulatory counterparts abroad, as well as with relevant international organizations, to promote high-quality securities regulation worldwide and convergence where appropriate. The SEC will conduct technical assistance programs that promote emerging and recently-emerged markets' capacity to take steps to minimize the likelihood of regulatory arbitrage and promote cross-border enforcement and supervisory assistance."*

Contrast the above quote with a quote from the SEC's earlier plan for 2010 to 2015:

> *"…the agency will promote high-quality financial reporting worldwide through, among other things, support for a single set of high-quality global accounting standards and promotion of the ongoing convergence initiatives between the FASB and the International Accounting Standards Board." In the new SEC draft, it is stated that "…the agency will work to promote higher quality financial reporting worldwide and will consider, among other things, whether a single set of high-quality global accounting standards is achievable."*

In the plan for 2014-2018, the SEC suggests it will cooperate and converge "where appropriate" while for the 2010-2015 period, the SEC appears to suggest that there was consideration to "a single set of high-quality global accounting standards."

No way says Schnurr

In July 2015, SEC Chief Accountant James Schnurr said he probably won't recommend that the SEC mandate use of IFRS for U.S. companies.

On May 7, 2015, speaking at the Baruch College Financial Reporting Conference, James Schnurr addressed current thinking with respect to IFRS, including the key question whether the SEC is still committed to the objective of a single set of high-quality, globally accepted accounting standards.

Schnurr noted:

- Based on interactions with constituents including investors, auditors, regulators and standard-setters, there is "virtually no support" to have the SEC mandate IFRS for all U.S. public companies.

- There is little support for the SEC to provide an option allowing U.S. companies to prepare their financial statements under IFRS.

- There still remains support for the objective of a single set of such globally accepted accounting standards.

- Although the FASB and IASB have worked on joint projects over the past decade, that cooperation has run its course with both boards now starting to move in different directions.

Chief Accountant Schnurr stated that plans to mandate IFRS, or to provide companies with the option to use them, probably will not be his recommendation to SEC Chair White.

Unless there is divine intervention, the goal of requiring U.S. companies to adopt international accounting standards is over.

G. Proposed Repeal of LIFO

More than a decade ago, when it looked like U.S. companies would be required to adopt international standards, the repeal of LIFO was a target of discussion for two reasons:

1. International accounting standards (IFRS) did not permit use of LIFO while U.S. GAAP does.

2. Congress was targeting use of LIFO for repeal.

Although it now looks like international standards will not be adopted by U.S. companies, the repeal of LIFO is still likely due to tax reform. Let's look at the rules and where LIFO is headed.

LIFO Conformity Requirement- IRC 472

Although some companies argue that they use LIFO to better match revenues and expenses, the reality is that LIFO is used for U.S. GAAP because it saves taxes. In a perfect situation, companies would prefer to use LIFO for tax purposes and use a higher-valued FIFO or average cost for GAAP. In doing so, they could have the best of both situations: a lower taxable income and a higher GAAP income.

However, use of LIFO is one of the few examples of accounting methods where the Internal Revenue Code interferes with GAAP by way of the IRC Section 472's *LIFO Conformity Requirement.*

In general, the LIFO Conformity Requirement states that if an entity uses LIFO for income tax purposes, it must also use it for GAAP to clearly reflect its income.

Over the years, the Section 472 regulations have watered down the LIFO Conformity Requirement to allow the issuance of non-LIFO disclosures and supplementary information. However, the current regulations allow for the following for U. S. GAAP, if LIFO is also used for tax purposes:

- The primary income statement must be presented on LIFO.

- The balance sheet may be presented on a non-LIFO (e.g., FIFO) basis.

- Supplementary information and footnotes can present non-LIFO information such as in the case of presenting an income statement on a FIFO basis as a supplementary schedule.

- Interim income statements may be presented on a non-LIFO basis as long as the total of the interim statements does not aggregate to one annual non-LIFO statement (e.g., three, quarterly non-LIFO income statements may be presented, but not four quarterly statements).

One study suggested that 36 percent of U.S. companies use LIFO and that a conversion from LIFO for income tax purposes would have the following impact based on a sample of 30 U.S. firms reviewed.

Impact of Converting from LIFO to Non-LIFO:
Sample 30 U.S. Companies

Change in	Average Change Increase (decrease)
Pre-tax income	11.9%
Net income	7.4%
Inventory- % of total assets	46.0%
Stockholder's equity	34.2%
Current ratio	26.2%
Debt/equity ratio	(23.1)%

Source: *The Potential Consequences of the Elimination of LIFO as a Part of IFRS Convergence* (Georgia Tech College of Management).

In addition, there would be other impacts including the fact that financial covenants, compensation plans, and contracts driven by income would be affected by higher non-LIFO income. Some of the drawbacks of using LIFO, such as the ability to manage earnings through liquidating LIFO layers, would be eliminated through a conversion to a non-LIFO method.

Will Congress repeal or save LIFO?

Although a conversion from LIFO to a non-LIFO inventory method would clearly result in financial statement improvement as shown in the previous table, the negative tax effects would severely impact cash flow. In essence, companies would be required to pay federal and state income taxes on the entire LIFO reserve. In some industries, such as oil and gas, the tax effect would be in the billions. Consider three U.S. oil companies, Exxon Mobil, Chevron, and Conoco-Phillip's inventories at December 31, 2014.

At December 31, 2014: (In billions)	At FIFO	At LIFO	LIFO Reserve
Exxon-Mobil	$27.3	$16.7	$10.6
Chevron	14.6	6.5	8.1
Conoco-Phillips	1.4	1.3	.1
Total	$43.3	$24.5	$18.8 [25]
% LIFO reserve to total LIFO inventory			*77%*

If LIFO were repealed, there would be a significant federal and state tax recovery:

- Overall, U.S. companies (public and nonpublic) would recapture approximately $253 billion in LIFO reserves and pay approximately $81 billion in additional federal taxes over a ten-year recapture period.[26]

- The top three oil companies, alone, would pay approximately $7 billion of additional federal income taxes ($8 billion federal and state taxes) due to recapture of their LIFO reserves.[27]

The overall tax revenue pickup from companies converting from LIFO to a non-LIFO basis would be sizeable and welcomed by Congress at a time when the U.S. Treasury desperately seeks additional tax revenue. The author's estimation is that the LIFO reserve recapture from LIFO repeal would be approximately $253 billion.

Although there are plenty of groups that will challenge the LIFO repeal, the political landscape points toward repeal of LIFO with a 10-year (or 4-year) phase-in (payback) of the LIFO reserve.

The politics of LIFO repeal

The impetus for the repeal of LIFO started in 2010 and has continued into 2016.

In August 2010, the Joint Committee on Taxation recommended repeal of LIFO.

Then, in December 2010, the National Commission of Fiscal Responsibility recommended that LIFO be "eliminated with appropriate transition." What is most significant about the National Commission recommendation is that at the time of its recommendation, the Commission was bi-partisan suggesting that both parties in Congress support a LIFO repeal.

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[25] At the end of 2013, the LIFO reserve for the three oil companies was $30 billion, and declined to $18.8 billion at the end of 2014 due to a decline in oil prices. Source of information: Company annual reports.

[26] The author's calculation is based on the White House 2016 budget which shows a 10-year tax revenue pickup of $81 billion from repeal. Computation: $81 billion /32% federal tax rate, net of state tax benefit = $253 billion estimated LIFO reserve recapture.

[27] Using the example in the previous chart, assuming a 40% federal and state income tax rate, collectively Exxon, Chevron and Conoco would have a current federal and state tax bill of approximately $8 billion ($18.8 billion LIFO reserve @ 40%) that would negatively impact each entity's cash flow. Of the $8 billion of additional taxes, approximately $7 billion would be payable to the federal government while the remaining $1 billion would be paid for state and local income taxes (based on an 8% state rate and a federal rate of 32% net of state tax benefit).

Since 2010, in each of its annual budgets, the Obama Administration has recommended the repeal of both LIFO and lower of cost or market for inventories. In the 2017 budget issued in February 2016, the proposed repeal of both LIFO inventories and lower of cost or market value is estimated to result in an increase in tax revenue of $81 billion for LIFO over 10 years, and $7 billion for lower of cost or market over four years.[28]

The U.S. Department of Treasury explains the reasons for the proposed repeal:

> **Reasons for Change**
>
> The repeal of the LIFO method would eliminate a tax deferral opportunity available to taxpayers that hold inventories, the costs of which increase over time. In addition, LIFO repeal would simplify the Code by removing a complex and burdensome accounting method that has been the source of controversy between taxpayers and the Internal Revenue Service. International Financial Reporting Standards do not permit the use of the LIFO method, and their adoption by the Securities and Exchange Commission would cause violations of the current LIFO book/tax conformity requirement. Repealing LIFO would remove this possible impediment to the implementation of these standards in the United States.
>
> *Proposal:*
> The proposal would repeal the use of the LIFO inventory accounting method for Federal income tax purposes. Taxpayers that currently use the LIFO method would be required to change their method of inventory accounting, resulting in the inclusion in income of prior-years' LIFO inventory reserves (the amount of income deferred under the LIFO method). The resulting section 481(a) adjustment, which is a one-time increase in gross income, would be taken into account *ratably over ten years*, beginning with the year of change.
>
> Source: *General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals*, Department of the Treasury

House Ways and Means Committee proposal

The House Ways and Means Committee also has LIFO and lower of cost or market on the chopping block.

In a tax bill proposal issued by the House Ways and Means Committee (David Camp, Chairman) in February 2014, the bill includes two sections to remove LIFO and lower of cost or market:

> *Section 3310: Repeal of last-in, first-out method of inventory*: States that use of LIFO shall in no event be treated as clearly reflecting income.

[28] *General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals Table of Revenue Estimates* (United States Department of Treasury), February 2016.

Section 3311: Repeal of lower of cost or market method of inventory: States that the lower of cost or market method of determining inventories shall in no event be treated as clearly reflecting income.

For tax purposes, both proposals would apply a change in accounting method with a four-year spread of the change. For GAAP purposes, most companies would convert from LIFO to FIFO with a restatement of prior years' financial statements required.

If there is corporate tax reform in 2017, expect that LIFO repeal will be at the top of the list.

H. The Continued Move to Fair Value Accounting

For the past decade, the historical cost model that has been the basis of GAAP accounting has slowly deteriorated, being gradually replaced by fair value accounting, but perhaps not fast enough for the investment community.

In one survey, *A Comprehensive Business Reporting Model*, (CFA Institute), investors noted 12 proposed changes to the business reporting model. Among them, was the need for full fair value financial statements.

Given the fact that the source of the survey is the end user of many financial statements, (that is, the investor), its results should be looked at seriously.

As stated in the survey:

1. "Fair value information is the only information relevant to financial decision making. …… Decisions about whether to purchase, sell or hold investments are based upon the fair values. Financial statements based on outdated historical costs are less useful for making such assessments."

2. Because current financial statements include a mixture of historical cost and fair value, investors who rely on fair values for decision making must expend considerable effort to restate cost to fair value.

3. Historic cost itself is in reality historic market value, the amount of a past transaction, and is never comparable on a firm-to-firm basis because the costs were incurred at different dates by different firms.

4. Investor conversion of historical cost components to fair value would be eliminated if GAAP recorded assets and liabilities at fair value at inception with a periodic revaluation to fair value.

5. FASB should make a move to fair value accounting a priority.

The fact is that the historical cost model is inconsistent with the way in which investors and other third parties measure an entity- by the change in entity value. Presently, GAAP uses a fair value model to record the initial measurement of assets and liabilities. Thereafter, many assets are recorded at historical cost, such as fixed assets, while others are recorded at fair value or a hybrid of cost and fair value.

The following table illustrates the blend of historical cost, fair value and other measurements presently used in GAAP.

Financial Measurements Under Existing GAAP	
Item and Standard	**Accounting Treatment**
Cash	Carrying amount
Trade receivables	Net realizable value
Inventories- ASC 330	Lower of cost or market
Securities including mortgage-backed securities- ASC 320	Measured at fair value or cost depending on category
Non-security investments- ASC 340	Historical cost, unless permanent writedown to market value
Loans receivable, including bank loans that are not securities- ASC 815	Carrying amount. Written down to fair value if the loan is impaired
Fixed assets	Historical cost, depreciated or amortized
Goodwill- ASC 350	Initially recorded at historical cost (purchase price) and written down if there is an impairment in value
Intangibles other than goodwill with finite lives- ASC 350	Initially recorded at historical cost (purchase price) and amortized over the estimated useful lives
Intangibles other than goodwill with indefinite lives- ASC 350	Historical cost and written down if there is an impairment in value
Hedging derivatives- ASC 815	Fair value
Accounts payable and accrued expenses	Recorded at estimated amount at which obligation will be settled
Notes payable	Settlement amount
Asset retirement obligations- ASC 410	Recorded at fair value
Guarantee liabilities- ASC 460	Recorded at the fair value of the guarantee obligation at its inception
Stock options- ASC 718	External fair value model
Business combinations- ASC 805	Identified assets acquired, liabilities assumed, and noncontrolling interests in the acquiree are recorded at fair value at acquisition date
Fixed assets	Historical cost, depreciated or amortized
Goodwill- ASC 350	Initially recorded at historical cost (purchase price) and written down if there is an impairment in value
Intangibles other than goodwill with finite lives- ASC 350	Initially recorded at historical cost (purchase price) and amortized over the estimated useful lives
Intangibles other than goodwill with indefinite lives- ASC 350	Historical cost and written down if there is an impairment in value
Hedging derivatives- ASC 815	Fair value
Accounts payable and accrued expenses	Recorded at estimated amount at which obligation will be settled
Notes payable	Settlement amount
Asset retirement obligations- ASC 410	Recorded at fair value
Guarantee liabilities- ASC 460	Recorded at the fair value of the guarantee obligation at its inception
Stock options- ASC 718	External fair value model
Business combinations- ASC 805	Identified assets acquired, liabilities assumed, and noncontrolling interests in the acquiree are recorded at fair value at acquisition date
Disclosures	SEC companies are required to disclose the fair value of financial instruments even if not recorded at fair value

The historical cost model has worked in terms of providing a format by which accountants can apply systematic and rational allocations of cost (such as in the case of depreciation and amortization) without the ambiguity of determining fair value. That is, the existing historical cost GAAP model has allowed

accountants to follow a set of standard rules in preparing financial statements. But are historical cost financial statements meaningful to third parties?

The FASB has suggested that the historical cost model no longer works and needs to be replaced or repaired with a fair value model whenever assets and liabilities can be reliably measured at fair value.

But, simply measuring the change in entity wealth from period to period has its critics who note the following challenges to a fair value model:

- Fair value accounting is merely an appraisal of an entity's net assets from period to period. As a result, it may disguise the true performance of the entity as appreciation in certain assets may reward management for value enhancement for which they should take no credit.

- Fair value accounting introduces a degree of volatility to the accounting model as sharp increases and decreases in values may distort comparisons from period to period.

- Fair value accounting is too subjective as many assets and liabilities cannot be easily measured without making valuation assumptions. Such assumptions can vary and result in entities not being comparable.

- Although fair value accounting may be more relevant, the historical cost model is more reliable.

- The costs of moving to fair value accounting may exceed the benefit as companies would be required to perform asset valuations on a period-to-period basis.

So, how would a fair value model be implemented on a period-to-period basis?

There are certainly challenges in applying a full fair value model to financial statements. For assets and liabilities with observable values (such as securities) fair value accounting is relatively easy to apply. However, for those assets that do not have observable values, such as fixed assets and intangibles, measuring fair value from period to period is difficult and costly. For example, a company with property and equipment would be required to revalue such assets from year to year and may require outside services from an appraiser. Such a valuation would not only be costly but could delay the timely issuance of financial statements. Moreover, for many smaller companies, such cost of application may exceed the benefit derived from fair value information.

Is fair value a better system?

There are arguments for and against a fair value system. The author believes that fair value is a far better system than a hybrid system (cost and fair value). The fact is that the historic cost model does not purport to display the way third parties think in evaluating their investment. Unrealized gains and losses on assets should be an important element of total earnings for a period. More particular, a company's performance for a period of time should be measured by the change in the fair value of its net assets from period to period as demonstrated below:

Fair value of net assets	
End of year	XX
Beginning of year	XX
Change = earnings for the period	XX

A common criticism of fair value accounting is that such a measurement may lack reliability and accuracy based on the fact that there is a range of fair value for each asset or liability. Yet, the counter-argument is that the worst fair value is far better than the best historic cost.

Another criticism is that use of fair value would introduce a high degree of volatility to financial statements from unrealized gains and losses on assets being recorded from year to year. However, volatility is an element of risk that an investor or third party should factor into its assessment of a company's value.

Status of the FASB's fair value project

Although the FASB's move toward fair value was slow at its inception, the pace has certainly picked up in the past few years due, in part, to the Wall Street and banking troubles and the challenges in valuing the billions of dollars of non-performing bank loans and mortgage backed securities.

The fair value process really started when the FASB issued ASC 820, *Fair Value Measurements* (formerly FASB No. 157).

ASC 820 defines fair value, establishes a framework for measuring fair value under GAAP, and enhances disclosures about fair value measurements. More specifically, ASC 820 does the following:

1. Defines fair value as the exit price which is:

   "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."

   a. The exit price (fair value) is market based, determined from the perspective of a market participant (the seller) that holds the asset or liability. An internally generated fair value is not relevant.

2. Develops a *three-level hierarchy* for valuation:

   a. *Level 1*: Observable market inputs that reflect quoted prices for identical assets or liabilities in *active markets* the reporting entity has the ability to access at the measurement date.

   b. *Level 2*: Observable market inputs other than quoted prices for identical assets or liabilities such as:
      - Quoted prices for similar assets and liabilities in active markets
      - Quotes prices for identical or similar assets and liabilities in markets that are not active
      - Market inputs other than quoted prices that are directly observable for the asset or liability, such as interest rates, yield curves, volatilities, and default rates.

c. *Level 3*: Unobservable market inputs, such as those derived through extrapolation or interpolation that are not able to be corroborated by observable market data.

3. Requires that in the absence of quoted prices for identical or similar assets or liabilities, fair value should be estimated using multiple valuation techniques consistent with the market approach, income approach, and cost approach whenever the information necessary to apply those techniques is available, without undue cost and effort. In all cases, the valuation techniques used for those estimates would emphasize relevant market inputs, including those derived from active markets.

4. Requires expanded disclosures about the use of fair value to remeasure assets and liabilities recognized in the statement of financial position, including information about the fair value amounts, how those fair value amounts were determined, and the effect of the remeasurements on earnings.

Next step- ASC 825 (formerly FASB No. 159) and the fair value option

After issuing ASC 820 (formerly FASB No. 157), the FASB introduced a project in ASC 825, (the fair value option (FVO)) to consider whether to permit (but not require) entities a one-time election to report certain financial instruments (and certain non-financial assets) at fair value with the changes in fair value included in earnings.

Subsequently, the FASB issued ASC 825, *Fair Value Instruments* (formerly FASB No. 159). ASC 825, which is still in effect, provides the option of recording certain financial assets and liabilities at fair value for initial and subsequent measurement.

It applies to financial asset and liabilities that, in general, are not otherwise subject to fair value accounting. Further, *ASC 825 is optional*; that is, an entity may choose (but is not required) to record certain financial assets and liabilities at fair value, contrary to the way they are recorded and measured under other GAAP. Moreover, the election is made on a contract-by-contract basis so that an entity may make the election for some contracts, but not make such an election for others.

ASC 825 applies to financial asset and liabilities defined as follows:

Financial asset: Cash, evidence of an ownership interest in an entity, or a contract.

Financial liability: A contract that imposes on one entity a contractual obligation to deliver cash or another financial instrument to a second entity or to exchange other financial instruments on potentially unfavorable terms with the second entity.

Examples of financial assets and liabilities to which the fair value option (FVO) applies and for which an entity has the option to use fair value accounting, include the following:

- Cash
- Investments
- Derivatives
- Receivables
- Trade payables
- Loans receivable and payable

ASC 825 applies to all financial assets and liabilities, except:

a. Investments that would otherwise be consolidated
b. Assets and liabilities covered under retirement and benefit plans
c. Financial liabilities recognized under lease contracts under ASC 840 (formerly FASB No. 13)
d. Written loan commitments not accounted for as derivatives, and
e. Financial liabilities for demand deposit accounts

If an entity chooses to record a financial asset or liability at fair value under ASC 825, the change in the fair value is recognized in earnings as the changes occur.

To date, the push to apply the fair value option to non-financial assets and liabilities has not moved forward.

FASB issues ASU 2016-01- Financial Instruments- overall

In January 2016, the FASB made dramatic changes to the accounting for financial instruments with the issuance of ASU 2016-01, *Financial Instruments- Overall*.

ASU 2016-01 is effective for public companies for fiscal years *beginning after December 15, 2017* (including interim periods within those fiscal years). For private companies, not-for-profit organizations, and employee benefit plans, the ASU is effective for fiscal years *beginning after December 15, 2018.*

The ASU changes the current GAAP model and affects:

- The accounting for equity investments
- The accounting for financial liabilities under the fair value option
- The presentation and disclosure requirements for financial instruments, and
- The guidance related to the valuation allowance assessment when recognizing deferred tax assets from available-for-sale debt securities.

The ASU makes no significant changes to the accounting for other financial instruments, such as loans, investments in debt securities, and financial liabilities is unchanged.

The amendments made by ASU 2016-01 include the following:

1. Require equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income.

2. *Eliminates* the categorization of an equity investment as *available-for-sale* with the change presented as part of other comprehensive income in stockholders' equity.

   Note: An entity may choose to measure equity investments that do not have readily determinable fair values at cost minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer.

3. Simplify the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment. When a qualitative assessment indicates that impairment exists, an entity is required to measure the investment at fair value.

4. Eliminate the requirement to disclose the fair value of financial instruments measured at amortized cost for entities that are not public business entities.

5. Eliminate the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet.

6. Require public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes.

7. Require an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments.

8. Require separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (that is, securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements.

9. Clarify that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets.

Details related to ASU 2016-01 follow:

Equity investments

a. Under the ASU, all equity investments in unconsolidated entities (other than those accounted for using the equity method of accounting) are measured at fair value with the change being recorded through earnings on the income statement.

b. For equity securities, existing the available-for-sale classification with the change in fair value reported in other comprehensive income, is eliminated.

c. For equity investments without readily determinable fair values, the cost method is eliminated.

d. Entities (other than certain investment companies and broker-dealers) are permitted to elect to record equity investments without readily determinable fair values using a formula based on cost, minus any impairment, and any subsequent adjustments for observable price changes. Any change in the basis is reported on the income statement.

e. The ASU provides a *one-step impairment model* for equity investments and eliminates the current two-step approach).

Under the single-step model:

- An entity performs a qualitative assessment at each reporting period to identify impairment.
- When a qualitative assessment indicates an impairment exists, the entity will estimate the fair value of the investment and recognize in current earnings an impairment loss equal to the difference between the fair value and the carrying amount of the equity investment.

Financial liabilities and the fair value option

a. If the fair value option has been elected for financial liabilities, the ASU requires the changes in fair value due to instrument-specific credit risk to be recognized separately in other comprehensive income.

   - The accumulated gains and losses due to these changes will be reclassified from accumulated other comprehensive income to earnings if the financial liability is settled before maturity.
   - The ASU permits (but does not require), companies to measure the change in fair value due to instrument-specific credit risk based on the portion of the total change in fair value that does not result from a change in a base market risk, such as a risk-free rate or a benchmark interest rate.

Disclosure

a. The ASU provides that entities (other than public business entities) are no longer required to disclose the fair value of financial instruments carried at amortized cost.

b. For public business entities, the ASU eliminates the requirement to disclose the methods and significant assumptions used to estimate the fair value of financial instruments recorded at amortized cost.

c. Public business entities are required to use the exit price when measuring the fair value of financial instruments measured at amortized cost for disclosure purposes.

d. Financial assets and financial liabilities must be presented separately in the notes to the financial statements, grouped by measurement category (e.g., fair value, amortized cost, lower of cost or market) and form of financial asset (e.g., loans, securities).

Financial Instruments—Credit Losses (Subtopic 825-15)

In December 2012, the FASB issued an exposure draft entitled, *Financial Instruments—Credit Losses (Subtopic 825-15).* As of early 2016, the exposure draft is pending.

The main objective of the exposure draft is to provide financial statement users with more information about the expected credit losses on financial assets and other commitments to extend credit held by a reporting entity at each reporting date.

The Exposure Draft would apply to all entities that hold financial assets that are not accounted for at fair value through net income and are exposed to potential credit risk would be affected by the proposed amendments.

Examples include:

- Loans
- Debt securities
- Trade receivables
- Lease receivables
- Loan commitments
- Reinsurance receivables, and
- Any other receivables that represent the contractual right to receive cash would generally be affected by the proposed amendments.

The Exposure Draft would:

- Replace the current impairment model, which reflects incurred credit events, with a model that recognizes expected credit risks and by requiring consideration of a broader range of reasonable and supportable information to inform credit loss estimates.
- Reduce complexity by replacing the numerous existing impairment models in current U.S. GAAP with a consistent measurement approach.

Here are some of the proposed amendments found in the Exposure Draft:

1. The proposal would require an entity to impair its existing financial assets on the basis of the current estimate of contractual cash flows not expected to be collected on financial assets held at the reporting date.
2. The impairment would be reflected as an allowance for expected credit losses.
3. The proposed amendments would remove the existing "probable" threshold in U.S. GAAP for recognizing credit losses and broaden the range of information that must be considered in measuring the allowance for expected credit losses.

   The estimate of expected credit losses would be based on factors that affect the expected collectibility of the assets' remaining contractual cash flows, including:

   - Relevant information about past events
   - Historical loss experience with similar assets
   - Current conditions, and
   - Reasonable and supportable forecasts

1. An estimate of expected credit losses would always reflect both the possibility that a credit loss results and the possibility that no credit loss results. Accordingly, the proposed amendments would prohibit an entity from estimating expected credit losses solely on the basis of the most likely outcome (that is, the statistical mode).

2. Financial assets carried at amortized cost less an allowance would reflect the current estimate of the cash flows expected to be collected at the reporting date, and the income statement would reflect credit deterioration (or improvement) that has taken place during the period.

3. For financial assets measured at fair value with changes in fair value recognized through other comprehensive income, the balance sheet would reflect the fair value, but the income statement would reflect credit deterioration (or improvement) that has taken place during the period.

4. An entity would be able to choose to not recognize expected credit losses on financial assets measured at fair value, with changes in fair value recognized through other comprehensive income, if both (1) the fair value of the financial asset is greater than (or equal to) the amortized cost basis and (2) expected credit losses on the financial asset are insignificant.

How would the ED change current GAAP?

1. Current U.S. GAAP includes five different incurred loss credit impairment models for instruments within the scope of the proposed amendments. The existing models generally delay recognition of credit loss until the loss is *considered probable*.

2. This initial recognition threshold is perceived to have interfered with the timely recognition of credit losses and overstated assets during the recent global economic crisis.

3. The credit loss recognition guidance in the proposed amendments *would eliminate the existing probable initial recognition threshold*, and instead reflect the *entity's current estimate of expected credit losses*.

4. When credit losses are measured under current U.S. GAAP, an entity generally only considers past events and current conditions in measuring the incurred loss. The proposed amendments *would broaden the information* that an entity is required to consider in developing its credit loss estimate.

   a. The proposed amendments would require that an entity's estimate be based on relevant information about past events, including historical loss experience with similar assets, current conditions, and reasonable and supportable forecasts that affect the expected collectibility of the financial assets' remaining contractual cash flows.

   b. In making the estimate, an entity would consider:

      - Quantitative and qualitative factors specific to the borrower, including the entity's current evaluation of the borrower's creditworthiness.

      - General economic conditions and an evaluation of both the current point in, and the forecasted direction of, the economic cycle (for example, as evidenced by changes in issuer or industry-wide underwriting standards).

c. An estimate of expected credit losses would reflect the time value of money either explicitly or implicitly. If an entity estimates expected credit losses using a discounted cash flow model, the discount rate utilized in that model shall be the financial asset's effective interest rate.

d. An estimate of expected credit losses would neither be a worst-case scenario nor a best-case scenario. Rather, an estimate of expected credit losses would always reflect both the possibility that a credit loss results and the possibility that no credit loss results. However, a probability-weighted calculation that considers the likelihood of more than two outcomes would not be required. An entity would be prohibited from estimating expected credit losses based solely on the most likely outcome (that is, the statistical mode).

5. The Exposure Draft would also expand disclosures related to credit losses.

Example 5: Estimation of Expected Credit Losses for Trade Receivables Using a Provision Matrix (from Exposure Draft)

The following Example illustrates how an entity might implement the guidance for trade receivables using a provision matrix under the Exposure Draft.

a. Entity D manufactures and sells toys to a broad range of customers, primarily retail toy stores.

b. Customers typically are provided payment terms of 90 days with a 2 percent discount if paid within 60 days.

c. The entity has tracked historical loss experience for its trade receivables over the past five years and calculated the following historical loss experience:

- 0.3 percent for receivables that are current
- 8 percent for receivables that are 1–30 days past due
- 26 percent for receivables that are 31–60 days past due
- 58 percent for receivables that are 61–90 days past due
- 82 percent for receivables that are more than 90 days past due.

d. Entity D believes that this historical loss experience is consistent with what will be experienced for financial assets held at the reporting date because the composition of the receivables at the reporting date is consistent with that used in developing the historical statistics (that is, the shared risk characteristics of its customers has not changed significantly over time) and the economic conditions in which the historical statistics were calculated generally are consistent with the economic conditions expected over the remaining lives of the receivables.

e. At the reporting date, Entity D develops the following provision matrix to estimate current expected credit losses.

	Carrying value	Loss rate	Expected credit loss estimate
Current	$5,984,698	.3%	$17,954
1-30 days past due	8,272	8%	662
31-60 days past due	2,882	26%	749
61-90 days past due	842	58%	488
More than 90 days past due	1,100	82%	902
	$5,997,794		$20,755

An allowance for doubtful accounts would be recorded in the amount of $20,755 even though it is not probable that loss would be incurred.

A final statement will be issued in 2016.

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self - study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

1. One parallel of a rules-based system versus a principles-based system is the Internal Revenue Code where:
   a. The rules are found in the tax law, while the principles are found in the regulations
   b. The rules are found in the regulations, while the tax law consists of the principles
   c. The tax law consists of both the rules and principles
   d. The regulations consist of both the rules and principles

2. In an objectives-oriented, principles-based system which of the following is correct:
   a. There are no bright-line tests
   b. There are no exceptions which are contrary to a pure principles-based system
   c. There is an overarching, coherent, conceptual framework that is meant to unify the system
   d. There is no need for further guidance which is most often confusing and results in inconsistencies

3. A cost of implementing an objectives-oriented, principles-based system would be:
   a. A decrease in the informative nature of financial statements
   b. A decreased quality, consistency, and timeliness of standard setting
   c. A loss of meaningfulness of financial information for investors with respect to complex business transactions
   d. An increase in litigation risk

4. The FASB issued three statements to revise existing U.S. GAAP to be consistent with IASB GAAP. One modification:
   a. Amends the language in ARB No. 43 to be consistent with IAS 2, with respect to inventory costs.
   b. Makes several changes to the computation of earnings per share (EPS)
   c. Requires the use of a book-value approach to account for the exchange of similar productive assets
   d. Requires the use of the cumulative effect of an accounting change for implementation of a voluntary accounting change

5. In A Comprehensive Business Reporting Model, investors stated which of the following:
   a. FASB should not move toward a fair value model
   b. Fair value information is the only information relevant for financial decision making
   c. Historical costs are more useful for making decisions about whether to purchase, sell or hold investments
   d. The fair *value model is inconsistent with the way in which investors measure an entity*

6. What inputs are placed into Level 3 inputs in the fair-value hierarchy:
   a. Inputs that are derived principally from or corroborated by observable market data by correlation
   b. Observable inputs other than quoted prices included in Level 1 that are observable
   c. Observable, unadjusted, quoted market prices in active markets for identical assets or liabilities that are accessible
   d. Unobservable inputs that should be used when observable inputs are unavailable

7. Which of the following does ASC 820, Fair Value Measurements (formerly FASB No. 157) do:
   a. Clarifies that book value is the price that would be received for an asset
   b. Develops a five-level hierarchy for valuation
   c. Requires expanded disclosures about the use of fair value to remeasure assets and liabilities
   d. Requires that fair value should always be estimated, even when quoted prices are available

8. The FASB's The Fair Value Option for Financial Asset and Financial Liabilities does which of the following:
   a. Creates the option of recording certain financial assets and liabilities at fair value for initial and subsequent measurement
   b. Defines the exchange price
   c. Requires a fair value election to be made on an annual basis
   d. Applies to investments that would otherwise be consolidated

9. In accordance with newly issued ASU 2016-01, how will equity investments be measured:
   a. At cost
   b. At fair value with the change presented in net income
   c. At fair value with the change presented as part of other comprehensive income
   d. At lower of cost or market

10. Under newly issued ASU 2016-01, which of the following is the impairment model for equity investments:
    a. The ASU offers a two-step model consistent with existing standards
    b. The model uses a quantitative assessment
    c. The ASU offers a new one-step model different from the existing GAAP model
    d. The ASU does not offer an impairment model

SUGGESTED SOLUTIONS

1. One parallel of a rules-based system versus a principles-based system in GAAP is the Internal Revenue Code where:
   a. Incorrect. The rules are found in the regulations, not the tax law. The regulations provide the general rules of how to implement the law, while the broad principles are found in the tax law.
   b. **Correct. The principles are the broad concepts that are embedded in the tax law, not the regulations which present the rules as to how to implement the tax law.**
   c. Incorrect. Although the tax law consists of principles, the rules are found in the regulations, rulings, etc.
   d. Incorrect. The regulations consist of rules, not the principles. The tax law provides the broad principles that are embedded in those regulations.

2. In an objectives-oriented, principles-based system which of the following is correct:
   a. Incorrect. The objectives-oriented approach has bright-line tests, which are contrary to a pure principles-based system.
   b. Incorrect. The objectives-oriented approach has exceptions which are contrary to a pure principles-based system.
   c. **Correct. In an objectives-oriented, principles-based system, each standard is drafted with objectives set by an overarching, coherent conceptual framework meant to unify the accounting system as a whole.**
   d. Incorrect. The objectives-oriented approach articulates the class of transactions to which they apply and contain sufficiently detailed guidance so that preparers and auditors have a structure to help determine the appropriate accounting.

3. A cost of implementing an objectives-oriented, principles-based system would be:
   a. Incorrect. A benefit of implementing an objectives-oriented, principles-based system would be an increase in the informative nature of financial statements, because broader concepts of accounting would be used to prepare financial statements.
   b. Incorrect. A benefit of implementing an objectives-oriented, principles-based system would be an increased quality, consistency, and timeliness of standard setting because a principles-based system is faster to implement and maintain. Using broad accounting principles means there are fewer rules to adopt and maintain thereby resulting in less financial statement preparation time.
   c. Incorrect. A benefit of implementing an objectives-oriented, principles-based system would be an improvement in the meaningful nature of financial information for investors with respect to complex business transactions. The reason is because the principles-based system would record business transactions more in line with the economic substance of the transactions.
   d. **Correct. Because a principles-based system does not have bright-line rules that a company can follow, there is heightened risk that the company may be sued. Thus, a cost of implementing an objectives-oriented, principles-based system would be an increase in litigation risk.**

4. The FASB issued three statements to revise existing U.S. GAAP to be consistent with IASB GAAP. One modification:
   a. **Correct. ASC 330, Inventory (formerly FASB No. 151), amends the language in ARB No. 43 to be consistent with IAS 2, with respect to inventory costs.**
   b. Incorrect. No changes have been made to the computation of EPS.
   c. Incorrect. ASC 845, Nonmonetary Transactions (formerly FASB No. 153, eliminates the use of a book-value approach to account for the exchange of similar productive assets (e.g., real estate exchanged for real estate) in situations in which the transaction does not have commercial substance.
   d. Incorrect. ASC 250, Accounting Changes and Error Corrections (formerly FASB No. 154) eliminates the use of the cumulative effect of an accounting change for implementation of a voluntary accounting change, replacing it with a required restatement of financial statements, applied retroactively.

5. In A Comprehensive Business Reporting Model, investors stated which of the following:
   a. Incorrect. Investors stated that the FASB <u>should</u> move toward a fair value model.
   b. **Correct. In A Comprehensive Business Reporting Model, investors stated, "Fair value information is the only information relevant for financial decision making." Decisions about whether to purchase, sell or hold investments are based upon the fair values. Financial statements based on outdated historical costs are less useful for making such assessments.**
   c. Incorrect. Investors stated that the fair value model is more useful for making decisions, and not the historical cost model.
   d. Incorrect. Investors stated that the historical cost model, and not the fair value model, is inconsistent with the way in which investors measure an entity.

6. What inputs are placed into Level 3 inputs in the fair-value hierarchy:
   a. Incorrect. Inputs used to measure fair value that result principally from or are substantiated with observable market data by correlation are an example of Level 2 inputs.
   b. Incorrect. Observable inputs used to measure fair value that are other than quoted prices included in Level 1 are classified as Level 2 inputs.
   c. Incorrect. Observable, unadjusted, quoted market prices in active markets for identical assets or liabilities that are accessible are classified as Level 1 inputs.
   d. **Correct. Unobservable inputs used to measure fair value that should be used when observable inputs are unavailable are classified as Level 3 inputs.**

7. Which of the following does ASC 820, Fair Value Measurements (formerly FASB No. 157) do:
   a. Incorrect. ASC 820 (formerly FASB No. 157), clarifies that the <u>exchange price</u> is the price that would be received for an asset or paid to transfer a liability in a transaction between market participants at the measurement date. Book value is not a factor.
   b. Incorrect. ASC 820 develops a <u>three</u>-level hierarchy for valuation consisting of Level 1, Level 2, and Level 3 inputs.
   c. **Correct. One of the changes made by ASC 820 is that it requires expanded disclosures about the use of fair value to remeasure assets and liabilities. Such disclosures includes requiring information about the fair value amounts, how those fair value amounts were determined, and the effect of the remeasurements on earnings.**
   d. Incorrect. ASC 820 requires that <u>in the absence of quoted prices for identical or similar assets or liabilities</u>, fair value may be estimated using multiple valuation techniques. Examples of such techniques consistent of the market approach, income approach, and cost approach.

8. The FASB's The Fair Value Option for Financial Asset and Financial Liabilities does which of the following:
   a. **Correct. The Fair Value Option for Financial Asset and Financial Liabilities creates the option of recording certain financial assets and liabilities at fair value for initial and subsequent measurement.**
   b. Incorrect. The Fair Value Option for Financial Asset and Financial Liabilities defines the financial asset and financial liability, but not the exchange price.
   c. Incorrect. The Fair Value Option for Financial Asset and Financial Liabilities requires the fair value election to be made on a contract-by-contract basis, and not on an annual basis.
   d. Incorrect. The Fair Value Option for Financial Asset and Financial Liabilities applies to all financial assets and liabilities <u>except</u> investments that would otherwise be consolidated, and certain other exclusions that are codified within GAAP.

9. In accordance with newly issued ASU 2016-01, how will equity investments be measured:
   a. Incorrect. ASU 2016-01 requires that equity investments are measured at fair value, not cost.
   b. **Correct. ASU 2016-01 makes a change to require that all equity investments are measured at fair value with the change in fair value presented in net income.**
   c. Incorrect. Although equity investments would be presented at fair value, the change would be presented in net income, not presented as part of other comprehensive income.
   d. Incorrect. Fair value, not lower of cost or market, would be the measurement.

10. Under newly issued ASU 2016-01, which of the following is the impairment model for equity investments:
    a. Incorrect. The new model offers a one-step model.
    b. Incorrect. The ASU offers an investment impairment model although its application differs from the current GAAP model.
    c. Incorrect. The model uses a qualitative (not quantitative) assessment at each reporting period to identify an impairment.
    d. **Correct. Unlike existing GAAP, the ASU offers a new, simpler one-step model under which an impairment loss is recorded on the income statement on the difference between the fair value and carrying amount of the equity investment.**

I. Changes Coming To Lease Accounting

The FASB has approved a final statement on lease accounting to be issued in 2016. Upon issuance, the statement will result in the culmination of a decade's work to dramatically transform how companies account for leases.

In particular, most leases will be capitalized resulting in billions of dollars of assets and liabilities being recorded on company balance sheets.

Although the lease accounting project has gone through numerous changes, the fundamental concept that leases be capitalized is not going to change in the final document.

In this section, the author discussions the general concepts that are to be included in the final statement, when issued.

Background

Under current GAAP, ASC 840, *Leases (formerly FASB No. 13)*, divides leases into two categories: operating and capital leases. Capital leases are capitalized while operating leases are not. In order for a lease to qualify as a capital lease, *one of four criteria* must be met:

1. The present value of the minimum lease payments must equal or exceed 90% or more of the fair value of the asset.

2. The lease term must be at least 75% of the remaining useful life of the leased asset.

3. There is a bargain purchase at the end of the lease, or

4. There is a transfer of ownership.

In practice, it is common for lessees to structure leases to ensure they do not qualify as capital leases, thereby removing both the leased asset and obligation from the lessee's balance sheet. This approach is typically used by restaurants, retailers, and other multiple-store facilities.

Consider the following example:

Facts:

Lease 1: The present value of minimum lease payments is 89% and the lease term is 74% of the remaining useful life of the asset.

Lease 2: The present value of minimum lease payments is 90% or the lease term is 75% of the remaining useful life of the asset.

Conclusion: There is a one percent difference between Lease 1 and 2. Lease 1 is an operating lease not capitalized, while Lease 2 is a capital lease under which both the asset and lease obligation are capitalized.

SEC pushes toward changes in lease accounting

In its report entitled, *Report and Recommendations Pursuant to Section 401(c.) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuer,* the SEC targeted lease accounting as one of the areas that results in significant liabilities being off-balance sheet.

According to the SEC Report that focused on U.S. public companies and a U.S. Chamber of Commerce report:

a. 63 percent of companies record operating leases while 22 percent record capital leases.

b. U.S. companies have approximately $1.5 trillion in operating lease obligations that are off-balance sheet.

c. European companies have a total of approximately $928 billion in off-balance sheet operating lease obligations.

d. 73 percent of all leases held by U.S. public companies ($1.1 trillion) involve the leasing of real estate.

In its Report, the SEC noted that because of ASC 840's (formerly FASB No. 13's) bright-line tests (90%, 75%, etc.), small differences in economics can completely change the accounting (capital versus operating) for leases.

Keeping leases off-balance sheet while still retaining tax benefits, is an industry unto itself. So-called synthetic leases are commonly used to maximize the tax benefits of a lease while not capitalizing the lease for GAAP purposes.

In addition, lease accounting abuses have been the focus of restatements with approximately 270 companies, mostly restaurants and retailers, restating or adjusting their lease accounting in the wake of Section 404 implementation under Sarbanes-Oxley.

Retailers have the largest amount of operating lease obligations outstanding that are not recorded on their balance sheets. Consider the following table:

Operating Leases Obligations Outstanding- Major Retailers

Retailer	Lease Obligations (in thousands)
Office Depot Inc.	$1,104
Walgreens Co.	27,434
CVS	38,917
Whole Foods	6,322
Sears	7,608

Source: Annual reports

The previous table shows the amount of off-balance sheet lease obligations for some of the largest U.S. retailers. These numbers are significant and bring to the forefront the pervasive impact the proposed lease standard would have on the larger retailers. For example, CVS has almost $39 billion of off-balance sheet lease obligations.

FASB-IASB lease project

Since the Sarbanes-Oxley Act became effective, the FASB has focused on standards that enhance transparency of transactions and that eliminate off-balance-sheet transactions, the most recent of which was the issuance of ASC 810, *Consolidation of Variable Interest Entities* (formerly FIN 46R). The FASB added to its agenda a joint project with the IASB that would replace existing lease accounting rules found in ASC 840 (formerly FASB No. 13) and its counterpart in Europe, IASB No. 17. The FASB and IASB started deliberations on the project in 2007, and issued a discussion memorandum in 2009, following by the issuance of an exposure draft in 2010 entitled, *Leases (Topic 840).*

The 2010 exposure draft was met with numerous criticisms that compelled the FASB to issue a second, replacement exposure draft on May 16, 2013 entitled, *Leases (Topic 842), a revision of the 2010 proposed FASB Accounting Standards Update, Leases (Topic 840).*

Given the fact that the FASB has now issued two exposure drafts and received extensive public comments, the second exposure draft is likely to pass as a final statement, with minor further edits.

Following are some of the changes that the FASB and IASB have included it their proposed new lease model as outlined in the May 2013 Exposure Draft:

Basic concepts of the proposed final statement

The core principle of the proposed requirements found in the final approved standard is that an entity should use the *right-of-use model* to account for leases which requires the entity to recognize assets and liabilities arising from a lease. Thus, most existing operating leases will be brought onto the balance sheet.

In accordance with the *right-of-use model*:

1. A lessee will recognize assets and liabilities for any leases that have a maximum possible lease term of more than 12 months.

    a. Leases with terms of 12 months or less will have the option of remaining as operating leases.

Following is a summary of the key elements of the final ease standard:

Lessee:

1. At the commencement date, a lessee will measure both of the following:

    - A lease liability (liability to make lease payments)
    - A right-of-use asset (right to use the leased asset for the lease term)

a. Lease liability: The lease liability will be recorded at the present value of the lease payments over the lease term, discounted using the *rate the lessor charges* (the lessor's imputed rate) the lessee based on information available at the commencement date.

1) If the lessor's imputed rate cannot be readily determined, the lessee will use its *incremental borrowing rate.*

2) Nonpublic entities will be permitted to use a *risk-free discount rate*, determined using a period comparable to that of the lease term, as an accounting policy election for all leases. The risk-free discount rate is defined as a U.S. Treasury instrument rate for the same term as the lease.

b. Right-of-use asset:

1) At the commencement date, the cost of the right-of-use asset will consist of all of the following:

- The amount of the initial measurement of the lease liability

- Any lease payments made to the lessor at or before the commencement date, less any lease incentives received from the lessor, and

- Any *initial direct costs* incurred by the lessee.

2) At the commencement date, initial direct costs will be included as part of the cost of the lease asset capitalized and may include:

- Commissions
- Legal fees
- Evaluating the prospective lessee‘s financial condition
- Evaluating and recording guarantees, collateral, and other security contracts
- Negotiating lease terms and conditions
- Preparing and processing lease documents, and
- Payments made to existing tenants to obtain the lease.

The following items are examples of costs that would not be initial direct costs:

- General overheads, including for example, depreciation, occupancy and equipment costs, unsuccessful origination efforts, and idle time, and

- Costs related to activities performed by the lessor for advertising, soliciting potential lessees, servicing existing leases, or other ancillary activities.

c. Lease payments:

1) At the commencement date, lease payments included in the lease liability will consist of the following payments related to the use of the underlying asset during the lease term that are not yet paid:

- Fixed payments, less any lease incentives receivable from the lessor

- Variable lease payments that depend on an index or a rate (such as the Consumer Price Index or a market interest rate), initially measured using the index or rate at the commencement date

- Variable lease payments that are in-substance fixed payments

  Note: The FASB has announced that the final statement will change the exposure draft so that variable lease payments would be included in the initial measurement of lease assets and liabilities only if such payments depend on an index or a rate.

- Amounts expected to be payable by the lessee under residual value guarantees

- The exercise price of a purchase option if the lessee has a *significant economic incentive* to exercise that option, and

  Note: The FASB has announced that the final statement will replace the "significant economic incentive" threshold with a higher threshold of being "reasonably assured" that the lessee will exercise the purchase option.

- Payments for penalties for terminating the lease, if the lease term, reflects the lessee exercising an option to terminate the lease.

2) Variable lease payments: Variable lease payments will included in lease payments used to calculation the lease liability if:

- The lease payments will depend on an index or rate, such as a CPI index. Each year, the lessee will adjust the lease obligation to reflect the present value of the remaining lease payments using latest index in effect at the end of that year.

- The lease payments will be in-substance, fixed payments, such as minimum annual increase of 2 percent per year.

Lease payments based on performance (such as a percentage of sales, with no minimum) will not be reflected in the lease payments in computing the lease obligation. Instead, such payments will be recorded annually as actual sales are generated.

d. Lease term: An entity will determine the lease term as the *noncancellable period of the lease*, together with *both* of the following:

1) Periods covered by an option to *extend the lease* if the lessee has a *significant economic incentive to exercise that option*, and

2) Periods covered by an option to terminate the lease if the lessee has a *significant economic incentive not to exercise that option*.

   a) Factors will be considered together, and the existence of any one factor would not necessarily signify that a lessee has a significant economic incentive to exercise, or not to exercise, the option. Examples of factors to consider will include, but would not be limited to, any of the following:

      - Contractual terms and conditions for the optional periods compared with current market rates

      - *Significant leasehold improvements* that are expected to have significant economic value for the lessee when the option to extend or terminate the lease or to purchase the asset becomes exercisable.

      - *Costs relating to the termination of the lease* and the signing of a new lease, such as negotiation costs, relocation costs, costs of identifying another underlying asset suitable for the lessee‘s operations, or costs associated with returning the underlying asset in a contractually specified condition or to a contractually specified location.

      - The importance of that underlying asset to the lessee‘s operations, considering, for example, whether the underlying asset is a specialized asset and the location of the underlying asset.

      Example: A retail lessee, a liquor store, has a 5-year lease with two, 5-year options. It would be very difficult for the lessee to move the liquor store due to neighborhood opposition. Thus, the store location is very important to the lessee.

      Conclusion: The lessee most likely has a s*ignificant economic incentive to exercise the options so that the lease term is probably 15 years.*

      Note: The FASB has announced that the final statement will replace the "significant economic incentive" threshold with a higher threshold of being "reasonably assured" that the lessee will exercise the option.

3) Reassessment of lease term: An entity will reassess the lease term *only if* either of the following occurs:

   a) There is a *change in relevant factors*, that will result in the lessee having or no longer having a significant economic incentive either to exercise an option to extend the lease or not to exercise an option to terminate the lease.

      Note: A change in market-based factors (such as market rates to lease a comparable asset) shall not, in isolation, trigger reassessment of the lease term.

   b) The lessee does either of the following:

- Elects to exercise an option even though the entity had previously determined that the lessee did not have a significant economic incentive to do so, or

- Does not elect to exercise an option even though the entity had previously determined that the lessee had a significant economic incentive to do so.

e. Classification of leases: The final statement will establish *two types of leases*:

Type A lease: Lease in which lessee expects to consume *more than an insignificant portion* of the economic benefits (life) of the asset:

- Will apply to most leases of assets other than property (for example, equipment, aircraft, cars, trucks).

- Will recognize a right-of-use asset and a lease liability, initially measured at the present value of lease payments.

- Will recognize the unwinding of the discount on the lease liability as interest separately from the amortization of the right-of-use asset.

- Total expense will be accelerated and shown in *two expense components*:

  - Interest expense (accelerated), and
  - Amortization expense (straight-line)

Type B lease: Lease in which the lessee expects to consume *only an insignificant portion* of the economic benefits (life) of the asset:

- Will apply to most leases of property (that is, land and/or a building or part of a building).

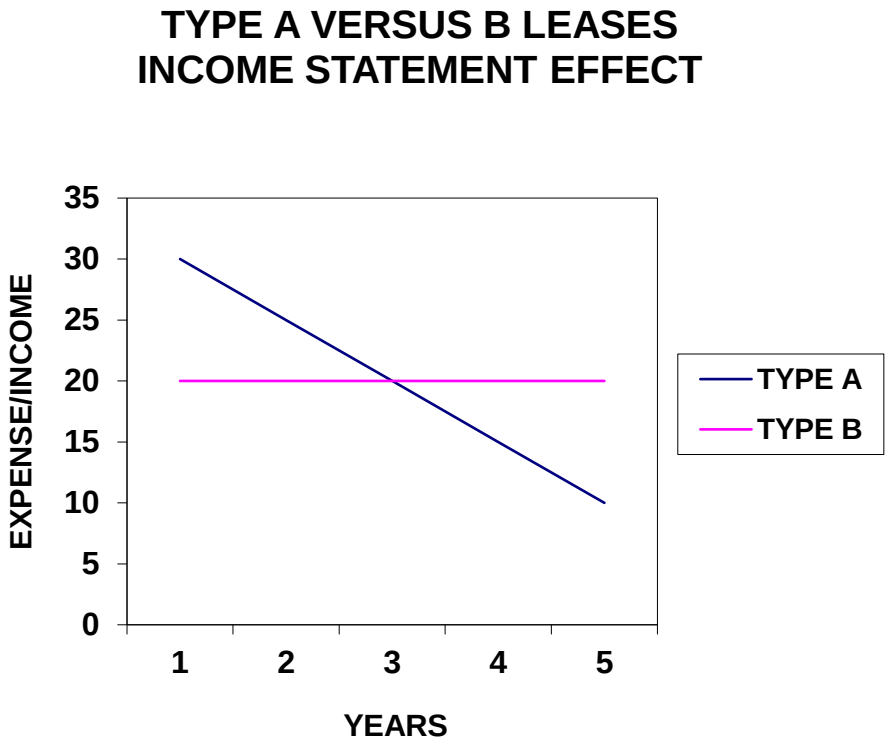
- Will recognize a right-of-use asset and a lease liability, initially measured at the present value of lease payments (same as Type A lease).

- Will recognize a single lease expense, combining the unwinding of the discount on the lease liability (interest) with the amortization of the right-of-use asset, on a *straight-line basis.*

- Total expense will be recorded on a *straight-line basis* throughout the lease term.

The following chart compares the proposed final standard with existing GAAP for leases.

Comparison of Existing GAAP Versus Proposed Final Lease Standard Lessee Side		
Description	**Current GAAP for Operating Leases**	**Proposed GAAP**
Lease type	Leases are classified as operating or capital leases (financing arrangements) based on satisfying one of four criteria. • 75% rule • 90% rule • Bargain purchase • Transfer of ownership	All leases classified as financing arrangements (as if asset purchases) Right-of-use asset and lease liability recorded at present value of payments over the lease term
Lease term	Non-cancellable periods Option periods generally not included in lease term	Non-cancellable period together with any options to extend or terminate the lease when there is a *significant economic incentive* for the lessee to exercise an option to extend the lease
Contingent/variable rents	Contingent rents excluded from lease payments. When paid, they are period costs	Variable rents included in lease payments in certain instances
Income statement	Operating leases- lease expense straight-line basis Capital leases- depreciation and interest expense	Two Approaches: *TYPE A LEASE*: Interest and amortization expense recorded. Accelerated expense *TYPE B LEASE:* Lease expense recorded as combination of interest and amortization- straight-line expense
Assessment	Terms are not re-assessed	Leases reassessed in certain instances



Short-term leases:

1. A lessee will not be required to recognize lease assets or lease liabilities for short-term leases.

2. A short-term lease is defined as follows:

   "A lease that, at the date of commencement of the lease, has a maximum possible term, including any options to renew, of 12 months or less."

3. For short-term leases, the lessee will recognize lease payments as rent expense in the income statement on a *straight-line basis* over the lease term, unless another systematic and rational basis is more representative of the time pattern in which use is derived from the underlying asset.

   Note: The final standard will treat short-term leases (12 months or less) as operating leases by not requiring the lessee to record the lease asset and liability. Instead, rent expense will be recorded on a straight-line basis as incurred, although the proposal will permit an entity to use another approach (other than a straight-line method) to record rent expense if that alternative is more representative of the time pattern in which the lessee uses the lease asset.

4. A lessee will be permitted (but is not required) to record a lease asset and liability for a short-term lease.

5. Lessors: Lessors will be permitted to elect to account for all short-term leases by not recognizing lease assets or lease liabilities and by recognizing lease payments received in rental income on a straight-line basis over the lease term, or another systematic and rational basis that is more representative of the time pattern in which use is derived from the underlying asset.

Disclosures:

1. Both lessees and lessors will be required to provide disclosures to meet the objective of enabling users of financial statements to understand the amount, timing, and uncertainty of cash flows arising from leases.

Transition- existing leases:

1. Existing leases *will not be grandfathered* thereby requiring existing operating leases to be brought onto the balance sheet.

   a. All existing outstanding leases would be recognized and measured at the date of initial application using a simplified retrospective approach.

   b. On transition, a lessee and a lessor will recognize and measure leases at the beginning of the earliest period presented using either a modified retrospective approach or a full retrospective approach.

Effective date: The FASB has announced that the final statement will establish and effective date of 2019 (public entities) and 2020 for nonpublic entities.

Impact of proposed changes to lease accounting

The proposed lease accounting changes could be devastating to many companies and may result in many more leases being capitalized which would impact all financial statements.

In particular, retailers may be affected the most.

If leases of retailers, for example, are capitalized, the impact on financial statements would be significant, as noted below:

- Lessee's balance sheets would be grossed up for the recognized lease assets and the lease obligations for all lease obligations.

  Note: Including contingent lease payments and renewal options may result in overstated liabilities given the fact that contingent payments must be included in the lease payments and renewal options must be considered in determining the lease term.

- For Type A leases, lessee's income statements would be adversely affected with higher lease expense in the earlier years of new leases.

  Note: Even though total lease expense is the same over the life of a lease, lease expense (interest and amortization expense) under a capital lease is higher in the earlier years as compared with lease expense under an operating lease.

  On average, a 10-year lease would incur approximately 15-20% higher annual lease expense in the earlier years, if capitalized, as compared with an operating lease. That higher lease amount would reverse in the later years.

- For Type A leases, on the statement of cash flows, there would be a positive shift in cash flow to cash from operations from cash from financing activities. A portion of rent expense previously deducted in arriving at cash from operations would now be deducted as principal payments in cash from financing activities. Thus, companies would have *higher cash from operating activities* and *lower cash from financing activities*.

- In most cases, annual lease expense for GAAP (interest and amortization) would not match lease expense for income tax purposes thereby resulting in deferred income taxes.

Changes to both the balance sheets and income statements of companies may have rippling effects on other elements of the lessee companies.

1. On the positive side, a lessee's earnings before interest, taxes, depreciation and amortization (EBITDA) may actually improve as there is a shift from rent expense under operating leases to interest and amortization expense under the proposed standard.

   a. Both interest and amortization expense are not deducted in arriving at EBITDA while rent expense is.

   b. Changes in EBIDTA may affect existing agreements related to compensation, earn outs, bonuses, and commissions.

2. On the negative side, for Type A and B leases, lessee debt-equity ratios may be affected with entities carrying significantly higher lease obligation debt than under existing GAAP. Higher debt-equity ratios could put certain loan agreements into default. Moreover, net income would be lower in the earlier years of the lease term due to higher interest and amortization expense replacing rental expense.

How significant would the change to the proposed lease standard be for U. S. companies?

As previously noted, there are approximately $1.5 trillion of operating lease obligations that are not recorded on public company balance sheets. That $1.5 trillion is magnified by the many nonpublic companies that have unpublished operating lease obligations that are unrecorded.

The author estimates that unrecorded lease obligations of nonpublic operating leases is at least another $1.3 trillion bringing to estimated total unrecorded lease obligations at approximately $2.8 billion.

Consider the following estimated impacts of shifting those operating leases to capitalized right-of-use leases, based on a report issued by Change & Adams Consulting, commissioned by the U.S. Chamber of Commerce and Others:

a. Earnings of retailers could decline significantly. One recent study suggested that there could be a median drop in EPS of 5.3 percent and a median decline in return on assets of 1.7 percent.

b. Public companies could face $10.2 billion of added annual interest costs.

c. There could be a loss of U.S. jobs in the range of 190,000 to 3.3 million.

d. Cost of compliance with the new standard could lower U.S. GDP by $27.5 billion a year.

e. Lessors could lose approximately $14.8 billion in the value in their commercial real estate.

f. Balance sheets could be loaded with significant lease obligations that would impact debt-equity ratios.

- Aggregate debt of nonfinancial S&P 500 companies could increase by 17 percent if all leases were capitalized.

- Return on assets could decline as total assets (the denominator) would increase by approximately 10 percent.

- The S&P 500 could record an estimate of $549 billion of additional liabilities under the proposed lease standard on existing operating leases.[29]

- U. S. companies, as a whole (public and nonpublic), could record approximately $7.8 trillion of additional liabilities if operating leases are capitalized.[30]

According to a Credit Suisse study,[31] there are 494 of the S&P 500 companies that are obligated to make $634 billion of total future minimum lease payments under operating leases. On a present value basis, including contingent rents, the $634 billion translates into an additional liability under the proposed standard of $549 billion. Of the $549 billion of additional liabilities, 15 percent of that total relates to retail companies on the S&P 500.

In some cases, the effect of capitalizing lease obligations under the proposed lease standard is that the additional liability exceeds stockholders' equity.

Consider the following table:

[29] Leases Landing on Balance Sheet (Credit Suisse)
[30] Author's estimate: $1.5 trillion for public companies and $6.3 trillion for nonpublic companies
[31] Leases Landing on Balance Sheet (Credit Suisse)

Impact of Capitalizing Leases –Selected Retailers
Based on Annual Reports

Retailer	Operating lease Obligations	PV converter 5 years 4% (a)	Additional liability under new lease standard	Stockholders' equity	**% equity**
Office Depot Inc.	$ 2 B	.822	$1.6 B	$661M	**248%**
Walgreens Co.	35 B	.822	28.8 B	18 B	**160%**
CVS	28 B	.822	23.0 B	38 B	**61%**
Whole Foods	6.8 B	.822	5.6 B	3.8 B	**147%**
Sears	4.5 B	.822	3.7 B	3.1 B	**119%**

Source: Annual Reports, as obtained by the author.
(a) Assumes the weighted-average remaining lease term is 5 years, and the incremental borrowing rate is 4%.

The previous table identifies the sizeable problem that exists for many of the U.S. retailers which is that there are huge off-balance sheet operating lease liabilities as a percentage of company market capitalization. Under the proposed lease standard, these obligations would be recorded, thereby having a devastating impact on those retailers' balance sheets. For example, look at Office Depot and its $1.6 billion lease liability that would represent 248% of its stockholders' equity of $661 million.

How would the proposed lease standard impact how leases are structured?

Companies are going to consider the balance sheet impact when structuring leases and in deciding whether to lease or buy the underlying asset, in the first place. There are several likely actions that would come from the proposed standard:

1. *Lease-versus-buy decision impacted:* By implementing the proposed standard, the GAAP differences between leasing and owning an asset would be reduced. Having to capitalize all leases may have a significant effect on the lease versus purchase decision, particularly with respect to real estate:

    a. Tenants, in particular those in single-tenant buildings with long-term leases, may choose to purchase a building instead of leasing it:

        - A similar amount of debt would be included on the tenant's balance sheet under a long-term lease as compared with a purchase.

        - GAAP depreciation under a purchase may actually be lower than amortization under a lease because the amortization life under the lease (generally the lease term) is likely to be shorter than the useful life under a purchase.

        Example: Assume there is a 10-year building lease with two, 5-year lease options, resulting in a maximum lease term of 20 years. Assume further that the useful life of the building is 30 years for depreciation purposes.

If the entity leases the real estate, the right-of-use asset would be amortized over a maximum of 20 years. If, instead, the entity were to purchase the real estate, the building would be depreciated over the useful life of 30 years.

Note: In some instances, lessees may choose to purchase the leased asset rather than lease it, if the accounting is the same. In particular, the purchase scenario may be more appealing for longer-term leases that have significant debt obligations on the lessee balance sheets. Lessees with shorter-term leases will not be burdened with the extensive debt obligations and, therefore, may choose not to purchase the underlying lease asset.

b. *Lease terms are likely to shorten*: For many companies who do not wish to purchase the underlying leased asset, lease terms may shorten to reduce the amount of the lease obligation (and related asset) that is recorded at the lease inception.

- The proposed lease standard may affect not only the landlords and tenants, but also brokers as there would be much greater emphasis placed on executing leases for shorter periods of times thereby increasing the paperwork over a period of time and the commissions earned.

c. *Deferred tax assets would be created*: Because many operating leases may be capitalized for GAAP but not for tax purposes, total GAAP expense (interest and amortization) will likely be greater than lease expense for tax purposes, resulting in deferred tax assets for the future tax benefits that would be realized when the temporary difference reverses in later years.

Under existing GAAP, most, but not all, operating leases are treated as operating leases for tax purposes. Therefore, rarely are operating leases capitalized for tax purposes. Now, the game is about to change if operating leases are capitalized as right-of-use assets under GAAP, while they continue to be treated as operating leases for tax purposes. As we have seen in the previous examples, most leases capitalized under the proposed standard would result in the creation of a deferred tax asset.

Other considerations- dealing with financial covenants

The proposed lease standard could cast a wide web across the accounting profession. By capitalizing leases that were previously off-balance sheet as operating leases, there may be consequences.

Examples:

- Impact on state apportionment computations: Many states compute the apportionment of income assigned to that state using a property factor based on real and tangible personal property held in that particular state.

  Note: When it comes to rent expense, most states capitalize the rents using a factor such as eight times rent expense. Although each state has its own set of rules, the implementation of the proposed standard may have a sizeable positive or negative impact on state tax apportionment based on shifting rent expense to capitalized assets.

- Impact on tax planning: Capitalizing leases might have a positive effect in tax planning.

Note: One example is where there is a C corporation with accumulated earnings and exposure to an accumulated earnings tax (AET). The additional lease obligation liability would certainly help justify that the accumulation of earnings is not subject to the AET.

- Impact on total asset and liability thresholds: Companies should also be aware that not only would the proposed standard increase liabilities, but would also increase total assets.

  Note: In some states, there are total asset thresholds that drive higher taxes and reporting requirements.

Dealing with financial covenants

A critical impact of the proposed standard would be that certain loan covenants may be adversely impaired thereby forcing companies into violations of their loans.

Consider the following ratios:

Ratio	Likely impact of proposed lease standard
EBITDA: *[Earnings before interest, taxes, depreciation and amortization]*	Type A Leases: Favorable impact due to shift from rental expense to interest and amortization expense, both of which are added back in computing EBITDA. Type B Leases: May be favorable impact depending on whether "lease expense" is added back to compute EBITDA.
Interest coverage ratio: $\frac{\textit{Earnings before interest and taxes}}{\textit{Interest expense}}$	May be negatively impacted from lower ratio
Debt-equity ratio: $\frac{\textit{Total liabilities}}{\textit{Stockholders' equity}}$	Negative impact from higher ratio

There would be a favorable impact on EBITDA for Type A leases by implementing the proposed standard. Rent expense recorded for operating leases under existing GAAP would be reduced while interest expense and amortization expense would increase once the leases are capitalized.

However, the issue is what happens to EBITDA for Type B leases. Under the proposal, interest and amortization are combined as one line item on the income statement entitled "lease expense." The question is whether that line item is added back in arriving at EBITDA. The author believes it should be added back because it represents interest and amortization despite the lease expense label.

As to the interest coverage ratio, the impact on the ratio depends on the whether there is a Type A or B lease. For a Type A lease, earnings before interest and taxes would likely be higher as rent expense is removed and replaced with interest and amortization expense. For Type A leases, the denominator increases significantly due to the higher interest expense. On balance, the slightly higher earnings before interest and taxes divided by a higher interest expense in the denominator yields a lower interest coverage ratio.

For a Type B lease, the impact on the ratio is unclear. Although interest expense, along with amortization expense, would be embedded in the caption line item "lease expense," most analysts would likely carve out the interest and amortization components and adjust the interest coverage ratio by the interest portion.

Perhaps the most significant impact of capitalizing leases under the proposed lease standard would be its effect on the debt-equity ratio. With sizeable liabilities being recorded, this ratio would likely turn quite negative and severely impact company balance sheets. In some cases, the debt-equity ratio would result in violation of existing loan covenants thereby requiring a company to renegotiate the covenants with its lenders or at least notify lenders in advance of the likely lack of compliance with loan covenants.

What about the impact on smaller nonpublic entities?

One leasing organization noted that more than 90 percent of all leases involve assets worth less than $5 million and have terms of two to five years.[32] That means that smaller companies have a significant amount of leases most of which are currently being accounted for as operating leases. Previously, the author estimated that the present value of unrecorded lease obligations under operating leases of nonpublic entities to be at least $6.3 trillion which is much higher than the estimated $1.5 trillion of unrecorded lease obligations of public companies.

Unless these smaller, nonpublic entities choose to use the income tax basis for their financial statements, under GAAP, these companies would be required to capitalize their operating leases.

What about related party leases?

Some, but not all, related party leases result in the lessee (parent equivalent) consolidating the lessor (subsidiary equivalent) under the consolidation of variable interest entity rules (ASC 810) (formerly FIN 46R). The common example of a related-party lease is where an operating company lessee leases real estate from its related party lessor. In general, under FIN 46R, if there is a related party lessee and lessor, consolidation is required if:

1. The real estate lessor is a variable interest entity (VIE) (e.g., it is not self-sustaining), and,

2. The lessee operating company and/or the common shareholder provide financial support to the real estate lessor in the form of loans, guarantees of bank loans, above-market lease payments, etc.

If these two conditions are met, it is likely that the real estate lessor must be consolidated in with the operating company lessee's financial statements. If there is consolidation, capitalizing the lease under the proposed standard would be moot because the asset and liability, and lease payments would be eliminated in the consolidation.

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[32] Equipment Leasing and Financing Association (ELFA) "Companies: New Lease Rule Means Labor Pains" (CFO. com).

In 2014, the Private Company Council (PCC) issued ASU 2014-07, *Consolidation (Topic 810) Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements (a consensus of the PCC)*, which provides private (nonpublic) entities an election not to apply the consolidation of VIE rules to a related-party lease arrangement. When implemented, the ASU should provide most private companies with relief from the VIE rules for related party leases. Thus, most private (nonpublic) entities involved in related-party leases will not be consolidating the lessor into the lessee.

When it comes to a related-party lease in which there is no consolidation, the parties would have to account for that lease as a right-of-use lease asset and obligation, just like any other lease transaction. Consequently, under the proposed standard, the operating company lessee would be required to record a right-of-use asset and lease obligation based on the present value of the lease payments.

Many related parties either do not have formal leases or the leases are short-term. If the operating company lessee is going to have to record a significant asset and liability, it may make sense to have a related-party lease that has a lease term of 12 months or less or is a tenant-at-will arrangement.

With respect to a related party lease that is 12 months or less, the proposed standard would permit (but not require) use of the short-term lease rules as follows:

a. A lessee would treat the short-term lease as an operating lease with no recognition of the lease asset or lease liability. The rental payments would be recognized as rent expense on a straight-line basis.

b. On the lessor side, the lessor would record rental income on a straight-line basis and not record the lease asset and liability.

c. Either the lessee or lessor could elect to record the lease asset and liability using the proposed standard rules.

With many related-party leases, the operating company lessee may issue financial statements while the real estate lessor does not. Therefore, how the lessee accounts for the transaction under GAAP may be more important than the lessor's accounting for the transaction.

Let's look at a simple example:

Example: Company X is a real estate lessor LLC that leases an office building to a related-party operating Company Y. X and Y are related by a common owner.

The companies sign an annual 12-month lease with no renewals, and no obligations that extend beyond the twelve months.

Monthly rents are $10,000.
Y issues financial statements to its bank while X does not issue financial statements.

Y chooses ASU 2014-07's election not to consolidate X into Y's financial statements.

Conclusion: Because the entities have a short-term lease of 12 months or less, Y, as lessee, would qualify for the short-term lease rules. Therefore, Y *would not* record a lease asset and liability and, instead, would record the monthly rent payments and rent expense on a straight-line basis over the short-term lease period.

Alternatively, Y could elect to treat the short-term lease as a standard lease by recording both the lease asset and liability.

As to the lessor, it would also not record the lease asset and liability and, instead, would record rental income on a straight-line basis over the 12-month period.

Observation: If the proposed standard is issued in final form, many nonpublic entities would take steps to avoid its arduous rules. One approach will likely be to make sure the related-party leases have terms that are 12 months or less so that the lease can be treated as an operating lease and not capitalized. Another approach would be to issue income tax basis financial statements.

Status of lease project:

The FASB has voted and approved for the issuance of a final lease statement in 2016.

J. The GAAP Codification

It is important for all accountants to fully understand the Accounting Standards Codification (ASC) that became effective in 2009.

After years of a FASB codification based on FASB statement numbers, the FASB recodified all standards by topic, rather than statement number reference.

Now, the FASB Accounting Standards Codification (ASC) consists of a single source of authoritative nongovernmental U.S. GAAP, that superseded all documents previously issued by the FASB, AICPA, EITF, and related literature.

The FASB's objective is to establish the *FASB Accounting Standards Codification*™ (Codification or ASC) as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of GAAP financial statements. Rules and interpretive releases of the Securities and Exchange Commission (SEC) under authority of federal securities laws are also sources of authoritative GAAP for SEC registrants.

The codification was established through the issuance of FASB No. 168: *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles* (currently ASC 105) which establishes a new Codification. FASB Accounting Standards Codification (FASB ASC) is the source of authoritative GAAP recognized by the FASB to be applied by nongovernmental entities.

Key elements of the codification follow:

1. FASB Statement No. 168 was the *final standard* issued by FASB in an individual statement format.

2. The FASB ASC contains the authoritative standards that are applicable to both public nongovernmental entities and nonpublic nongovernmental entities.

    a. Categories (a), (b), (c) and a portion of (d) of the GAAP hierarchy are included in the new FASB Codification.

- A portion of Category (d) related to "practices that are widely recognized and prevalent either generally or in the industry" and the "other accounting literature" are excluded from the FASB Codification and are considered nonauthoritative GAAP.

3. The ASC is broken down by topics, rather than by pronouncements, segregated into five areas as follows:

FASB Codification (FASB ASC)		
Area	Description	Topic Codes
General Principles	Relates to conceptual matters and includes GAAP	105-199
Presentation	Relates to presentation matters	205-299
Financial Statement Accounts	Includes assets, liabilities, equity, revenue and expenses	305-700
Broad Transactions	Includes business combinations, derivatives and other	805-899
Industry	Relates to accounting that is unique to an industry or type of activity. Topics include airlines and financial services	905-999

The above table shows the general structure of the ASC which consists of five areas of:

- General Principles
- Presentation
- Financial Statement Accounts
- Broad Transactions
- Industry

Under each of the areas are numerous topics. Although not presented in the table, under each Topic there are Subtopics followed by Sections for each Subtopic.

Thus, the system looks like this:

Topic	XXX
Subtopic	YY
Section	ZZ

A Section of GAAP would be referenced by a unique number as follows: XXX-YY-ZZ with the XXX being the Topic, YY being the Subtopic, and ZZ being the Section. Under the Section there are Paragraphs.

FASB ASC organizes accounting and reporting guidance without regard to the original standard from which the guidance was derived. FASB ASC uses a topical structure in which Topics, Subtopics, and Sections are numerically referenced:

Example: An accountant wishes to look up the general rule for accounting for loss contingencies previously presented in ASC 450, *Contingencies* (formerly FASB No. 5).

Conclusion: The general rule is found in FASB ASC 450-20-25-1 as follows:

1. Go to the *Financial Statement Accounts* area (one of the 5 areas).

2. Select *Topic*: ASC 450 to access the "*Contingencies"* topic.

3. Select *Subtopic: ASC 450*-20 to access the "*Loss Contingencies.*" (subtopic 20 of topic 450).

4. *Select Section: ASC 450-20-25* to access the "*Recognition*" (section 25 of subtopic 450-20).

5. *Select Paragraph.* ASC 450-20-25-1 to access Paragraph 1 "*General Rule*" (paragraph 1 of section 450-20-25).

Once you get to Paragraph 1, the information is presented as follows:

> *FASB ASC 450-20-25-1*
>
> 25-1 When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. As indicated in the definition of contingency, the term *loss* is used for convenience to include many charges against income that are commonly referred to as expenses and others that are commonly referred to as losses. The Contingencies Topic uses the terms *probable*, reasonably possible, and *remote* to identify three areas within that range.

All FASB statements (FASB No. 1-168) and other GAAP in existence as of *July 1, 2009* were merged into the new FASB ASC.

Note: Previous GAAP is no longer identified by the old FASB statement numbers. Now such GAAP is identified by the new Topic Code. Example: FASB No. 140 is no longer referenced within the FASB ASC.

Although the original FASB reference number was eliminated and replaced with a Topic Code, there is a Cross Reference feature that allows a user to insert a FASB statement number and find the corresponding place within the Topic Codes where that statement information is located.

If the guidance for a transaction or event is not specified within a source of authoritative GAAP for that entity, an entity shall first consider accounting principles for similar transactions or events within a source of authoritative GAAP for that entity and then consider non-authoritative guidance from other sources.

An entity shall not follow the accounting treatment specified in accounting guidance for similar transactions or events when those accounting principles either prohibit the application of the accounting treatment to the particular transaction, or indicate that the accounting treatment should not be applied by

analogy. The appropriateness of other sources of GAAP depends on its relevance to particular circumstances, the specificity of the guidance, the general recognition of the issuer or author as an authority, and the extent of its use in practice.

Simplifying the language within the Codification

In writing the Codification, the FASB had a goal of using simple, module writing style that was used consistently across the Codification. In doing so, the FASB followed a few guidelines:

- The term *entity* is used to replace terms such as *company*, *organization*, *enterprise*, *firm*, *preparer*, etc.
- The term *intra-entity* replaces the term *intercompany*.
- The terms *shall*, *should*, and *would*, are used in lieu of the terms, *is required to*, and *must*.
- Terms such as *usually*, *ordinarily*, and *generally*, have been eliminated from the Codification.
- Most acronyms as stand-alones without the underlying text have been eliminated.
- Footnotes from the original documents have been eliminated and are now part of the text within the Codification.
- A Master Glossary has been provided to look up any term along with a separate glossary within each subtopic.

Accounting Standards Updates (ASUs):

Subsequent to the effective date of the FASB ASC, all updates are achieved through the issuance of *Accounting Standards Updates (ASUs*).

a. The ASUs are not considered authoritative in their own right, and serve only to update the Codification, provide background information about the guidance, and provide the bases for conclusions on the change(s) in the Codification.

b. After the effective date of FASB No. 168 (currently ASC 105), all non-grandfathered non-SEC accounting literature not included in the Codification is superseded and deemed non-authoritative.

c. The ASUs are organized into a format that includes the year (XXXX) followed by the sequential number for each accounting standard issued.

   Note: An example of the format for issuing an ASU is found with the August 2009 issuance of FASB Accounting Standards Update No. 2009-05, *Fair Value Measurements and Disclosures (Topic 820): Measuring Liabilities at Fair Value.* ASU No. 2009-05 is an amendment to Subtopic 10 of Topic 820, *Fair Value Measurements and Disclosures- Overall.*

Note further that all new EITF Abstracts, FASB Staff Positions, etc. will be issued as ASUs instead of as EITFs or FASB Staff Positions.

d. Once an ASU is issued, it will be shown as "*Pending Content*" within the FASB ASC until the ASU becomes effective for all entities. At that time, the outdated guidance will be removed and the new amended ASU information will be inserted into the FASB ASC.

Where do you find the FASB Codification?

On the FASB's website, the FASB ASC is available in two versions: a *Basic View* and a *Professional View*. The Basic View offers users basic printing and topical browsing functionality, as well as a utility to identify the location of legacy standards, and is free. The Professional View offers expanded functionality for an annual fee. Both views are available at http://asc.fasb.org/home.

The FASB has announced that it plans to issue the Codification in a print version, as well.

How do you locate previous GAAP standards within the FASB Codification?

Within the Codification is a *Cross Reference* feature which allows a user to look up information in one of two directions:

1. Cross reference a FASB standard to a Codification topic, subtopic, section or paragraph, or

2. Cross reference a Codification topic, subtopic, section or paragraph to a FASB standards.

By inserting either a FASB standard number or a Codification number, the feature generates a report that lists the corresponding cross referenced material.

How should you reference FASB ASC and ASUs in financial statements?

When referencing FASB ASC in financial statements, such as in footnote disclosures, FASB recommends using a plain English approach to describe broad FASB ASC topic references such as:

> **NOTE X:**
>
> *"As required by the Fair Value Measurements and Disclosures Topic of* FASB ASC 820*, ABC Entity is required to use its own credit spreads in determining the current value for its derivatives liabilities and all other liabilities for which it has elected the fair value option."*

In some cases entities may find it more useful for users to describe the specifics of the accounting policy applied rather than simply give the FASB reference. For example, a clear description of an entity's accounting policies for share-based payment arrangements would often be more relevant to financial statement users than a general statement that the entity follows FASB ASC 718, *Compensation—Stock Compensation*.

How should an accountant or auditor reference the FASB ASC in working papers or other memoranda?

The FASB ASC *Notice to Constituents* (NTC) describes how to reference FASB ASC in financial statements and other documents, working papers, articles, textbooks, and related items. Audit, compilation and review working papers associated with financial statements for a period ending after September 15, 2009 should reflect the FASB ASC because the underlying financial statements, which are the subjects of those engagements, reference FASB ASC.

FASB recommends, but does not require, using the detailed numerical referencing system as described previously. For example:

Sample documentation in working papers:

> "Under FASB ASC 820-10-35-18, ABC Entity is required to use its own credit spreads in determining the current value for its derivatives liabilities and all other liabilities for which it has elected the fair value option."

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self - study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

1. Under existing GAAP (Leases (ASC 840) (formerly FASB No. 13)), in order for a lease to qualify as a capital lease, which one of the following conditions must be satisfied:
   a. The future value of the minimum lease payments must be equal to or exceed 10% or more of the fair value of the asset
   b. The lease term must be no more than 50% of the remaining useful life of the leased asset
   c. There must be a bargain purchase at the end of the lease
   d. There must not be a transfer of ownership

2. Which of the following models does the proposed lease standard use:
   a. Right-of-use model
   b. Operating lease model
   c. Capital lease model
   d. True lease model

3. How would options to extend a lease be accounted for in determining the lease term under the proposed lease standard:
   a. The lease term should take into account the effect of any options to extend the lease in certain cases
   b. Lease options are only considered once they are exercised
   c. The proposed standard states that options are too vague and should not be considered in determining the lease term
   d. Only certain options to extend within a short-term period are considered because it is difficult to estimate the likelihood of the options being exercised

4. Under the proposed lease standard, expense on the lessee's income statement would consist of which of the following components under a Type A lease:
   a. Rent expense
   b. Interest and depreciation expense
   c. Rent and interest expense
   d. Interest and amortization expense

5. Facts: A company is a lessee of a lease with a lease term of 12 months. How may the lessee account for this lease under the proposed lease standard:
   a. The company is required to record a lease asset and liability
   b. The company is required to record the lease as an operating lease
   c. The company has the option to record the lease asset and liability, or record the lease as an operating lease
   d. The proposed standard does not deal with shorter lease terms

6. According to the author, which of the following would be an effect of the proposed lease standard:
   a. The lessee's income statement would have lower total lease expense in the earlier years of new leases
   b. There would be a negative shift in cash from operations from cash from financing activities in the statement of cash flows
   c. In most cases, total expense for GAAP would be the same as total expense for income tax purposes
   d. The lessee's EBITDA may increase as there is a shift from rent expense to interest and amortization expense

7. One change that may occur as a result of the proposed lease standard being implemented is_____.
   a. Companies that typically purchase a single-tenant building may choose to lease instead of buy
   b. Tenants in multi-tenant buildings would likely sign longer-term leases
   c. Tenants in single-tenant buildings with long term leases may choose to buy
   d. There is likely to be no change

8. Annual GAAP depreciation expense for a purchase of a leased asset may be _____ assuming there is a Type A lease:
   a. Higher than annual amortization expense under a lease
   b. Lower than annual amortization expense under a lease
   c. The same as annual amortization expense under a lease
   d. Either higher or lower than amortization expense under a lease, depending on whether options are part of the lease term

9. Under ASC 810 (formerly FIN 46R), if there is a related party lessee and lessor, which of the following would possibly result in consolidation of the two entities:
   a. The real estate entity is self-sustaining
   b. The real estate lessor is a variable interest entity
   c. The real estate lessor guarantees its own loan
   d. The lease is at market value

10. Facts: GAAP within the FASB ASC has the following reference: 605-20-30-3. Which of the following is correct:
    a. 605 is the section, 20 is the subtopic, 30 is the topic, and 3 is the paragraph
    b. 605 is the subtopic, 20 is the topic, 30 is the section, and 3 is the paragraph
    c. 605 is the topic, 20 is the subtopic, 30 is the section, and 3 is the paragraph
    d. 605 is the paragraph, 20 is the topic, 30 is the section, and 3 is the subtopic

SUGGESTED SOLUTIONS

1. Under existing GAAP (Leases (ASC 840) (formerly FASB No. 13)), in order for a lease to qualify as a capital lease, which one of the following conditions must be satisfied:
   a. Incorrect. In order for a lease to qualify as a capital lease, the present value of the minimum lease payments must be equal to or exceed 90% or more (and not 10%) of the fair value of the asset.
   b. Incorrect. In order for a lease to qualify as a capital lease, the lease term must be at least 75% (not more than 50%) of the remaining useful life of the leased asset.
   c. **Correct. If there is a bargain purchase at the end of the lease, the lease is a capital lease.**
   d. Incorrect. If there is a transfer of ownership, the lease qualifies as a capital lease, making the answer incorrect.

2. Which of the following models does the proposed lease standard use:
   a. **Correct. The proposal uses the right-of-use model under which a lease obligation is recorded at the present value of cash flows with the recording of a corresponding right-of-use asset.**
   b. Incorrect. Operating leases are part of existing GAAP and have nothing to do with the proposed lease standard.
   c. Incorrect. The term "capital lease" is part of existing GAAP and is not used in the proposed model even though the new model does capitalize assets and liabilities.
   d. Incorrect. The concept of "true lease" is found in taxation and not in GAAP.

3. How would options to extend a lease be accounted for in determining the lease term under the proposed lease standard:
   a. **Correct. The lease term would take into account the effect of any options to extend the lease or terminate the lease in certain cases where the lessee has a significant economic incentive to do so.**
   b. Incorrect. The proposed standard would not provide for lease options being considered only once they are exercised.
   c. Incorrect. The proposed standard states that options would be considered making the statement incorrect.
   d. Incorrect. The proposed standard does not differentiate between an option to extend within a short-term period as compared with one that is long-term.

4. Under the proposed lease standard, expense on the lessee's income statement would consist of which of the following components under a Type A lease:
   a. Incorrect. Operating leases record rent expense while the proposed standard would not account for a lease as an operating lease.
   b. Incorrect. Interest would be recorded but amortization would be the second component, not depreciation.
   c. Incorrect. Interest expense, but not rent expense, would be a component of a lease recorded under the proposed standard. Rent expense would apply to an operating lease and not a lease capitalized under the proposed standard.
   d. **Correct. Both amortization and interest expense would be components of expense recorded under the proposed standard. Amortization would relate to the asset capitalized while interest expense would relate to the payments of the lease obligation.**

5. Facts: A company is a lessee of a lease with a lease term of 12 months. How may the lessee account for this lease under the proposed lease standard:
   a. Incorrect. The proposed standard would not require the company to record a lease asset and liability for a short-term lease of 12 months or less, making the answer incorrect.
   b. Incorrect. The proposed standard would permit, but not require, that the company record a short-term lease as an operating lease, making the answer incorrect.
   c. **Correct. If the lease is 12 months or less, a lessee would be able to elect to record the lease as an operating lease, or would also be allowed to record the lease asset and liability, similar to other leases.**
   d. Incorrect. The proposed standard would not deal with leases of a lease term of 12 months or less, making the answer incorrect.

6. According to the author, which of the following would be an effect of passage of the proposed lease standard:
   a. Incorrect. Total expense (interest and amortization) on the lessee's income statement would be higher, not lower, in the earlier years of new leases.
   b. Incorrect. There would be a positive (not negative) shift to cash from operations from cash from financing activities in the statement of cash flows.
   c. Incorrect. Total expense for GAAP may differ from total expense for income tax purposes resulting in deferred income taxes being recorded.
   d. **Correct. The lessee's EBITDA may increase as there is a shift from rent expense to interest and amortization expense. Interest and amortization are not deducted in arriving at EBITDA while rent expense under existing operating leases is deducted.**

7. One change that may occur as a result of the proposed lease standard being implemented is_____.
   a. Incorrect. The proposed standard is not likely to expand leases because those leases will have lease obligations that have to be recorded on the lessee's balance sheet.
   b. Incorrect. Shorter, not longer leases will be the trend so that smaller liabilities are recorded on the lessee's balance sheet.
   c. **Correct. Tenants in single-tenant buildings with long-term leases may choose to buy because they already have to record lease obligations that are similar to the debt they will have to record in a purchase.**
   d. Incorrect. The status quo is not likely to be the case given the enormity of the impact of the proposed standard on company balance sheets.

8. Annual GAAP depreciation expense for a purchase of a leased asset may be _____ assuming there is a Type A lease:
   a. Incorrect. GAAP depreciation under a purchase may be lower, not higher, because the useful life used to depreciate the purchased asset is usually longer than the lease term used to amortize the lease.
   b. **Correct. The useful life used to depreciate an asset under a purchase is likely to be longer than the lease term used to amortize a lease thereby resulting in lower depreciation with a purchase than amortization with a Type A lease.**
   c. Incorrect. There is no indication that the amounts would be the same.
   d. Incorrect. Even if the option periods are included in the lease term, that term will be lower than the useful life of the purchase. Thus, depreciation will always be lower than amortization, making the answer incorrect.

9. Under ASC 810 (formerly FIN 46R), if there is a related party lessee and lessor, which of the following possibly result in consolidation of the two entities:
   a. Incorrect. Consolidation may be required only if the real estate entity is not self-sustaining.
   b. **Correct. If the real estate lessor is a variable interest entity (VIE), consolidation may be required.**
   c. Incorrect. If the lessee operating company or the common shareholder guarantee the lessor's loan, consolidation may be required. This is not the case where the real estate lessor guarantees its own loan.
   d. Incorrect. If the lease is above market, and not at market value, consolidation may be required.

10. Facts: GAAP within the FASB ASC has the following reference: 605-20-30-3. Which of the following is correct:
   a. Incorrect. 605 is not the section, 20 is not the subtopic, 30 is not the topic, and 3 is the paragraph.
   b. Incorrect. 605 is not the subtopic, 20 is the topic, 30 is the section, and 3 is the paragraph.
   c. **Correct. 605 is the topic, 20 is the subtopic, 30 is the section, and 3 is the paragraph.**
   d. Incorrect. 605 is not the paragraph, 20 is not the topic, 30 is the section, and 3 is not the subtopic.

K. Big GAAP- Little GAAP

In 2016, there finally appears to be progress toward the creation of a little-GAAP alternative to U.S. GAAP for nonpublic (private) companies. After all, it has only taken more than 40 years to get to the point where practitioners and their clients are fed up with the extensive growth of GAAP much of which is not relevant to nonpublic entities. For purposes of this section, the author uses the terms "nonpublic" and "private" interchangeably.

Background

For years there has been discussion about establishing two sets of GAAP rules; one for private (nonpublic) companies, and the other for SEC companies. Yet, each time there has been a little GAAP proposal, the discussion has fallen into oblivion with no real support from the AICPA and FASB.

The Big-GAAP, Little-GAAP issue has been around since 1974. There is a long history of various attempts to develop two sets of rules for GAAP, one for private companies, and the other for public companies. For purposes of this discussion, the term “Big-GAAP” refers to GAAP for public companies, while “Little GAAP” refers to a modified and simplified version of GAAP applicable to private (nonpublic) companies.

Because prior to 2014, the continued start and stop of the Big GAAP-Little GAAP debate had yielded little fruit, nonpublic companies and their accountants had to apply the same standards used by IBM and Microsoft, to Joe’s Pizza Shop and Mary’s Office Supply Store.

Nevertheless, the Big GAAP-Little GAAP movement has received new impetus over the past few years. Here is the status of events:

1. In the past decade, the FASB has issued several extremely controversial FASB statements and interpretations that are costly and difficult for nonpublic entities to implement, and not meaningful to the third party users they serve.

2. The Sarbanes-Oxley Act of 2002 mandated that the FASB’s funding come primarily from SEC registrants, thereby suggesting that the FASB’s focus, has been and will continue to be on issues important to public entities.

3. Presently, accountants from smaller CPA firms and nonpublic companies are not serving as FASB staff or board members which results in no small business representation or perspective within the FASB.

4. On the auditing side, the role of the Auditing Standards Board (ASB) has diminished to issuing auditing standards for nonpublic entities only. The Public Company Accounting Oversight Board (PCAOB) is now the standard-setter for SEC auditors. Thus, the AICPA’s ASB, and the AICPA, in general, are now more closely aligned with the needs of nonpublic entities.

Over the past decade, there has been sharp criticism pointed toward the FASB in their issuance of several extremely controversial statements that are difficult to implement for smaller, nonpublic companies including:

- *Consolidation of Variable Interest Entities* (ASC 810) (formerly FIN 46R): Requires entities (large and small) to consolidate their operating entities with their off-balance real estate leasing entities, if certain conditions are met.

- *Accounting for Uncertainty in Income Tax (An Interpretation of FASB No. 109)* (ASC 740) (formerly FIN 48): Clarifies the accounting for uncertainty in tax positions related to income taxes recognized in an entity's financial statements.

In addition, layers of mindless disclosures have been added to GAAP over the past decade many of which are targeted at larger publicly held entities. Yet, in most cases, the FASB has not exempted nonpublic entities from the application of those disclosures.

In general, there have been few instances in which the FASB has issued standards that exempt private companies:

A few of those instances include:

- ASC 260 (formerly FASB No. 128: *Earnings Per Share*)

- ASC 280 (formerly FASB No. 131: *Disclosures about Segments of an Enterprise and Related Information*)

- ASC 825 (formerly FASB No. 107: *Disclosure About Fair Value of Financial Instruments*)

In fact, the extent to which the FASB has carved out GAAP exclusions for private companies has been limited to delaying the effective date of a new standard and, in very limited cases, exempting private companies from one or two disclosures. Otherwise, private (nonpublic) companies have had to adopt the same standards that public companies do.

Consequently, accountants and their clients have defaulted to using several techniques to avoid the burdensome task of having to comply with recently issued difficult and irrelevant accounting standards, including:

a. Using OCBOA (income tax basis) financial statements
b. Including a GAAP exception in the accountant's/auditor's report, or
c. Ignoring the new GAAP standards by arguing their effect is not material

However, some third parties have not been receptive to receiving OCBOA financial statements and reports with a GAAP exception. Simply ignoring the new GAAP standards has its obvious problems.

Adding to the difficulty has been the FASB's unwillingness to focus on the needs of private companies. Prior to the issuance of Sarbanes-Oxley in 2002, the FASB received most of its funding from the SEC's Fortune 500 companies. After the Sarbanes-Oxley Act, essentially all of the FASB's funding is financed by SEC companies as mandated by Sarbanes-Oxley, so that the FASB's emphasis is in serving the public company arena. Consequently, the needs of nonpublic entities have been ignored.

The FASB established a Blue Ribbon Panel to evaluate the little-GAAP issue from which they issued a report. In that report, the Panel recommended to the FASB that the best course of action to deal with the little-GAAP dilemma was to:

> *established a new separate private company standard board to offer exceptions and modifications from GAAP for nonpublic (private companies).*

The Panel's recommendation was used as the basis for the FASB to move forward with a little-GAAP solution.

FASB and AICPA simultaneously jump on the little-GAAP bandwagon

Prior to May 23, 2012, it had taken more than 40 years for there to be a legitimate alternative to regular (big) GAAP. During that time, practitioners and their nonpublic company clients had used a variety of alternatives to avoid the traditional complex GAAP that had evolved. Such solutions included using GAAP exceptions and issuing income-tax-basis financial statements, among others.

On May 23, 2012, a rather profound series of events happened. After more than 40 years of the profession seeking a little-GAAP alternative, both the FASB and AICPA simultaneously announced their own independent proposals for a little-GAAP alternative for nonpublic companies as follows:

1. FASB's new Private Company Council (PCC) was created to issue GAAP exceptions and modifications for private companies

2. AICPA created its new Financial Reporting Framework for Small and Medium-Sized Entities (FRF for SMEs)

Let's take a look at the status of each of these little-GAAP alternatives:

FASB's Private Company Council (PCC)

On May 23, 2012, the FASB's Financial Accounting Foundation (FAF) Board of Trustees announcing that it was establishing a new body to improve the process of setting accounting standards for private companies, referred to as the *Private Company Council (PCC).*

According to the FAF, the PCC has the following principal responsibilities:

1. Based on criteria mutually developed and agreed to with the FASB, the PCC determines whether exceptions or modifications to existing nongovernmental U.S. GAAP are necessary to address the needs of users of private company financial statements.

2. The PCC identifies, deliberates, and votes on any proposed changes, which are then subject to *endorsement* by the FASB and submitted for public comment before being incorporated into GAAP.

3. The PCC also serves as the primary advisory body to the FASB on the appropriate treatment for private companies for items under active consideration on the FASB's technical agenda.

   Key elements of the Private Company Council responsibilities and operating procedures include:

a. *Agenda Setting*: The PCC and the FASB mutually agree on criteria for determining whether and when exceptions or modifications to GAAP are warranted for private companies.

- Using the criteria, the PCC determines which elements of existing GAAP to consider for possible exceptions or modifications by a vote of two-thirds of all sitting members, in consultation with the FASB and with input from stakeholders.

b. *FASB Endorsement Process:* If endorsed by a simple majority of FASB members, the proposed exceptions or modifications to GAAP are exposed for public comment. At the conclusion of the comment process, the PCC redeliberates the proposed exceptions or modifications and forwards them to the FASB, who makes a final decision on *endorsement* (not ratification), generally within 60 days.

c. *Membership and Terms:* The PCC consists of 9 to 12 members, including a Chair, all of whom are selected and appointed by the FAF Board of Trustees.

- The PCC Chair is *not* a FASB member.

- Membership of the PCC includes a variety of users, preparers, and practitioners with substantial experience working with private companies. Members are appointed for a three-year term and may be reappointed for an additional term of two years. Membership tenure may be staggered to establish an orderly rotation.

- The PCC members serves without remuneration but are reimbursed for expenses.

d. *FASB Liaison and Staff Support:* A FASB member is assigned as a liaison to the PCC. FASB technical and administrative staff are assigned to support and work closely with the PCC. Dedicated full-time employees are supplemented with FASB staff with specific expertise, depending on the issues under consideration.

e. *Meetings:* During its first three years of operation, the PCC holds at least five meetings each year, with additional meetings if determined necessary by the PCC Chair.

- All FASB members attend and participate in deliberative meetings of the PCC, but closed educational and administrative meetings may be held with or without the FASB.

f. *Oversight:* The FAF Board of Trustees has created a special-purpose committee of Trustees, the Private Company Review Committee (Review Committee), which has primary oversight responsibilities for the PCC.

- The Review Committee holds both the PCC and the FASB accountable for achieving the objective of ensuring adequate consideration of private company issues in the standard-setting process.

g. *FAF Trustees' Three-Year Assessment:* The PCC provides quarterly written reports to the FAF Board of Trustees. The FAF Trustees conducts an overall assessment of the PCC following its first three years of operation to determine whether its mission is being met and whether further changes to the standard-setting process for private companies are warranted.

FASB's PCC comes to life

As of February 2016, the PCC Members consist of the following:

PCC Members

Candace E. Wright (Council Chair) Postlethwaite & Netterville	Mr. Thomas Groskopf Barnes, Dennig & Co., Ltd.
Mr. George Beckwith National Gypsum Company	Mr. Neville Grusd Merchant Financial Corporation
Mr. Steven Brown U.S. Bank	Mr. Carleton Olmanson GMB Mezzanine Capital
Mr. Jeffery Bryan Dixon Hughes Goodman LLP	Ms. Diane Rubin Novogradac & Company LLP
Timothy J. Curt Warburg Pincus LLC	Mr. Lawrence Weinstock Mana Products, Inc.
Mr. Mark Ellis PetCareRx Inc.	David S. Lomax Liberty Mutual Insurance
Carleton Olmanson GMB Mezzanine Capital	Harold L. Monk Jr. Carr, Riggs & Ingram LLC

PCC Issues Private Company Decision-Making Framework

In December 2013, the Private Company Council issued a final guide (framework) entitled, *Private Company Decision-Making Framework: A Guide for Evaluating Financial Accounting and Reporting for Private Companies.*

The purpose of the Guide is to assist the FASB and PCC in determining whether and in what circumstances to provide alterative recognition, measurement, disclosure, display, effective date, and transition guidance for private company reporting under U.S. GAAP.

The framework:

1. Allows a private company to select alternatives in recognition and measurement guidance its considers appropriate without having to apply all alternatives available, and

2. Removes the presumption that industry-specific recognition and measurement guidance is relevant to users of both public and private company financial statements.

The framework addresses five significant factors that exist that differential between public- and private-company financial reporting, that include:

- Number of primary users and their access to management
- Investment strategies of primary users
- Ownership and capital structures
- Accounting resources, and
- Learning about new financial reporting guidance

The framework also identifies five areas where financial accounting and reporting guidance might differ for between public and private companies:

- Recognition and measurement
- Disclosures
- Display (or presentation)
- Effective dates
- Transition method

The framework is used by the FASB and PCC to identify the unique needs of private company financial statement users, as well as opportunities to reduce the cost and complexity of preparing private company financial statements under U.S. GAAP.

PCC passes its first four statements:

In January 2014, the FASB endorsed and passed two new statements at the request of the PCC.

In March 2014, the FASB endorsed a third statement, ASU 2014-07 to provide relief to private companies with respect to the consolidation of variable interest entity rules.

In December 2014, the PCC passed its fourth statement, ASU 2014-18: *Business Combinations (Topic 805): Accounting for Identifiable Intangible Assets in a Business Combination,* to allow private companies the option not to allocate a portion of the acquisition cost in a business combination to certain intangible assets other than goodwill.

These four statements, issued in the form of Accounting standards Updates (ASUs), provide exemptions and simpler GAAP application for nonpublic (private) companies as identified in the following table:

Description of new ASU for Nonpublic Entities	What the New ASU Does
ASU No. 2014-02: *Intangibles-Goodwill and Other (Topic 350) Accounting for Goodwill* (Issued January 2014)	Allows a nonpublic (private) entity to amortize goodwill on a *straight-line basis over 10 years*, or less if another shorter life is more appropriate. Goodwill is tested for impairment when a triggering event occurs that indicates that the fair value of the entity may be below the carrying amount. The automatic annual goodwill impairment test is eliminated if a nonpublic entity elects to amortize goodwill under this ASU.
ASU No. 2014-03: *Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps- Simplified Hedge Accounting Approach* (Issued January 2014)	Allows a nonpublic (private) entity to use a simplified hedge accounting approach to account for swaps that are entered into for the purpose of economically converting a variable-rate borrowing into a fixed-rate borrowing. Under this approach, the income statement charge for interest expense is similar to the amount that would result if the entity had directly entered into a fixed-rate borrowing instead of a variable-rate borrowing and a receive-variable, pay-fixed interest swap.
ASU 2014-07: *Consolidation (Topic 810)- Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements* (Issued March 2014)	Allows a nonpublic (private) company lessee to elect an accounting alternative not to consolidate a variable interest entity (VIE) if certain criteria are met.
ASU 2014-18: *Business Combinations (Topic 805): Accounting for Identifiable Intangible Assets in a Business Combination* (Issued December 2014)	Allows a nonpublic (private) company to elect an accounting alternative not to allocate a portion of the acquisition cost of a business combination to certain intangible assets other than goodwill.

As of February 2016, the PCC has one project on its agenda as follows:

- Definition of a Public Business Entity (phase 2)

Note: The PCC is off to a good start by issuing four statements to date. If the PCC continues with its initial pace, private companies should see a rapid expansion in the number of GAAP exemptions and modification available to private companies.

FIN 46R and the PCC

Perhaps PCC's most important achievement to date is the issuance of ASU 2014-07: *Consolidation (Topic 810) - Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements*, which was issued in March 2014.

The ASU offers an accounting alternative for private companies in applying variable interest entity (VIE) guidance to lessor entities under common control.

Under the ASU, a private company (nonpublic entity) lessee may elect an accounting alternative in applying the variable interest entity rules to a lessor under common ownership.

Under the accounting alternative, a *private company* (nonpublic entity) lessee is not required to consolidate a variable interest entity (VIE) if all of the following *four criteria* are met:

> **Criterion 1:** The private company lessee (the reporting entity) and the lessor entity are under common control.
>
> **Criterion 2:** The private company lessee has a *lease arrangement* with the lessor entity.
>
> **Criterion 3:** *Substantially all activities* between the private company lessee and the lessor entity are related to leasing activities between those two entities.
>
> **Criterion 4:** If the private company lessee *explicitly guarantees* or *provides collateral* for any obligation of the lessor entity related to the asset leased by the private company, then the principal amount of the obligation at inception of such guarantee or collateral arrangement *does not exceed the value of the asset* leased by the lessee from the lessor entity.

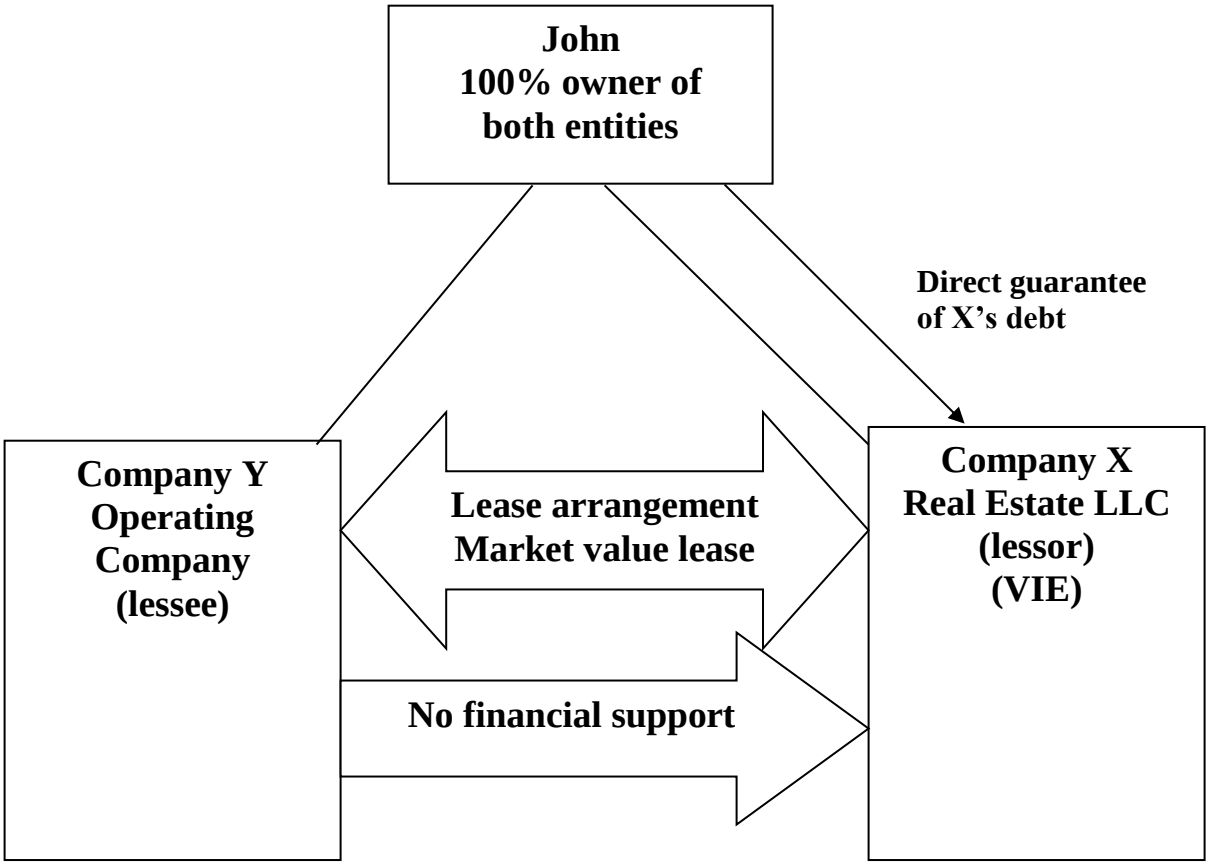
If the four criterion above are met, a private company lessee is not required to consolidate a related-party lessor real estate entity.

Following is an example the illustrates the specific situation that the ASU addresses, which is a common problem for practitioners to apply:

Example: Lease with loan guarantee by owner

Facts:

- John is a 100% shareholder of Company X (lessor VIE) and Company Y (lessee operating company).
- X is a VIE and owns real estate that it leases to Company Y (e.g., LTV is greater than 65%).
- The lease is at a market lease rate with no residual value guarantee, no option to purchase at a fixed price, and no renewal options. There are no variable interests between the parties such as loans, guarantees, etc. (e.g., no financial support is coming from the lessee).
- X has a $1,000,000 bank loan and John has *personally guaranteed* that loan.
- Y has not guaranteed X's loan although there are no restrictions to Y if it had chosen to guarantee X's loan. Y has not guaranteed the loans of any entities in the past.
- John's primary assets are his 100% equity holding in Y and X.



Under the current FIN 46R rules, if certain conditions are satisfied, FIN 46R requires that the real estate lessor (Company X) be consolidated into the financial statements of the related party lessee (Company Y). Of course, many lenders do not want consolidated financial statements. Moreover, the current FIN 46R rules are unworkable for nonpublic entities that have to test to determine whether a consolidation is required in the first place.

Under ASU 2014-07, Company Y (lessee), as a private company, would not be required to consolidate Company X (real estate lessor) if the four criteria are satisfied as follows:

Criterion 1: Y (the reporting entity) and X (lessor entity) are under common control.

Criterion 2: Y has a *lease arrangement* with X.

Criterion 3: *Substantially all activities* between Y and the X are related to leasing activities between those two entities.

Criterion 4: If Y *explicitly guarantees* or *provides collateral* for any obligation of X related to the asset leased by Y, then the principal amount of the obligation at inception of such guarantee or collateral arrangement *does not exceed the value of the asset* leased by Y from X.

AICPA's FRF for SMEs

In the previous section, the author addressed the activities of the Private Company Council (PCC) which is the FASB's solution to the little GAAP (private company) problem.

As a counter-punch to the FASB taking control over the nonpublic company issue through the newly established PCC, the AICPA took its own action to deal with the needs of nonpublic a (private) companies.

On May 23, 2012, the AICPA announced that it was developing a financial reporting framework for private small-and medium-sized entities (FRF for SMEs) that do not need U.S. GAAP financial statements. Contrary to the FASB's PCC that works within existing GAAP, the AICPA's approach is to develop a non-GAAP alternative in the form of the FRF for SMEs.

According to the AICPA, the AICPA's FRF for SME framework would be less complicated and a less costly alternative system of accounting to U.S. GAAP for private companies that do not need U.S. GAAP financial statements.

Barry Melancon, President of the AICPA stated:

> *"In addition to advocating for appropriate differences in U.S. GAAP to recognize the unique circumstances of the private company environment, we will be launching a complementary OCBOA financial reporting framework. The enhanced and simplified financial reporting framework will be a cost beneficial solution for smaller privately held entities that do not need to comply with U.S. GAAP."*

In 2013, the AICPA issued a final framework for FRF for SMEs, entitled, *Financial Reporting Framework for Small- and Medium-Sized Entities.* The framework consists of 188 pages, and represents the entire codification of FRF for SMEs.

The FRF for SMEs:

- Represents one additional financial reporting framework consisting of a set of criteria used to determine measurement, recognition, presentation, and disclosure of all material items appearing in the financial statements.

- Is a self-contained special-purpose framework intended for use by privately held small-to-medium-sized entities (SMEs) in preparing their financial statements.

- Draws upon a blend of traditional methods of accounting with some accrual income tax methods.

- Is a non-authoritative framework

One key point that appears to be of great concern to practitioners is that the FRF for SMEs is a *non-authoritative framework*. The FRF for SMEs has not been approved, disapproved, or otherwise acted upon by any senior technical committee of the AICPA or the Financial Accounting Standards Board and therefore has no official or authoritative status. Therefore, a large question is whether third party users

will accept a non-authoritative framework, particularly if the AICPA does not get behind educating third party users about it.

Is the FRF for SMEs a special-purpose framework under auditing standards and the SSARSs?

Yes, the provisions of AU-C Section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks* (AICPA, *Professional Standards*), apply to financial statements prepared under the FRF for SMEs. AU-C section 800, states that if special-purpose framework financial statements include items that are the same or similar to those in GAAP financial statements, similar informative disclosures are required.

The AICPA has stated that it believes the FRF for SMEs consists of disclosures that are similarly informative disclosures to GAAP.

What are some of the differences between FRF for SMEs and traditional GAAP?

Embedded within the 188 pages of the FRF for SMEs framework are numerous abbreviated disclosures.

Following is a listing of some of the key recognition, measurement and disclosure standards found in the FRF for SMEs:

Key Provisions within FRF for SMEs Framework
General provisions: The proposed framework is built upon a foundation of reliable and comprehensive accounting principles: • **Historical cost is the primary measurement basis**. • Disclosures are reduced, while still providing users with the relevant information they need. • Familiar and traditional accounting methods are employed. • Adjustments needed to reconcile tax return income with book income are reduced. • The framework is a principles-based framework, usable across industries by incorporated and unincorporated entities. • The framework contains less complicated, leaner, relevant financial reporting principles for SMEs. • Only financial statement matters that are typically encountered by SMEs are addressed in the framework. • **There is no concept of comprehensive income.** Specific rules: • Historical cost is be used

- **Fair value is eliminated except for available-for-sale securities which are be recorded at fair value**

- Inventories are measured at lower of cost or market, using FIFO, LIFO, average cost

- Fixed assets:
  - Same rules as existing GAAP
  - Depreciation based on useful lives of assets
  - Still does not allow 179/bonus depreciation

- Lease accounting:
  - **Recorded as a capital or operating lease based on whether substantially all of the risks and benefits of ownership transfer**
  - **Existing five-year disclosures of lease payments remain in effect**

- Financial instruments: cost is used except for available for sale securities for which fair value would be used

- Derivatives are disclosed only

- Equity method- follows existing GAAP and is used if there is significant influence presumed at 20-50% ownership

- % completion or completed contract methods are retained

- Consolidations:
  - **No consolidation of variable interest entities (VIEs)**
  - Consolidate occurs only if there is more than 50% ownership
  - Parent-only financial statements are available where the subsidiary could be recorded using the equity method instead of consolidating

- Income taxes: The company has the choice of:
  - Recording deferred income taxes, or
  - **Recording only the current tax provision without deferred income taxes**

- Intangible assets other than goodwill:
  - Would be amortized over their useful life.
  - **Intangibles would be tested for impairment unless the life is indefinite.**

- **Goodwill is amortized over the *tax life of 15 years*.**
  - **If GW is not amortized for tax purposes, it would be amortized over 10 years**
  - **No impairment tests is required for goodwill and indefinite-lived intangibles**

- Impairment:
  - Impairment rules would apply to fixed assets, inventory, equity method investments, intangible assets with finite lives.
  - Reversal of impairment losses is required except for intangible assets with finite lives

- Impairment rules do not apply to goodwill and indefinite lived intangibles.

- Pushdown accounting is allowed when there is a stock redemption or stock purchase

- Statement of cash flows required:
  - Cash and cash equivalents should include those bank accounts with positive balances only
  - Interest and income taxes paid would not be disclosed

- Start-up costs are capitalized if capitalized for tax purposes

- Defined benefit pension plans:
  - Pension liabilities may be measured using either the current contribution payable method (only the contribution attributable to the current year is expensed), or
  - the accrued benefit obligation method (an accrued benefit obligation is recorded)

- FRF for SMEs would not apply to non-profit organizations

- The FRF for SMEs framework would be "stable" so that changes would be made only every 3-4 years only

In a Q&A published by the AICPA:[33]

> **Question:** Will lenders/financial institutions accept financial statements prepared under the FRF for SMEs?
>
> **AICPA Response:** Owner-managers and their CPA practitioners will need to consult with lenders and other key external stakeholders about the use of the FRF for SMEs. With substantial relevance and cost-benefit factors, the AICPA believes that the lending community will accept financial statements prepared under the FRF for SMEs. Lenders are often very flexible in accommodating various financial frameworks for smaller entities.

The AICPA's response noted above is a foreshadowing of problems with FRF for SMEs. Notice "owners-managers and their CPA practitioners need to consult with lenders." Nothing is mentioned about a vigorous marketing campaign initiated by the AICPA. Simply put, if the AICPA does not get behind its own product and endorse and promote it with third parties, its use will wither on the vine.

Why wouldn't a practitioner simply use tax-basis financial statements instead of the FRF for SMEs?

Exactly. In looking at FRF for SMEs and the fact that it is a *nonauthoritative framework* with no AICPA promotion of its use, one has to ask why a practitioner wouldn't simply suggest to his or her client to use tax-basis accrual financial statements instead of FRF for SMEs. Both frameworks are considered a special-purpose framework and not GAAP. FRF for SMEs looks very similar to the way GAAP looked thirty years ago before the FASB issued many of the recent complex and controversial standards. However, one might conclude that once there is a deviation from U.S. GAAP, income tax basis financial

[33] AICPA's *Financial Reporting Framework for Small- to Medium-Sized Entities: Frequently Asked Questions*

statements might be more easily accepted by banks. Moreover, tax-basis financial statements are probably a more meaningful special-purpose framework because it is based on income tax reporting, a framework that is understandable to a nonpublic company client.

Why doesn't a U.S. private company simply adopt the European version of SMEs?

Europe's IASB has been ahead of the U.S on the little-GAAP issue, with its own IFRS for SMEs (small and medium-sized entities) for their private companies.

IFRS for SMEs is not to be confused with the AICPA's FRF for SMEs.

In Europe, the IASB already has its own small business GAAP framework for small to medium sized entities referred to as IFRS for SMEs, which was issued in July 2009.

The *IFRS for SMEs* is an abbreviated standard that was adopted by numerous countries. According to the IASB publication, *A Guide to the IFRS For SMEs*, more than 68 jurisdictions have either adopted IFRS for SMEs or have committed to adopt it over the next three years. United States companies can adopt it presently but few companies have done so.

The key difference between the IFRS for SMEs as compared with full IFRS, is that:

a. The *IFRS for SMEs* is *much less complex* than full IFRS due to the simpler reporting needs of most small and medium-sized entities, and

b. Listed companies (public companies) and financial institutions should not use IFRS for SMEs while they can and do use full IFRS. U.S. public companies are permitted to use IFRS but should not use IFRS for SMEs.

Consider the following attributes found in the IFRS for SMEs:[34]

- There are only 230 pages of material in the IFRS for SMEs as compared with thousands of pages in the full set of IFRS.

- It is organized by topic within 35 sections.

- Topics that are not relevant to small and medium-sized private companies have been omitted and many principles have been simplified.

  Examples: Amortization of goodwill and the accounting for investments have been simplified from the approach under IFRS.

- The IFRS for SMEs only allows use of the easiest option among a choice of accounting policies available under IFRS.

- There are significantly fewer disclosures required (roughly 300 versus 3,000) as compared with the full IFRS.

[34] A Guide to the IFRS for SMEs (IASB)

- The standard has been written in a clear and easily translatable language.

- To further reduce the burden for SMEs, revisions to the IFRS for SMEs are limited to once every three years.

According to a document published by the IASB, more than 95 percent of all companies worldwide are eligible to use IFRS for SMEs:[35]

a. There are only 45,000 public companies worldwide (listed on the 52 largest stock exchanges) that must use full IFRS or United States GAAP.

b. All other companies, which are primarily private companies, are eligible to use the IFRS for SMEs.

   - Europe and the United States have approximately 53 million private companies:
     - Europe has 33 million (U.K. alone has 4.5 million)
     - United States has 20 million

   Note: There is a discrepancy between the number of private companies in the United States as identified in the IASB report and the Blue Ribbon Panel Report. The IASB states that there are 20 million private companies in the United States while the Blue Ribbon Report states there are 28 million.

Can U.S. private companies adopt the IASB's IFRS for SMEs?

Although public companies, in general, should not use IFRS for SMEs, U.S. private companies are permitted (but not required) to adopt the IFRS for SMEs.

Even though the rest of the world appears slated to adopt the IFRS for SMEs, the author believes it is dubious that many U.S. private companies will adopt IFRS for SMEs unless they have to use it for international reporting. Under the current reporting needs, few U.S. private companies have to issue their financial statements to international third parties. Consequently, use of IFRS for SMEs may be useful, but is not likely to be a priority for most U.S. private companies.

Moreover, if IFRS for SMEs were to be used by U.S. private companies, there is a question as to whether U.S. third-party users (banks, etc.) would understand it or even permit it. Most loan documents in the United States, for example, state that financial statements must be prepared in accordance with U.S. GAAP. Changing that requirement to IFRS for SMEs is likely to be difficult, if not impossible, as banks and other third parties are reluctant to accept an accounting standards that they do not understand.

Why didn't the AICPA simply adopt the IASB's IFRS for SMEs instead of creating its own FRF for SMEs?

[35] A Guide to the IFRS for SMEs (IASB)

It would seem that the AICPA could have endorsed and supported the existing IFRS for SMEs instead of adopting its own FRF for SMEs. After all, the codification for IFRS for SMEs was already written and approved for use by U.S. private companies.

It its Q&A, the AICPA offered the following question and answer:

> **Question:** Why not promote the use of IFRS for SMEs rather than develop a new framework?
>
> **AICPA Response:** The International Accounting Standards Board) has been recognized by the AICPA as an international accounting standard setting body and, as a result, the IFRS for SMEs may be an alternative for those SMEs needing GAAP financial statements. Although there will be some similarities between the FRF for SMEs framework and the IFRS for SMEs, the AICPA believes that the *FRF for SMEs framework will be more understandable and more useful at this time because it is specifically written for U.S. entities*. Additionally, the FRF for SMEs framework will reduce differences between the FRF for SMEs framework and the U.S. tax code. For example, last-in, first-out (LIFO) inventory is not permitted by the IFRS for SMEs whereas it will be permitted by the FRF for SMEs framework.

The multiple framework options for nonpublic entities

With the advent of the FASB's Private Company Council (PCC) and the AICPA's FRF for SMEs, U.S. nonpublic companies now have several special-purpose frameworks from which to choose.

Consider the list of reporting alternatives for U.S. nonpublic entities:

Types of Frameworks Available (or Pending) For U.S. Nonpublic Entities	
Framework	**Comments**
U.S. GAAP	• In effect but getting more complex • Generally accepted by all third parties
U.S. GAAP with GAAP exceptions	• Can be used but the number of GAAP exceptions that can be included in the report is limited
Income-tax-basis financial statements	• Popular special-purpose framework effective for profitable, nonpublic businesses • Many third parties accept its use
FASB's Private Company Council Framework (GAAP Light)	• Goal is to create exceptions and exclusions to existing GAAP for nonpublic entities • Authoritative and endorsed by the FASB
AICPA's Financial Reporting Framework for Small- to Medium-Sized Entities (FRF for SMEs)	• Simpler version of U.S. GAAP • Non-authoritative • Concern about whether third parties will accept its use
IASB's IFRS for SMEs	• Can be used by U.S. nonpublic entities • U.S. accountants and third party users are not familiar with its application

The FASB's PCC framework and AICPA's FRF for SMEs are in their infancy, but will evolve over the next two years. In the end, the author believes that survivors of this "little-GAAP" battle will be:

- U.S. GAAP
- FASB's PCC framework
- Income-tax-basis financial statements

The author predicts that going forward, accountants will issue either full, traditional U.S. GAAP financial statements, or will default to the FASB's PCC framework that will offer exemptions and exclusions to U.S. GAAP for nonpublic companies. The PCC framework is authoritative so that practitioners and their clients will not have trouble with third parties accepting the PCC framework. In situations in which the practitioner and his or her client seek to use a nonauthoritative framework, the author thinks that practitioners will use income-tax-basis financial statements and not the AICPA's FRF for SMEs, unless, and only unless, FRF for SMEs becomes acceptable to third parties.

L. Going Concern Assessment By Management- ASU 2014-15

In this section, the author addresses the recently issued ASU 2014-15, *Presentation of Financial Statements- Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern.* ASU 2014-15 requires management to perform a going concern assessment of an entity.

With the introduction of ASU 2014-15, now *both management and the auditor* must perform their own separate going-concern assessments of the same entity. This section addresses the interrelation of the new GAAP rules in ASU 2014-15 with the auditing standards found in AU-C 570.

Background- going concern

For years, the rules for going concern have been found in auditing literature within AU-C Section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (formerly SAS No. 59), which *requires an auditor to assess* whether an entity has the ability to continue as a going concern for a *reasonable period of time* (usually one year from the balance sheet date.) Because going concern is a GAAP issue, it belongs within accounting literature, in addition to auditing standards.

In 2015, Audit Analytics issued a report in which it performed a 15-year study of going- concern opinions.

The report, which samples financial statements through 2014, identifies the following trends:

1. 2014 going-concern report modifications were at the lowest level over a 15-year period.

Year	Going-concern opinions
2014	2,233
2013	2,403
2012	2,565
2011	2,670
2010	2,988
2009	3,102
2008	3,355

Source: Audit Analytics

2. 15.8% of auditor opinions filed in 2014 contained a going-concern report modification. [The highest percentage was 21.1% in 2008, and lowest was 14.2% in 2000.]

3. Going-concern report modifications peaked at 3,355 in 2008 and dropped to 2,233 in 2014.

What percentage of companies recover from a going-concern report modification?

Interestingly, only a small percentage (ranging from 5% to 9%) of companies that had going concern report modifications rebounded with a clean opinion in the subsequent year.

The following table shows the details:

Number of Clean Opinions in Subsequent Year to Going-Concern Report Modification

Current year	# going concerns prior year	# clean opinions current year, going concern prior year	% recovery in subsequent year
2014	2,403	200	8.3%
2013	2,565	188	7.3%
2012	2,670	144	5.4%
2011	2,988	208	7.0%
2010	3,102	276	8.9%
2009	3,355	265	7.9%
2008	3,309	200	6.0%
2007	2,878	253	8.8%

Source: Audit Analytics, as modified by Author.

Observation: The previous table illustrates a key point with respect to going-concern report modifications. If such a report modification is made, it can be the "kiss of death" for a company in the subsequent years. A very low percentage of companies subsequently survive a going-concern report modification.

Going Concern- GAAP - FASB issues ASU 2014-15

In August 2014, the FASB issued ASU 2014-15, *Presentation of Financial Statements- Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern.*

ASU 2014-15 provides guidance about *management's responsibility* to evaluate an entity's ability to continue as a going concern and to provide related disclosures. Previously, no such guidance existed in GAAP.

ASU 2014-15 is effective for the annual period *ending after December 15, 2016*, and for annual periods and interim periods thereafter. Early application is permitted.

The objective of ASU 2014-15 is to provide guidance for evaluating whether there is substantial doubt about an entity's ability to continue as a going concern and about related footnote disclosures.

ASU 2014-15 does the following:

a. Requires *management to make an evaluation of going concern* every reporting period, including interim periods.

b. Defines the term *substantial doubt* about an entity's ability to continue as a going concern (substantial doubt) as follows:

   "Substantial doubt about an entity's ability to continue as a going concern exists when conditions and events, considered in the aggregate, indicate that it is probable that the entity will be unable to meet its obligations as they become due within one year after the date that the financial statements are issued (or within one year after the date that the financial statements are available to be issued when applicable)."

   Note: The term "probable" is used consistently with its use in Topic 450 on contingencies.

c. Provides that management should consider the mitigating effect of management's plans only to the extent it is probable the plans will be effectively implemented and mitigate the conditions or events giving rise to substantial doubt.

d. Requires certain disclosures when substantial doubt is alleviated as a result of consideration of management's plans

e. Requires an explicit statement in the notes that there is substantial doubt and other disclosures when substantial doubt is not alleviated, and

f. Requires an evaluation for a period of one year after the date that the financial are issued (or available to be issued if a nonpublic entity).

Auditing Standards Board clarifies its going concern rules

After the issuance of ASU 2014-15, there were certain inconsistencies between the GAAP and auditing rules for dealing with going concern.

In particular, the one-year period of time for evaluating going concern was different as follows:

a. AU-C 570 uses a reasonable period of time as the period for which an auditor should evaluate going concern. Generally, in practice, that period is one-year period from the balance sheet date.

b. ASU 2014-15 uses a one-year period from the date the financial statements are issued or available to be issued.

Thus, after the FASB issued ASU 2014-15, the GAAP going concern period extended several months beyond the one-year period used by auditors under AU-C 570.

In response, in January 2015, the Auditing Standards Board (ASB) issued an interpretation to address conflicting issues related to GAAP's recently issues, ASU 2014-15, *Presentation of Financial Statements- Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern* and, going concern rules found in AU-C 570.

The purpose of this audit interpretation is to clarify how AU-C 570's requirements for an auditor addressing going concern interrelate with the new GAAP rules found in ASU 2014-15.

The auditing interpretation brings the auditing rules for dealing with going concern in parity with the new GAAP rules found in ASU 2014-15.

The auditing interpretation states the following:

1. When an applicable financial reporting framework (such as GAAP) includes a definition of *substantial doubt* about an entity's ability to continue as a going concern, that definition would be used by the auditor when applying AU-C section 570.

   For example, if an entity is required to comply with, or has elected to adopt, ASU 2014-15, the definition of substantial doubt about an entity's ability to continue as a going concern found in GAAP would be used by the auditor.

2. When the applicable financial reporting framework (such as GAAP) requires management to evaluate whether there are conditions and events that raise substantial doubt for a period of time *greater than one year* from the date of the financial statements, the auditor's assessment of management's *going concern evaluation would be for the same period of time as required by the applicable financial reporting framework* (such as GAAP).

   For example, if an entity is required to comply with, or has elected to adopt, ASU 2014-15, the auditor's assessment of management's going concern evaluation would need to be for the *same period of time as required by ASU 2014-15* (that is, *one year after the date that the financial statements are issued or available to be issued*).

3. When the applicable financial reporting framework (such as GAAP) provides disclosure requirements related to management's evaluation of substantial doubt, the auditor's assessment of the financial statement effects under AU-C section 570 would be based on the disclosure requirements of the applicable financial reporting framework (such as GAAP).

Observation: The auditing interpretation essentially states that in evaluating going concern, an auditor should follow the same rules found in GAAP with respect to the period of time to which the evaluation should be applied. That period of time is *one year from the date the financial statements are issued or available to be issued (if a nonpublic entity).* Thus, the period of time that has been used for auditors previously (one year from the balance sheet date) is extended to be one year from the date the financial statements are either issued (public entities) or available to be issued (nonpublic entities). This change adds a few months to the going concern assessment period for an auditor. It also means that it is important that the auditor conclude his or her audit and ensure that the financial statements are issued so that the one-year period commences. The later the financial statements are issued, the later the one- year going-concern period is extended.

Going concern in a review engagement

In connection with a review engagement, Paragraph .65 of AR-C 90, SSARS No. 21 states:

> "The accountant should consider whether, during the performance of review procedures, evidence or information came to the accountant's attention indicating that *there could be an uncertainty* about an entity's ability to continue as going concern for a *reasonable period of time."*

SSARS No. 21 defines a *reasonable period of time* to be:

> *"the same period of time required of management to assess going concern when specified by the applicable financial reporting framework."*

a. For a GAAP framework, the reasonable period of time is *one year from the date the financial statements are available to be issued* (one year from the review report date).

   Note: Under SSARS No. 21, for a compilation or review engagement on GAAP financial statements, the accountant should consider whether an uncertainty exists using the same one-year window that GAAP uses under ASU 2014-15.

   That window for a nonpublic entity is *one-year from the date the financial statements are available to be issued.*

b. For a non-GAAP framework (such as tax basis), if that non-GAAP framework *does not specify* a period of time for management's assessment, a reasonable period of time is *one year from the date of the financial statements being reviewed* (which is one year from the balance sheet date).

   The result of the previous analysis is that the one-year going concern assessment period is now the same among GAAP, audit and review engagements.

   That one-year period is *one year from the date the financial statements are issued (available to be issued for nonpublic entities*).

M. Sustainability Standards is a Hot Issue

If keeping up with GAAP standards is not difficult enough, now there is a new set of standards that deal with "sustainable" accounting standards.

In 2011, the *Sustainability Accounting Standards Board (SASB)* was created with a goal to develop sustainability accounting standards that would "guide" SEC companies in disclosing material factors that the SEC requires companies to address in their filings.

According to the SASB, the Board is a non-profit organization funded by several private foundations. Some of its supporters include:

- Bloomberg Philanthropies
- Kresge Foundation
- Rockefeller Foundation
- FB Heron

The SASB notes the following based on information published on its website (www.sasb.org):

- Through 2016, SASB is developing sustainability accounting standards for more than 80 industries in 10 sectors.

- SASB standards are designed for the disclosure of *material sustainability issues* in mandatory SEC filings, such as the Form 10-K and 20-F.

- SASB is also an ANSI accredited standards developer. Accreditation by ANSI signifies that SASB's procedures to develop standards meet ANSI's requirements for openness, balance, consensus, and due process.

- SASB is not affiliated with FASB, GASB, IASB or any other accounting standards boards.

To date, the SASB has issued sustainability accounting standards for the following industries:

- Health care
- Financials
- Technology and communication
- Non-renewable resources
- Transportation
- Services

Does GAAP or the SEC require disclosures of sustainability?

The SASB is relying on certain provisions within SEC filing requirements and is interpreting them to mean that an SEC company must include disclosures about sustainability.

SEC disclosure requirements

When a public company is required to file a disclosure document with the SEC under SEC Regulation S-K and Regulation S-X[36], in addition to information expressly required to be filed, the company must disclose:

> *"such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading."*

Regulation S-K already requires companies to disclose environmental issues as they relate to:

Description of business (Item 101): including the material effects that compliance with Federal, State and local environmental laws may have upon the capital expenditures, earnings and competitive position.

Legal proceedings (Item 103): including any material pending legal proceeding to which it is a party including a description of material pending legal actions in which its property is the subject of the litigation.

***Risk factors (Item 503)*: consisting of the most significant factors that make an investment in the registrant speculative or risky.**

Management Discussion and Analysis (Item 303): consisting of various disclosures that provide a narrative explanation of the financial statements that enhance disclosures and provide information about the quality of, and potential variability of earnings and cash flow. Such disclosures includes known trends, events, demands, commitments, and uncertainties that are reasonably likely to have a material effect on financial condition or operating performance.

In addition to Regulation S-K disclosures, Securities Act Rule 408 and Exchange Act Rule 12b-20 require a registrant to disclose, in addition to the information expressly required by law or regulation:

> *"such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading."*

In the SASB's "*Legal Q&A*" the SASB addresses the issue of whether SEC companies must disclose information about sustainability.

[36] Regulation S-X deals with the form, content and requirements of financial statements issued by public companies.

LEGAL Q&A (SASB):

Are companies required to disclose material sustainability information under current regulations, rules, or case law?

Corporations subject to SEC filing requirements must disclose material information in their SEC filings, such as the Form 10-K. Several rules and regulations, including Regulation S-K and the Sarbanes-Oxley Act, arguably require the disclosure of *material sustainability information* on Form 10-K and other periodic SEC filings in some circumstances (e.g., as discussed in the SEC Guidance on Disclosures Regarding Climate Change[8] and the SEC's Disclosure Guidance on Cybersecurity).

Securities Act Rule 408 and Exchange Act Rule 12b-20 require a registrant to disclose, in addition to the information expressly required by line-item requirements, "*such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading.*" For example, if a pharmaceutical company states that its continued success depends on maintaining a strong reputation for safety, then the company should consider disclosing information regarding Drug Safety and Side Effects, Safety of Clinical Trial Participants, and Counterfeit Drugs, all of which are SASB disclosure topics in the Pharmaceutical industry. Making the disclosures about Drug Safety and Side Effects, Safety of Clinical Trial Participants, and Counterfeit Drugs can help the company satisfy Rule 12b-20. Depending on the company's performance on the SASB disclosure topics, shareholders could allege that the disclosure about reputation for safety, by itself, is materially misleading. Further, the SEC explains that a company's disclosure controls and procedures should not be limited to disclosure specifically required, but should also ensure timely collection and evaluation of "information potentially subject to [required] disclosure," "information that is relevant to an assessment of the need to disclose developments and risks that pertain to the [company's] businesses," and "information that must be evaluated in the context of the disclosure requirement of Exchange Act Rule 12b-20.

Source: SASB Legal Q&A

Following is an excerpt from the SASB Sustainability Accounting Standard related to the Containers & Packaging industry.

SUSTAINABILITY ACCOUNTING STANDARD
RESOURCE TRANSFORMATION SECTOR
CONTAINERS & PACKAGING
Sustainability Accounting Standard
March 2015

1. Industry-Level Sustainability Disclosure Topics

For the Containers & Packaging industry, SASB has identified the following sustainability disclosure topics:

- Greenhouse Gas Emissions
- Air Quality
- Energy Management
- Water Management
- Waste Management
- Product Safety
- Product Lifecycle Management
- Materials Sourcing

Guidance on Accounting for Material Sustainability Topics

For each sustainability topic included in the *Containers & Packaging industry* Sustainability Accounting Standard, SASB identifies accounting metrics.

SASB recommends that each company consider using these sustainability accounting metrics when preparing disclosures on the sustainability topics identified herein;

As appropriate—and consistent with Rule 12b-206—when disclosing a sustainability topic identified by this Standard, companies should consider including a narrative description of any material factors necessary to ensure completeness, accuracy, and comparability of the data reported.

Where not addressed by the specific accounting metrics, but relevant, the registrant should discuss the following, related to the topic:

- The registrant's **strategic approach** to managing performance on material sustainability issues;
- The registrant's **relative performance** with respect to its peers;
- The **degree of control** the registrant has;
- Any **measures the registrant has undertaken** or **plans to undertake** to improve performance; and
- Data for the registrant's **last three completed fiscal years** (when available).

SASB recommends that registrants use SASB Standards specific to their primary industry as identified in the Sustainable Industry Classification System (SICS™). If a registrant generates significant revenue from multiple industries, SASB recommends that it also consider sustainability topics that SASB has identified for those industries and disclose the associated SASB accounting metrics.

In disclosing to SASB Standards, it is expected that registrants disclose with the same level of rigor, accuracy, and responsibility as they apply to all other information contained in their SEC filings.

SEC created the impetus for sustainability disclosures

The SEC helped create SASB by giving credibility to the "climate change" or "sustainability" movement.

It started in February 2010 when the SEC issued, *Commission Guidance Regarding Disclosure Related to Climate Change* (the SEC Release). The SEC Release provided public companies with interpretive guidance on existing SEC disclosure requirements as they apply to business or legal developments relating to the issue of climate change. Since time, the term "climate change' is more frequently replaced with the term "sustainability."

The SEC Release provides guidance on certain existing disclosure rules that may require a company to disclose the impact that business or legal developments related to climate change may have on its business.

The relevant rules cover a:

- Company's risk factors
- Business description
- Legal proceedings, and
- Management discussion and analysis.

Specifically, the SEC's interpretative guidance highlights the following areas as examples of where climate change may trigger disclosure requirements:

- *Impact of Legislation and Regulation*: When assessing potential disclosure obligations, a company should consider whether the impact of certain existing laws and regulations regarding climate change is material. In certain circumstances, a company should also evaluate the potential impact of pending legislation and regulation related to this topic.

- *Impact of International Accords*: A company should consider, and disclose when material, the risks or effects on its business of international accords and treaties relating to climate change.

- *Indirect Consequences of Regulation or Business Trends:* Legal, technological, political and scientific developments regarding climate change may create new opportunities or risks for companies such as:

  - Decreased demand for goods that produce significant greenhouse gas emissions, or

  - Increased demand for goods that result in lower emissions than competing products.

A company should consider, for disclosure purposes, the actual or potential indirect consequences it may face due to climate change related regulatory or business trends.

- **<u>Physical Impacts of Climate Change</u>: Companies should also evaluate for disclosure purposes, the actual and potential material impacts of environmental matters on their business.**

In October 2011, the SEC also issued guidance on cybersecurity and referenced the fact that SEC companies should disclose the risk of cyber incidents as significant risk factors, as well. Thus, once the SEC opened the notion that companies should address climate change/sustainability disclosures, it validated such disclosures.

Are sustainability disclosures going to become a requirement under GAAP?

There is a movement afloat to further push the SEC to force public companies to make disclosures related to risks associated with climate change, sustainability, and other environmental risks. Although a company's financial statement users may be interested in the overall risks surrounding a company, query whether such information should involve risks that, in and of themselves, might be remote and, if active, would have a long-term (not short-term) impact on the entity, such as climate change and sustainability.

The purpose of this section of the course is to educate the reader as to the trend that is occurring in requiring companies to expand disclosures of sustainability and the advent of the SASB movement.

First, let's look at the basic SEC rules related to disclosures of risks and uncertainties.

<u>GAAP disclosure requirements:</u>

The GAAP rules for disclosing risks and uncertainties are found in ASC 275, *Risks and Uncertainties* (formerly SOP 94-6), and apply to all companies.

ASC 275 requires reporting entities to make disclosures in their financial statements about the risks and uncertainties existing as of the date of those statements in the following areas:

a. Nature of operations
b. Use of estimates in the preparation of financial statements
c. Certain significant estimates
d. Current vulnerability due to certain concentrations (e.g., major customers, suppliers, etc.)

ASC 275's disclosure requirements *<u>do not apply</u>* to risks and uncertainties that might be associated with any of the following:

- Management or key personnel
- Proposed changes in government regulations
- Proposed changes in accounting principles
- Deficiencies in the internal control structure, and
- The possible effects of acts of God, war, or sudden catastrophes.

The following chart compares the disclosure requirements for risks and uncertainties under SEC and GAAP rules:

Disclosures of Risks and Uncertainties	
SEC	**GAAP**
SEC Regulation S-K requires disclosure of: *Risk factors (Item 503)*: Requires disclosure of the most *significant factors* that make an investment in the registrant speculative or risky.	*ASC 275, Risks and Uncertainties (formerly SOP 94-6) requires disclosure of:* *Current Vulnerability Due to Certain Concentrations:* Requires disclosure of the concentrations if, based on information known to management before the financial statements are issued or are available to be issued, and all of the following criteria are met: • The concentration exists at the date of the financial statements. • The concentration makes the entity vulnerable to the risk of a ***near-term severe impact (within one year).*** • It is at least *reasonably possible* that the events that could cause the severe impact will occur in the near term.

SEC puts pressure on SEC companies to expand climate change/risk disclosures:

In looking at the GAAP and SEC disclosures related to climate issues, the rules that push companies to expand climate change/risk disclosures are found within the SEC rules, not the GAAP rules.

Recapping, Regulation S-K requires companies to disclose environmental issues as they relate to:

a. Description of business (Item 101)
b. Legal proceedings (Item 103)
c. **Risk factors (Item 503)**
d. Management Discussion and Analysis (Item 303)

Notice that the author highlighted "risk factors" because this is the section of the Regulation S-K rules that the SASB and SEC are using the force companies to expand their environmental and climate risk disclosures.

What is the future of climate change (sustainability) disclosures?

SEC companies continue to be under pressure from environmental groups and the SEC to expand their disclosures of the potential risks associated with climate change and sustainability. Expansion of

disclosures related to climate change/sustainability is just a symptom of a much larger challenge. In some instances, companies are being sued for not having effective climate change/sustainability disclosures.

Although the FASB does not have a specific project in the works to enhance disclosures invol-ving environmental issues and climate change, expect this to change in the next few years. It is common for GAAP changes to start with proposed changes and enhancements for public company disclosures and then to be applied to nonpublic companies.

With the intensive drive of the SASB movement, it is just a matter of time before the FASB is coerced into expanding climate change and other environmentally related disclosures for all companies, public and nonpublic, alike.

Are nonpublic companies required to make disclosures about climate change?

Using today as a snapshot in time, nonpublic companies *are not required* to make climate change disclosures unless it is reasonably possible that the climate change risk could expose the company to *a near-term (one year or less) severe impact* on its operations. In most cases, such a risk does not exist.

Because SEC rules do not apply to nonpublic companies, the GAAP rules for disclosing risks and uncertainties are found in ASC 275, *Risks and Uncertainties* (formerly SOP 94-6).

ASC 275 requires that reporting entities shall make disclosures in their financial statements about the risks and uncertainties existing as of the date of those statements in the following areas:

a. Nature of operations
b. Use of estimates in the preparation of financial statements
c. Certain significant estimates
d Current vulnerability due to certain concentrations.

ASC 275's disclosure requirements do not encompass risks and uncertainties that might be associated with any of the following:

- Management or key personnel
- Proposed changes in government regulations
- Proposed changes in accounting principles
- Deficiencies in the internal control structure
- The possible effects of acts of God, war, or sudden catastrophes.

Out of the four disclosures required for risks and uncertainties, the only one that could require a nonpublic entity to make general climate change disclosures would be the disclosure about the "*current vulnerability due to certain concentrations.*"

Current vulnerability due to certain concentrations disclosure and climate/sustainability risk

ASC 275 states that the vulnerability from concentrations arises because an entity is exposed to risk of loss greater than it would have had it mitigated its risk through diversification.

Financial statements shall disclose the concentrations if, based on information known to management before the financial statements are issued or are available to be issued, all of the following criteria are met:

1. The concentration exists at the date of the financial statements.

2. The concentration makes the entity vulnerable to the risk of a *near-term severe impact*.

3. It is at least *reasonably possible* that the events that could cause the severe impact will occur in the near term.

In order for there to be a concentration that exposes an entity to a *near-term severe impact*, it must be at least *reasonably possible* that such a severe impact will occur in the near term.

ASC 275 defines *near term*, and *severe impact* as the following:

> **Near term:** is defined as a period of time *not to exceed one year* from the date of the financial statements.
>
> **Severe impact:** is defined as a *significant financially disruptive effect on the normal functioning of an entity*. Severe impact is a higher threshold than material. Matters that are important enough to influence a user's decisions are deemed to be material, yet they may not be so significant as to disrupt the normal functioning of the entity.

Examples of group concentrations:

Concentrations can fall into the following categories, among others:

a. Concentrations in the volume of business transacted with a particular customer, supplier, lender, grantor, or contributor.

b. Concentrations in revenue from particular products, services, or fund-raising events.

c. Concentrations in the available sources of supply of materials, labor, or services, or of licenses or other rights used in the entity's operations.

d. Concentrations in the market or geographic area in which an entity conducts its operations.

So, do the concentration of risk rules under ASC 275 require a nonpublic company to make general risk disclosures about climate change?

The author believes there is *no concentration of risk* that requires disclosure pertaining to climate change or overall climate risk.

Here is the reason.

First, in order to have a concentration of risk and uncertainty disclosure under ASC 275, there must be a concentration of some kind.

Then, *three conditions* must be satisfied:

a. The concentration must exist at the date of the financial statements.

b. The concentration must make the entity vulnerable to the risk of a ***near-term severe impact.***

c. It must be at least *reasonably possible* that the events that could cause the severe impact will occur in the near term.

As to climate change or general environmental disclosures, in order to the disclosure rules of ASC 275 to apply, *three requirements* must be satisfied:

First, the concentration (exposure to climate change) must exist at the date of the financial statements. There could certainly be a concentration, particularly if an entity operates in an industry that is exposed to the risks from climate change.

Second, the concentration (e.g., exposure to climate or environmental change) must make the entity vulnerable to a risk of a *near term, severe impact*. That means that the concentration (climate change) must expose the company to a *significant financially disruptive effect on the normal operations*, and it must be reasonably possible that it will occur *within one year* from the balance sheet date.

Third, it must be *reasonably possible* (less than probable and greater than remote) that the events that could occur (e.g., climate change) could cause a near term severe impact.

The problem with climate change is that if it is real, it has its effect gradually over time and not necessarily within one year from the balance sheet. Thus, the ASC 275 rule that discloses that it is reasonably possible that the concentration of risk could cause a near-term severe impact, is not likely to apply.

There is one additional point that supports that climate change disclosures are not required for nonpublic entities under ASC 275. Specifically, ASC 275's disclosure requirements do not apply to risks and uncertainties that might be associated with any of the following:

- Management or key personnel
- Proposed changes in government regulations
- Proposed changes in accounting principles
- Deficiencies in the internal control structure
- ***The possible effects of acts of God, war, or sudden catastrophes.***

Notice that the fifth exception is a concentration related to "*the possible effects of acts of God, war, or sudden catastrophes*." There is an argument that climate change is an act of God for which GAAP (ASC 275) exempts disclosure of the risks and uncertainties.

In conclusion, unless a nonpublic entity is exposed to a short-term (one year or less) severe impact on its business due to climate change, there is no disclosure required for that nonpublic entity.

AICPA is getting into the sustainability game

It appears that sustainability engagements are becoming big business as more SEC companies are either compelled or motivated to engage in sustainability reporting.

In December 2012, the AICPA created a *Sustainability Task F*orce to address sustainability issues. The Task Force was created under the guidance of the AICPA Assurance Services Executive Committee (ASEC).

SOP 13-1

In August 2012, the AICPA Auditing Standards Board (ASB) issued SOP 13-1, *Attest Engagements on Greenhouse Gas Emissions Information*, which addresses attest engagements on greenhouse gas emissions information. The SOP superseded previously issued SOP 03-2 under the same title.

SOP 13-1 provides guidance for practitioners who perform an *examination or a review* under the attestation standard, of a greenhouse gas emissions statement containing either a schedule with the subject matter or an assertion relating to information about an entity's greenhouse gas (GHG) emissions.

The AICPA previously issued SOP 03-2, *Attest Engagements on Greenhouse Gas Emissions Information*, to provide guidance to CPAs on how to apply the attestation standards to GHG emissions reporting for an examination level of service with the expectation that it would be used to satisfy requirements for assurance in connection with GHG trading schemes or regulatory submissions.

According to the ASB, companies are primarily interested in *voluntarily adding more credibility* to green information they are reporting. Many companies seek a cost-effective means to do such reporting other than an examination under the attestation standard.

To respond to this need, SOP 13-1 updates SOP 03-2 by including guidance on how to apply the attestation standards for a *review engagement* to the specific subject matter of GHG emissions information.

Proposed attestation standard- sustainability information

In May 2015, the AICPA Sustainability Task Force considered drafting a proposed attestation standard that addresses examinations and reviews of sustainability information and, simultaneously, a guide that provides more detailed implementation guidance.

That project is pending.

N. The Politics of Disclosures

As the author discussed in the previous section, there is a movement afloat to force public companies to expand environmental disclosures including those related to greenhouse gases (GHG) and climate change. Although there may be some useful information that such disclosures provide stakeholders, there is little doubt that politics has playing some role in the SEC’s push toward expanded disclosures.

Expanding environmental disclosures is not the only example where public company disclosures are a byproduct of the political landscape.

Dodd-Frank Wall Street Reform and Consumer Protection Act has made monumental changes to many aspects of the financial services industry. Embedded in Dodd-Frank is a series of disclosures that public companies are now required to disclose in many of their public reports including those issues quarterly, annually and proxy statements. Luckily, Dodd-Frank does not apply to nonpublic entities.

Following is a chart that summarizes the key provisions found in Dodd-Frank that affect disclosures:

New Disclosures Under Dodd-Frank Act	
Section and required disclosure	**When required**
Section 942: Requires issuers of asset-backed securities, at a minimum, to disclose asset-level or loan-level data, including: • data having unique identifiers relating to loan brokers or originators • the nature and extent of the compensation of the broker or originator of the assets backing the security, and • the amount of risk retention by the originator and the securitizer of such assets.	Registration statements
Section 951: Requires disclosure of: • any agreements that a company has with its executive officers concerning any compensation that a company will pay out to its executive officers that is based on the acquisition, merger, consolidation, sale, or disposition of substantially all of the assets, and the total compensation that may be paid and the conditions upon which it will be paid.	Proxy or consent material
Section 952: Requires disclosure of whether: • a company's compensation committee retained or obtained the advice of a compensation consultant, and • the work of the compensation consultant has raised any conflict of interest and, if so, the nature of the conflict and how the conflict is being addressed.	Proxy or consent material
Section 953: Requires disclosure of: • the median of the annual total compensation of all employees of the issuer, except the chief executive officer (a) • the annual total compensation of the chief executive officer (or any equivalent position) of the issuer (b), and • the ratio of (a) to (b).	Proxy or consent material

Section 955: Requires disclosure as to whether any employee or member of the board of directors is permitted to purchase financial instruments that are designed to hedge or offset any decrease in the market value of equity securities: • granted to the employee or member of the board of directors as part of the company compensation, or • held, directly or indirectly, by the employee or member of the board of directors.	Proxy or consent material
Section 1502: Requires disclosure when a company uses "conflict minerals" (gold, wolframite, columbite-tantalite, etc.) that are necessary to the functionality or production of its product (such as jewelry manufacturing, etc.): • whether conflict minerals originated in the Democratic Republic of the Congo (DRC) or an adjoining country. Note: If "conflict minerals" did originate in the DRC, the company must submit an audited report to the SEC that includes a description of the measures taken to exercise due diligence on the source and chain of custody of such minerals. • a description of the products manufactured that are not DRC conflict free, the entity that conducted the independent private sector audit, the facilities used to process the conflict minerals, the country of origin of the conflict minerals, and the efforts to determine the mine or location of origin with the greatest possible specificity. Note: "DRC conflict free" means products that do not contain minerals that directly or indirectly finance or benefit armed groups in the Democratic Republic of the Congo or an adjoining country.	Annual reports and filings
Section 1503: If a company or its subsidiary is an operator of a coal or other mine, the company must disclose the following: 1. For each coal or other mine: • the total number of violations of mandatory health or safety standards that could significantly and substantially contribute to the cause and effect of a coal or other mine safety or health hazard for which the operator received a citation from the Mine Safety and Health Administration • the total number of orders • the total number of citations and orders for unwarrantable failure of the mine operator to comply with mandatory health or safety standards	Quarterly and 8K reports

• the total number of flagrant violations • the total number of imminent danger orders issued • the total dollar value of proposed assessments from the Mine Safety and Health Administration • the total number of mining-related fatalities • the receipt of an imminent danger order issued by the Federal Mine Safety and Health Act, and • the receipt of written notice from the Mine Safety and Health Administration that the coal or other mine has a pattern of violations of mandatory health or safety standards that are of such nature as could have significantly and substantially contributed to the cause and effect of coal or other mine health or safety hazards, or the potential to have such a pattern. 2. A list of such coal or other mines, of which the company or its subsidiary is an operator, that receive written notice from the Mine Safety and Health Administration of: • a pattern of violations of mandatory health or safety standards that are of such nature as could have significantly and substantially contributed to the cause and effect of coal or other mine health or safety hazards, or • the potential to have such a pattern. 3. Any pending legal action before the Federal Mine Safety and Health Review Commission involving such coal or other mine.	
Section 1504: Requires each resource extraction company (oil, natural gas, or minerals) to disclose any payment made by the company (directly or indirectly) to a foreign government or the Federal Government for the purpose of the commercial development of oil, natural gas, or minerals, including: • the type and total amount of such payments made for each project of the resource extraction issuer relating to the commercial development of oil, natural gas, or minerals, and • the type and total amount of such payments made to each government.	Annual reports and filings
Source: Dodd-Frank Wall Street Reform and Consumer Protection Act	

There are other bills pending that would require companies to disclose information ranging from political contributions to details about business dealings with Iran.

Observation: As the reader looks at the list of disclosures required by Dodd-Frank, few of them have anything to do with providing meaningful information to investors. Instead, information such as the purchase of conflict minerals in the Democratic Republic of Congo, or the safety record of coal mine

operators, are politically charged and most likely forced into the Dodd-Frank law by constituents with an agenda. Because Congress funds the SEC, it can use the SEC to coerce public companies to adopt certain actions to avoid being "shamed" through public disclosure. For example, shareholders of a diamond company may not care whether the company purchases diamonds from the Congo as long as the company is profitable and stock price remains high. Now change that fact as the company is required to disclose that it purchases certain materials from the Congo. Once that disclosure becomes public, stakeholders may place pressure on the company to change its policy to avoid the publicity that may result from the disclosure. Similarly, it should be irrelevant how much a company pays its executives in relation to its employees as executive compensation is generally the responsibility of a company's board of directors who, in turn, represent the shareholders. Section 953 of Dodd-Frank adds a new disclosure in which a company is required to disclose the ratio of compensation made to its employees as a multiple of executive compensation. Why is this information relevant if the company has a board of directors? The answer is that it is not relevant and is required solely to appease certain groups that believe executives are overpaid.

In light of the recent expansion of company disclosures lead by Dodd-Frank, one has to ask where disclosures are headed and whether Congress, through the SEC, will continue with its effort to expand company disclosures as a means to promote a political agenda instead of doing its job, which is to protect investors within the marketplace.

Will the Dodd-Frank disclosures spread into the financial statements of nonpublic companies?

It is not clear. The SEC has the power to put pressure on the FASB to enhance disclosures. Although the emphasis in expanding disclosures surrounds public companies, we continue to see the FASB's unwillingness to carve out disclosure exclusions for nonpublic companies.

One can see a future in which there is an expansion of politically charged disclosures that are wrapped into existing GAAP.

SEC focuses on missing disclosures

Beyond the new requirements under Dodd-Frank, the SEC has expanded its review of company disclosures in annual and interim reports.[37]

SEC comment letters have focused on the following key areas:

1. Revenue Recognition, including the accounting policy used

2. Related-party transactions and disclosures

3. Fair-value measurements, including management's judgment used to determine fair value

4. Intangible assets and goodwill, including testing for impairment

5. Disclosure controls including wording used in the certificate

6. Executive compensation

[37] Audit Analytics, as published by CFO.com.

7. Management Discussion and Analysis, including more information about liquidity, accounting estimates and capital resources

8. Segment reporting including how companies are dividing business units

9. Non-GAAP measures, including information that is being disclosed in press releases, websites, and analyst calls, and

10. Debt and equity issues including valuation and disclosure.

SEC conflict minerals disclosures

On August 22, 2012, the SEC adopted rules requiring companies to publicly disclose their use of conflict minerals that originated in the Democratic Republic of the Congo or an adjoining country.

The rules were mandated by Section 1502 of the Dodd-Frank Act and Section 13(p) of the Securities Exchange Act of 1934 (the "Exchange Act"). Section 1502 directs the SEC to issue rules requiring certain companies to disclose their use of conflict minerals if those minerals are "necessary to the functionality or production of a product" manufactured by those companies.

The scope of the new rules is expansive, both in terms of the number of public companies potentially impacted and the extent of information required to be reported. The expense required to comply with the new rules will be substantial for those companies required to make the disclosure.

The disclosures required under the new rules will be filed on a "Conflict Minerals Report" using a new form, Form SD. The first reports cover calendar year ended December 31, 2013 and were due *May 31, 2014*.

For purposes of the new rules, "*conflict minerals*" are defined as:

- cassiterate
- columbite-tantalite (also known as coltan)
- gold, and
- wolframite and their derivatives: tantalum, tin and tungsten.

These conflict minerals are commonly known to originate, and in some cases, finance armed groups, in the Democratic Republic of Congo and the adjoining countries that include Angola, Burundi, the Central African Republic the Republic of Congo, Rwanda, Sudan, Tanzania, Uganda and Zambia (collectively, the "Covered Countries").

Under the rules, companies must take a three-step process:

Step One: A company must determine if it is subject to the new rules based on its use of conflict minerals.

a. A company is subject to the rules if:

1) it is a public company under SEC, and

2) conflict minerals are necessary to the *functionality* or *production of a product manufactured by the company* or *contracted by the company to be manufactured*.

   Note: Whether a company "contracts to manufacture" a product depends on the degree of influence exercised by the issuer on manufacturing of the product. The SEC has indicated that issuers will not be viewed as "contracting to manufacture" a product if their actions involve no more than:

   - specifying or negotiating contractual terms with a manufacturer that do not relate directly to manufacturing of the product

   - affixing its brand, marks, logo, or label to a generic product manufactured by a third party, and

   - servicing, maintaining, or repairing a product manufactured by a third party. But it is understood, for example, that a semiconductor supplier that relies on third party foundries for production of its products would ordinarily be covered by the rules.

Step Two: A company that is subject to the rules must conduct a country of origin inquiry to determine if the conflict minerals it uses originated in one of the Covered Countries or came from recycled or scrap sources.

Step Three: A company that determines, or has reason to believe, that its conflict minerals originated in a Covered Country and are not from recycled or scrap sources must conduct diligence as to the source and chain of custody and may be required to file a *Conflict Minerals Report.*

a. All conflict minerals disclosures must be provided using new Form SD.

   Note: The disclosure will not be automatically incorporated into registration statements filed under the Securities Act of 1933 and will not be covered by executive officer certifications required in connection with the Form 10-K.

What is the estimated cost of compliance with the conflict minerals disclosure?

The SEC estimates the initial compliance costs for the Conflict Minerals Rule to be about $3 to $4 billion, and ongoing compliance costs at about $200 to $600 million annually.

Retailers and the conflict minerals rule

In the first version of the SEC rule, retailers such as Target and Wal-Mart that sell goods produced by outside contractors would have been subject to the conflict minerals rule if they sold retail products under their own brand. However, in the final vote, the SEC ruled that such retailers are exempt from the conflict minerals rule, if they don't have any control over the manufacture of products sold under their brand name.

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self - study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

1. Why has the Big GAAP-Little GAAP movement received new impetus over the past few years:
   a. Many changes that will be required by the single set of international GAAP standards will not be important to public entities
   b. Recent controversial FASB statements and interpretations are costly and difficult for nonpublic entities to implement
   c. The Sarbanes-Oxley Act mandates that the FASB's funding come from nonpublic entities
   d. There is no large business representation or perspective on the FASB

2. Which of the following is one of the controversial statements that is difficult to implement for smaller closely held companies:
   a. Consolidation of Variable Interest Entities
   b. Disclosure about Fair Value of Financial Instruments
   c. Earnings Per Share
   d. Segment Reporting

3. Under the Blue Ribbon Panel Report on GAAP for private companies, how did the Panel recommend that GAAP for private companies be monitored:
   a. Establish a new separate private company standards board
   b. Have the FASB add two new board members that are from private companies
   c. Have the AICPA take over monitoring GAAP for private companies
   d. Have the SEC carve out staff to monitor GAAP for private companies

4. Which of the following is an accounting principle that is part of AICPA's FRF for SMEs:
   a. Fair value is used instead of historical cost
   b. Tax return depreciation is used
   c. Deferred income taxes are still be required
   d. Goodwill is amortized over the tax life of 15 years

5. Prior to the issuance of ASU 2014-15, the going concern assessment was done by _____.
   a. The auditor
   b. Management
   c. Board of directors
   d. No assessment is done

6. Which of the following is not an example of a disclosure required under Regulation S-K in connection with environmental issues:
   a. Description of business
   b. Legal proceedings
   c. Risk factors
   d. Going concern

7. Which of the following is an example of a disclosure related to environmental issues required by a company under GAAP, in addition to those disclosures required under Regulations S-K and S-X:
   a. Revenue recognition
   b. Going concern
   c. Operating performance
   d. Risks and uncertainties

8. Which of the following is correct with respect to the requirement for nonpublic companies to make disclosures about climate change:
   a. GAAP requires such disclosures in all cases
   b. GAAP does not require such disclosures because the author believes there is no climate change
   c. GAAP does not require such disclosures because there is no concentration
   d. GAAP requires such disclosures for companies that have their manufacturing plants located on a waterway

9. Section 952 of Dodd-Frank does which of the following*:*
   a. Requires disclosure regarding asset-level or loan-level data
   b. Requires disclosure of the median of the annual total compensation
   c. Requires disclosure regarding advice of a compensation consultant
   d. Requires disclosure about whether an employee or board member is permitted to purchase financial instruments

10. In order for a company to be subject to the use of conflict minerals disclosure rules, conflict minerals must be necessary to the _____.
    a. Distribution of a product
    b. Production of a product manufactured
    c. Retailing of a product
    d. Expansion of the product

SUGGESTED SOLUTIONS

1. Why has the Big GAAP-Little GAAP movement received new impetus over the past few years:
   a. Incorrect. The FASB and IASB are working on an international standards convergence project that will ultimately result in one set of international GAAP standards. Changes will be required to existing U.S. GAAP standards and many of those changes will not be important to nonpublic entities.
   b. **Correct. The FASB has issued several extremely controversial FASB statements and interpretations that are costly and difficult for nonpublic entities to implement and are not meaningful to the third parties they serve. One example is the issuance of ASC 810 (formerly FIN 46R).**
   c. Incorrect. Sarbanes-Oxley mandates that FASB's funding come primarily from SEC registrants, thereby suggesting that the FASB's focus continue to be on issues important to public entities, not nonpublic entities.
   d. Incorrect. Actually, accountants from smaller firms are not serving as FASB staff or board members, which results in no small business representation or perspective on the FASB.

2. Which of the following is one of the controversial statements that is extremely difficult to implement for smaller nonpublic companies:
   a. **Correct. Consolidation of Variable Interest Entities requires certain companies to consolidate off-balance sheet entities referred to as variable interest entities. Since its inception, it has been quite difficult for smaller companies to implement as it requires technical expertise and knowledge of FIN 46R.**
   b. Incorrect. In issuing Disclosure about Fair Value of Financial Instruments, the FASB chose to limit its application to public companies and large nonpublic entities. Thus, smaller nonpublic companies are exempt from its application.
   c. Incorrect. Because nonpublic entities are exempt from Earnings Per Share, its implementation by nonpublic entities is moot.
   d. Incorrect. Segment Reporting is one instance where the FASB has limited GAAP to public companies, thereby exempting nonpublic entities. Thus, it is not difficult to implement because it does not apply to nonpublic companies.

3. Under the Blue Ribbon Panel Report on GAAP for private companies, how did the Panel recommend that GAAP for private companies be monitored*:*
   a. **Correct. The Panel recommended that a new separate private company standard board be established to ensure that sufficient exceptions and modifications are made to GAAP for private companies.**
   b. Incorrect. The Panel did not recommend that the FASB be involved in monitoring GAAP for private companies.
   c. Incorrect. The Panel did not mention having the AICPA take over monitoring GAAP for private companies.
   d. Incorrect. The SEC deals with public companies and not private companies.

4. Which of the following is an accounting principle that is part of AICPA's FRF for SMEs:
   a. Incorrect. Historical cost is the model. Fair value is eliminated except for available for sale securities.
   b. Incorrect. Depreciation is based on useful lives of assets, not tax return depreciation.
   c. Incorrect. A company has a choice of recording deferred income taxes or booking only the current taxes payable.
   d. **Correct. The principle for goodwill is that goodwill is amortized over the tax life of 15 years in most cases.**

5. Prior to the issuance of ASU 2014-15, the going concern assessment was done by _____.
   a. **Correct. Prior to the FASB issuing ASU 2014-15, the going concern assessment was found only in auditing literature in AU-C 570, and not GAAP.**
   b. Incorrect. Prior to the issuance of ASU 2014-15, there was no requirement for management to assess going concern.
   c. Incorrect. There has never been a requirement for the board of directors to assess going concern.
   d. Incorrect. Auditing standards have required that an auditor perform a going concern assessment, making the answer incorrect.

6. Which of the following is not an example of a disclosure required under Regulation S-K in connection with environmental issues:
   a. Incorrect. Item 101 of Regulation S-K does require disclosures within the description of business including the material effects that compliance with environmental laws may have upon the company.
   b. Incorrect. Item 103 of Regulation S-K does require disclosure of legal proceedings including any material pending legal proceeding to which the company is a party.
   c. Incorrect. Item 503 of Regulation S-K requires disclosure of the most significant risk factors related to an investment in a registrant.
   d. **Correct. Regulation S-K does not have a specific disclosure related to going concern.**

7. Which of the following is an example of a disclosure related to environmental issues required by a company under GAAP, in addition to those disclosures required under Regulations S-K and S-X:
   a. Incorrect. Although there are disclosures required for revenue recognition, they do not typically relate to environmental issues making the answer incorrect.
   b. Incorrect. In general, going concern disclosures do not apply to environmental issues.
   c. Incorrect. Operating performance is generally not specific to environmental issues.
   d. **Correct. ASC 275 (formerly SOP 94-6) requires disclosures related to significant estimates used to determine the carrying amounts of assets or liabilities, or in the disclosure of gain or loss contingencies, both of which may relate to environmental issues.**

8. Which of the following is correct with respect to the requirement for nonpublic companies to make disclosures about climate change:
   a. Incorrect. GAAP does not require such disclosures in all cases. In fact, the author suggests that such disclosures would be required in rare cases.
   b. Incorrect. The author does not address the climate change debate and instead states that such a disclosure is not required for other reasons.
   c. **Correct. One of the reasons why the author believes that such a disclosure is not required is because there is no concentration where it is reasonably possible that there could be a near-term severe impact. Thus, there is no disclosure required under GAAP.**
   d. Incorrect. Although a plant on the water could have additional risks of damage to operations from rising water levels, the location on the water is not likely to severely impact the entity's operations within one year. Moreover, any impact from rising water levels is likely to be considered an act of God for which GAAP has a disclosure exemption.

9. Section 952 of Dodd-Frank does which of the following:
   a. Incorrect. Section 942, not Section 952, requires issuers of asset-backed securities to disclosure asset-level or loan-level data.
   b. Incorrect. Section 953, not Section 952, requires disclosure of the median of the annual total compensation of all employees of the issuer.
   c. **Correct. Section 952 requires disclosure about whether a company's compensation committee retained or obtained the advice of a compensation consultant. Thus, the answer is correct.**
   d. Incorrect. Section 955, not Section 952, requires disclosure as to whether any employee or member of the board of directors is permitted to purchase financial instruments that are designed to hedge or offset any decrease in the market value of equity securities.

10. In order for a company to be subject to the use of conflict minerals disclosure rules, conflict minerals must be necessary to the _____.
   a. Incorrect. Distribution of a product does not make an entity subject to the conflict mineral rules.
   b. **Correct. Conflict minerals must be necessary to the functionality or production of a product manufactured by the company, making the answer correct.**
   c. Incorrect. Retailers are exempt from the conflict mineral rules making the answer incorrect.
   d. Incorrect. Expansion of the product is not an action that makes an entity subject to the conflict mineral rules.

O. FASB's Eliminates Classification Shifting: Extraordinary Items and Discontinued Operations

Over the past two years, the FASB has taken steps to eliminate or significantly reduce the application of two items on the statement of income, that are presented net of tax. They are:

- Discontinued operations, and
- Extraordinary items

In 2014, the FASB issued ASU 2014-08 *Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity,* which tightens the discontinued operations rules so that fewer transactions now qualify as discontinued operations.

In 2015, the FASB issued *ASU 2015-01- Income Statement—Extraordinary and Unusual Items (Subtopic 225-20) Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items,* which eliminates the concept of extraordinary items altogether starting in 2016.

Background

Before the author reviews the new rules found in ASU 2014-08 (discontinued operations) and ASU 2015-01 (extraordinary items), let's do a quick review of the existing GAAP rules for discontinued operations and extraordinary items, and the motivation that management has had to move transactions below the line into these categories.

Existing GAAP requires discontinued operations and extraordinary items to be presented below income from continued operations, net of the tax effect, as follows:

Income from continuing operations before income taxes	$XX
Income taxes	XX
Income from continuing operations	XX
Discontinued operations (net of taxes of $XX)	(XX)
Extraordinary item (net of taxes of $XX)	(XX)
Net income	$XX

Existing GAAP- discontinued operations

The rules for discontinued operations have been found in ASC 205, *Presentation of Financial Statements,* which states:

1. The results of operations of a *component of an entity* that either has been disposed of or is classified as held for sale shall be reported in discontinued operations if *both* of the following conditions are met:

- The operations and cash flows of the *component have been (or will be) eliminated* from the ongoing operations of the entity as a result of the disposal transaction, and

- The entity *will not have any significant continuing involvement* in the operations of the component after the disposal transaction.

2. A component of an entity is defined as operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity, and may consist of a reportable segment, operating segment, reporting unit, subsidiary, or an asset group.

Note: The definition of discontinued operations that has been in place has made it easy to qualify an individual transaction within the discontinued operations category. All that was required was that a) the component be eliminated from the ongoing operations, and b) the entity not have any significant continuing involvement in the operations of the component.

The definition of a discontinued operation, and the criteria for reclassifying asset disposals as discontinued operations, has changed over time. The original APB Opinion No. 30, *Reporting the Results of Operations*, provided that only dispositions of "business segments" could qualify as being reported as discontinued operations. APB No. 30 defined a business segment as a "major line of business or a customer class." The current definition found in ASC 205, *Presentation of Financial Statements*, uses the "component of an entity" as a more liberal threshold that replaced the business segment concept.

Prior GAAP- extraordinary items

For years, the rules for extraordinary treatment have been found in ASC 225-20, *Income Statement, Extraordinary and Unusual Items*, which defines an extraordinary transaction as one that satisfies two criteria:

a. *Unusual nature:* The underlying event or transaction should possess a high degree of abnormality and be of a type clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the entity, taking into account the environment in which the entity operates and,

b. *Infrequency of occurrence*: The underlying event or transaction should be of a type that would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the entity operates.

Is a company motivated to move losses and expenses into discontinued operations or extraordinary items?

Several studies have suggested that companies have taken specific steps to qualify transactions as either discontinued operations or extraordinary items to move those transactions below the line, net of tax.

Under existing GAAP rules, companies have been highly motivated to shift losses into either the discontinued operations or extraordinary items category from continuing operations, but retain income items within continuing operations.

Discontinued operations and extraordinary items have been subject to *classification manipulation*. Companies with losses from discontinued operations and losses from extraordinary items have been

motivated to position those items net of tax, below the line and out of the coveted "income from continuing operations" line which is part of core earnings.

By moving an expense or loss down to discontinued operations or extraordinary items, a company can increase three key measurements that drive stock price and value:

- Operating income
- Income from continuing operations
- Core earnings

Stock price value for a public company and the value of a nonpublic company's stock are driven by multiples of earnings, whether core earnings or earnings before interest, taxes, depreciation and amortization (EBITDA). Both measurements start with income from continuing operations. If a company shifts a loss or expense item from continuing operations to discontinued operations or extraordinary items, that shift may increase the value of that entity's stock by a multiple of 4 to 10 times.

Example: Company X has the following information for the year ended December 31, 20X1:

X's price-earnings multiple is 10 times. If the price-earnings ratio is 10 times, the value of the company is: $650,000 x 10 = $6,500,000, computed as follows:

Operating income	1,100,000
Loss from discontinued operations	(100,000)
Net income before income taxes	1,000,000
Income taxes (35%)	(350,000)
Net income	$650,000
Multiple	10
Value of X's stock	***$6,500,000***

Change the facts: X decides to classify the $100,000 loss as a discontinued operation.

Income from continuing operations before income taxes	1,100,000
Income taxes (35%)	(385,000)
Income from continuing operations	715,000
Loss from discontinued operations (net of taxes of $35,000)	***(65,000)***
Net income	$650,000
Income from continuing operations	715,000
Multiple	10
Value of X's stock	***$7,150,000***

Conclusion: By making a classification shift for the $100,000 loss from continuing operations to discontinued operations, the stock value increases from $6,500,000 to $7,150,000, all done without changing net income.

Change the facts: Assume the company is nonpublic and its value is determined based on 6 times EBITDA.

	Without DO classification	With DO classification
Net income	$650,000	$650,000
Add back DO	0	65,000
Income from CO	650,000	715,000
Add backs:		
Income taxes	350,000	385,000
Interest (GIVEN)	100,000	100,000
Depreciation/amortization (GIVEN)	50,000	50,000
EBITDA	$1,150,000	$1,250,000
Multiple factor	6	6
Value of Company X's business	$6,900,000	$7,500,000

Conclusion: Company X's value, based on a multiple of EBITDA, increases from $6,900,000 to $7,500,000 simply by classification shifting of the $100,000 loss from continuing operations to discontinued operations.

Observation: Another area is which companies have used a shift of transactions to discontinued operations is in valuing an entity for estate and gift planning purposes. By shifting income (rather than losses) to discontinued operations, an entity effectively reduces the valuation by a multiple of the item shifted.

For example, if an entity can justify shifting a $100,000 gain to discontinued operations, that $100,000 gain will not be included in EBITDA so that the valuation will be reduced by $600,000 before applying any discounts.

Is there evidence that companies have engaged in classification shifting to manipulate earnings and stock value?

There have been several studies that have concluded that companies continue to play the game of "classification shifting" by moving transactions from continuing operations to discontinued operations or extraordinary items. This trend has occurred particularly with respect to losses.

Two recent studies provide empirical evidence that companies have and continue to shift losses and expenses from continuing operations to discontinued operations or extraordinary items.

1. Earnings Management Using Classification Shifting: An Examination of Core Earnings and Special Items (Sarah Elizabeth McVay)

2. *Earnings Management Using Discontinued Operations* (Abhijit Barua, Steve Lin, and Andrew M. Sbaraglia, Florida International University)

One of the studies focuses on use of extraordinary items in classification shifting, while the other one focuses on the shift of losses to discontinued operations.

Following are some of the conclusions reached by the two studies:

1. Companies are highly motivated to shift loss and expense items from continuing operations to discontinued operations and extraordinary items to manipulate stock value.

    a. Unlike accrual manipulation, there is no "settling-up" in the future for past earnings management.

        - If a manager decides to increase earnings using income-increasing accruals, then, at some point, the accruals must reverse. The reversal of the accruals reduces future reported earnings. In contrast, *classification shifting involves simply reporting recurring expenses in a nonrecurring classification on the income statement*, having no implications for future earnings.

    b. Because classification shifting does not change net income, it is potentially subject to less scrutiny by auditors and regulators than forms of earnings management that change net income.

    c. Shifting losses and expenses from continuing operations to discontinued operations or extraordinary items, is an easy form of managed earnings to increase stock price without changing net income:

        - Net income does not change, but operating income, income from continuing operations and core earnings do change.

2. There is empirical evidence that companies have actually engaged in classification shifting to augment operating income, income from continuing operations, and core earnings:

    a. Companies regularly classify losses from continuing operations to discontinued operations to increase core earnings.

    b. Companies classify operating expenses to discontinued operations. Such a shift is not easy for investors to identify because the *details of discontinued operations are not disclosed*.

    c. One key reason why there has been an expansion in classification shifting to discontinued operations is due to the issuance of FASB No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (now part of ASC 360).

        - FASB No. 144 (now ASC 360) broadened the definition of discontinued operations by replacing the business segment requirement under APB No. 30 with the *component of an entity* concept.

Note: The ability of asset disposals to be classified as discontinued operations has changed over time. The original APB Opinion No. 30 provided that only dispositions of "business segments" could qualify for being reported as discontinued operations. APB No. 30 defined a business segment as a "major line of business or a customer class."

Then, the FASB liberalized the definition of a discontinued operations with the issuance of FASB No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets (now part of ASC 360).*

ASC 360 (formerly FASB No. 144) reduced the threshold for recognition of discontinued operations treatment by replacing the concept of "business segment" with a broader concept of "component of an entity." ASC 360's current definition of a component of an entity treats a component separately from the rest of the entity because the component has its own clearly defined operations and cash flows. Moreover, a component can be a reportable segment, an operating segment, a reporting unit, a subsidiary, or an asset group. ASC 360's reduction in the threshold for discontinued operations has encouraged companies to classify more asset disposals as discontinued operations. Thus, if those disposals result in losses, management has the perfect situation in which to shift those losses into discontinued operations.

Classification shifting- less risk to the CEO and CFO

One reason why management of a company might engage in classification shifting to discontinued operations and extraordinary items is because it creates far less exposure to the CEO and CFO.

Because the classification shifting does not alter net income, there is less exposure to the CEO or CFO for a few reasons:

1. Sarbanes Section 302 certification of the financial statements (for SEC companies only) focuses on net income.

2. Sarbanes Section 304 and Dodd-Frank Section 954 clawback provisions are triggered based on *restatement of net income* and not necessarily affected by restatements due to classification shifting.

3. It is difficult for a CEO or CFO to be charged with financial statement fraud due to classification shifting which is very subjective and does not impact net income.

The result is that classification shifting may be the most effective technique used by unscrupulous executives who want to drive stock price and entity value, without affecting net income.

FASB attacks extraordinary items and discontinued operations

Over the past decade, the FASB has taken actions to reduce the number of transactions that qualify as either discontinued operations or extraordinary items. Those actions culminated with the FASB's issuance of two statements in 2014 and 2015 as follows:

ASU 2014-08- *Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity*

ASU 2015-01- *Income Statement—Extraordinary and Unusual Items (Subtopic 225-20) Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items.*

ASU 2014-08: discontinued operations

In 2014, the FASB issued ASU 2014-08 *Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity,* which does the following:

- Changes the definition of discontinued operation to make it more difficult to qualify a transaction as a discontinued operation, and,

- Enhances disclosures about discontinued operations and individually significant components of an entity that have been (or will be) disposed.

The rules for ASU 2014-08 state the following:

1. A discontinued operation may include a:

   a. *Component (or group of components) of an entity* that either has been disposed of or is classified as held for sale, or

   b. *Business or nonprofit activity* that, on acquisition, is classified as held for sale.

2. The ASU carries over the existing definition of a component which:

   "Comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. A component of an entity may be a reportable segment or an operating segment, reporting unit, subsidiary, or an asset group."

3. A disposal of a component of an entity or a group of components of an entity shall be reported in discontinued operations only if the disposal has *two elements*:

   a. It represents a *strategic shift,* and

   b. It has (or will have) a *major effect* on an entity's operations and financial results.

4. Strategic shift:

   a. Examples of a *strategic shift* that has (or will have) a major effect on an entity's operations and financial results could include a disposal of:

      - A major geographical area
      - A major line of business
      - A major equity method investment, or
      - Other major parts of an entity.

5. Major effect:

   a. The ASU does not define the threshold for "major effect."

      - The FASB (and SEC) unofficially use a threshold of 15-20% of either total assets, total revenue, or net income, to satisfy the "major effect" threshold.

Do the new rules in ASU 2014-08 permit the effects of a sale of a single asset to be presented as discontinued operations?

Under the current pre-ASU 2014-08 rules for discontinued operations, many companies have taken liberty to classified sales of individual assets as part of discontinued operations. This has been an effective strategy for companies to shift losses from sales of certain assets, such as real estate, out of income from continuing operations.

Now, the issue is whether the new rules allow for a effects of a sale of a single asset to be presented as part of discontinued operations. In the case of the sale of a single piece of real estate, the effect of such a sale would include not only presenting the gain or loss on sale, but also the net rental income, in the discontinued operations section of the income statement, net of the applicable tax effect.

Let's look at the analysis of single asset transaction:

Recall that the new rules in ASU 2014-08 state the following:

> *"A disposal of a component of an entity or a group of components of an entity shall be reported in discontinued operations if the disposal represents a strategic shift that has (or will have) a major effect on an entity's operations and financial results."*

The new definition requires two elements: First, the disposal must represent a *strategic shift*, and second, it must have a *major effect on the entity's operations and financial results*.

The ASU further provides examples of events that may represent a "*strategic shift*" that has, or will have, a *"major effect"* to include a disposal of:

- A major geographical area,
- A major line of business,
- A major equity method investment, or
- Other major parts of an entity

The ASU is clear that the simple sale of one major asset is not enough to qualify for discontinued operations classification because the disposal must involve a "strategic shift."

ASU 2015-01- Income Statement—Extraordinary and Unusual Items (Subtopic 225-20) Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items

More specifically, the FASB has gradually eliminated certain transactions from qualification for extraordinary treatment. In 2015, the FASB completed its effort by issuing ASU 2015-01 to eliminate, once and for all, the concept of extraordinary items, from U.S. GAAP.

Over the past decade, the FASB has issued standards to eliminate from extraordinary treatment specific transactions including:

- Extinguishment of debt
- Tax benefit of a net operating loss carryforward
- Negative goodwill
- Losses related to motor carriers
- Gains and losses related to Katrina and acts of God
- Gains and losses related to 9/11 and Boston terrorist attacks

Thus, after the elimination of specific items identified above from extraordinary treatment, the only way an entity could present a transaction as extraordinary (below the line, net of tax) was to satisfy the two criteria:

> *Unusual nature:* The underlying event or transaction should possess a high degree of abnormality and be of a type clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the entity, taking into account the environment in which the entity operates.
>
> *Infrequency of occurrence*: The underlying event or transaction should be of a type that would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the entity operates.

International standards eliminate use of extraordinary items

While the FASB was still holding onto the use of extraordinary treatment for certain transactions, the IASB in Europe had taken a different path by eliminating the extraordinary item category on the income statement.

IAS 1 *Presentation of Financial Statements*, states that an *entity shall not present any items of income or expense as extraordinary items*, in the statement of comprehensive income or the separate income statement (if presented), or in the notes.

In removing extraordinary items from international standards, the IASB indicated that the elimination of the category of extraordinary items eliminates the need for arbitrary segregation of the effects of related external events-some recurring and others not-on the profit or loss of an entity for a period.

FASB Issues ASU 2015-01- ***Income Statement—Extraordinary and Unusual Items (Subtopic 225-20) Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items.***

Finally, in 2015, the FASB removed the concept of extraordinary items from U.S. GAAP once and for all with the passage of ASU 2015-01.

ASU 2015-*01 eliminates extraordinary items from GAAP*, and is effective for fiscal years, and interim periods within those fiscal years, *beginning after December 15, 2015*. A reporting entity may apply the amendments prospectively.

In issuing ASU 2015-01, the FASB noted that it was responding to criticisms of current practice under which:

- The concept of extraordinary items causes uncertainty because it is unclear when an item should be considered both unusual and infrequent.
- Separating extraordinary items on the income statement is not necessary to identify those events and transactions.
- It is rare in current practice for a transaction or event to meet the requirements to be presented as an extraordinary item.

Now, effective for years beginning after 2015, no transactions will qualify for extraordinary income classification on the income statement.

P. GAAP for Terrorism and Nature Disasters

In April 2013, Boston was the victim of one of the U.S.'s worst terrorist attacks yet, with at least four individuals dead and more than 160 persons wounded.

More than 300 businesses in the Boylston Street, Downtown Boston area were shut down for more than a week as investigators sorted through the rubble and debris left behind by the two bombs that exploded.

Unfortunately, the effects of any terrorist attack are not limited to the immediate act that was perpetrated and extend into the lives of many individuals and businesses.

Prior to the Boston attack, there have been several large nature disasters such as Katrina and Sandy, and ongoing tornados and earthquakes.

The purpose of this section is to address some of the GAAP issues that may have to be considered as a result of gains and losses related to terrorism and acts of God.

Some of these issues were addressed going as far back as the September 11 attack in New York. Others are now being brought to the forefront as the United States now realizes that terrorism is no longer an isolated 9/11 attack, but now is an ongoing risk that is part of the fabric of the United States. GAAP issues pertaining to terrorism are now becoming relevant. As for nature disasters, they are ongoing and are likely to recur in the future.

In this section, the author addresses the following issues related to gains and losses involving terrorism and nature disasters.

1. Disclosure issues- risks and uncertainties (terrorism versus acts of God and the GAAP exception)

2. Presentation of gains and losses from terrorism and acts of God

3. Dealing with insurance including:

    - Presentation of business interruption insurance
    - Dealing with involuntary conversions for GAAP
    - Dealing with gain contingencies and insurance recoveries

1. Terrorism and disclosures of risks and uncertainties

ASC 275 requires that reporting entities shall make disclosures in their financial statements about the risks and uncertainties existing as of the date of those statements in the following areas:

a. Nature of operations
b. Use of estimates in the preparation of financial statements
c. Certain significant estimates
d. Current vulnerability due to certain concentrations.

ASC 275's disclosure requirements do not encompass risks and uncertainties that might be associated with any of the following:

- Management or key personnel
- Proposed changes in government regulations
- Proposed changes in accounting principles
- Deficiencies in the internal control structure
- The possible effects of acts of God, war, or sudden catastrophes.

Current vulnerability due to risk of a terrorist attack

ASC 275 states that the vulnerability from concentrations arises because an entity is exposed to risk of loss greater than it would have had it mitigated its risk through diversification.

Financial statements shall disclose the concentrations if, based on information known to management before the financial statements are issued or are available to be issued, all of the following criteria are met:

1. The concentration exists at the date of the financial statements.

2. The concentration makes the entity vulnerable to the risk of a *near-term severe impact*.

3. It is at least *reasonably possible* that the events that could cause the severe impact will occur in the near term.

In order for there to be a concentration that exposes an entity to a *near-term severe impact.* it must be at least *reasonably possible* that such a severe impact will occur in the near term (within one year).

ASC 275 defines near term, and severe impact as the following:

> **Near term:** is defined as a period of time *not to exceed one year* from the date of the financial statements.
>
> **Severe impact:** is defined as a *significant financially disruptive effect on the normal functioning of an entity*. Severe impact is a higher threshold than material. Matters that are important enough to influence a user's decisions are deemed to be material, yet they may not be so significant as to disrupt the normal functioning of the entity.

ASC 275's disclosure requirements do not apply to risks and uncertainties that might be associated with any of the following:

- Management or key personnel
- Proposed changes in government regulations
- Proposed changes in accounting principles
- Deficiencies in the internal control structure
- ***The possible effects of acts of God, war, or sudden catastrophes***

The question is whether the potential risk of a terrorist attack results is a current vulnerability due to terrorist attack? The same question applies to an act of God.

The answer is that *GAAP has not addressed terrorist attacks* in the capacity of whether such an attack results in a disclosure of the current vulnerability due to a terrorist attack. GAAP also does not specifically address the disclosures as they relate to acts of God or even war.

Example: Company X is a restaurant in downtown New York City. Because of its location, there is a concentration (terrorist attack) that exposes X to a *near-term severe impact.* Further, it is *reasonably possible* that a terrorist attack will occur in the near term (within the next year) and it would have a severe impact on X's business.

Does the concentration of terrorism risk result in a required disclosure under ASC 275?

On its face, the answer is yes. However, ASC 275 states that disclosure requirements do not apply to risks and uncertainties involving ***"the possible effects of acts of God, war, or sudden catastrophes."***

A terrorist attack is not necessarily an act of God, and may or may not be an act of war, but it would appear to fall into the category of a *sudden catastrophe*.

Although ASC 275 does not define the term "catastrophe" the dictionary definition is:

> *"an event causing great and often sudden damage or suffering; a disaster."*

The author believes a terrorist attack would be considered a sudden "catastrophe." Therefore, the author believes that regardless of where a business is located (downtown Manhattan, Boston), there is no disclosure requirement pertaining to a concentration of risk or uncertainty of a terrorist attack.

The same conclusion would be reached if Company X is located on the ocean and subject to the risk of a flood or hurricane. No disclosure would be required under the "possible effects of acts of God, war, or sudden catastrophes" exception.

2. Losses from terrorism and acts of God

The terrorist attack in Boston is the second major one in the United States after September 11.
Add to that the numerous acts of God involving earthquakes, floods and hurricanes.

Losses from such attacks and acts of God can be significant including:

- Physical damage to premises
- Lost revenue and profits from business shutdown
- Additional consulting fees for psychotherapists and medical care for employees
- Relocation costs
- Employee expenses to carry employees during a shutdown

Both the 9/11 and Boston terrorist attacks, and the Katrina storm, have resulted in businesses having significant losses that, in some cases, were not covered by insurance. In preparing financial statements, companies with losses from terrorism and acts of God, have asked the question as to whether such losses (or in limited cases gains) qualified for extraordinary treatment, to be shown net of tax below the line.

Through a series of Emerging Issues Task Force consensus opinions (EITFs) and practice aids, the FASB has opined as follows:

1. Gains or losses from terrorist attacks and most acts of God *do not qualify for extraordinary treatment* because they do not satisfy the unusual nature and infrequency of occurrence criteria.

    a. Although the "unusual nature" criterion may be met, the "infrequency of occurrence" criterion is not satisfied because it is reasonable to expect another terrorist attack or act of God to recur in the foreseeable future, taking into account the environment in which the entity operates.

    b. The magnitude of any loss has no impact on whether the loss qualifies for extraordinary treatment.

Note that the FASB took the same position with respect to both terrorism and acts of God, such as the Katrina floods and the losses from Sandy, both of which do not qualify for extraordinary treatment because it was reasonable that they would recur in the future.

Impact of FASB ASU 2015-01 on presentation of terrorist attack losses or gains

As discussed in the previous section to this course, in 2015, the FASB issued ASU 2015-01, *Income Statement—Extraordinary and Unusual Items (Subtopic 225-20) Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items.*

ASU 2015-01 eliminates all transactions from extraordinary treatment effective for years beginning after 2015.

Thus, the debate as to whether a gain or loss from a terrorist attack qualifies for extraordinary treatment becomes moot beginning in 2016. For 2015, any such gain or loss also does not qualify for extraordinary treatment simply because the FASB has said so.

3. Insurance recoveries from terrorist attacks

Question: How should insurance recoveries of losses and costs incurred as a result of a natural disaster, terrorist act or act of God be classified in the statement of operations and when should those recoveries be recognized?

Response: Following are the rules:

a. Any insurance recoveries of losses and costs incurred should be classified in a manner consistent with the related losses within the income from continuing operations.

b. An asset (receivable) relating to the insurance recovery should be recognized only when realization of the claim for recovery of the loss recognized in the financial statements is deemed *probable*.[38]

c. A gain should not be recognized until any contingencies relating to the insurance claim have been resolved.

Observation: In accounting for insurance payments to cover losses, entities should follow the guidance in FASB ASC 210-20; FASB ASC 225-20; FASB ASC 410-30; FASB ASC 605-40; and FASB ASC 815, *Derivatives and Hedging*.

FASB ASC 605-40 clarifies the accounting for involuntary conversions of nonmonetary assets (such as property or equipment) to monetary assets (such as insurance proceeds). It requires that a gain or loss be recognized when a nonmonetary asset is involuntarily converted to monetary assets even though an enterprise reinvests or is obligated to reinvest the monetary assets in replacement nonmonetary assets. FASB ASC 605-40-45-1 states:

> *"Gain or loss resulting from an involuntary conversion of a nonmonetary asset to monetary assets shall be classified in accordance with the provisions of Subtopic 225-20 (Extraordinary and Unusual Items)."*

That guidance generally requires that an asset relating to the insurance recovery *should be recognized only when realization of the claim for recovery of a loss recognized in the financial statements is deemed probable* (as that term is used in FASB ASC 450). In addition, under FASB ASC 450-30-25-1, a gain (that is, a recovery of a loss not yet recognized in the financial statements or an amount recovered in excess of a loss recognized in the financial statements) *should not be recognized* until any contingencies relating to the insurance claim have been resolved. It is important to note that in some circumstances, losses and costs might be recognized in the statement of operations in a different (earlier) period than the related recovery.

An additional consideration relates to FASB ASC 225-30, which indicates that entities may choose how to classify such recoveries in the statement of operations, provided that classification does not conflict with existing GAAP requirements.

One issue to consider is that an entity is not allowed to record a receivable due from the insurance company for the insurance proceeds from a recovery until realization of the amount of insurance is probable. The reason is because the receivable is considered a gain contingency until the amount of the insurance to be received is settled with the insurance company. What that means is that there could be a fire or other calamity that occurs in the middle of a year but is not settled with the insurance company by year end. The entity is not allowed to record a receivable for the estimated insurance receivable until the company has settled the claim with the insurance company. Recording a "best estimate" as a receivable is not allowed because to do so would result in the company recording a gain contingency, which is not allowed under GAAP.

Following are examples that illustrate the applications just discussed:

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[38] Under ASC 410, if a claim is the subject of litigation, a rebuttable presumption exists that realization of the claim is not probable.

Example 1: Company X's equipment was heavily damaged in April 2013 from a Boston terrorist act. X maintains insurance on the equipment that provides for recovery of its replacement value. The equipment has a net book value of $1,000 and an estimated replacement value of $1,500 as of April 2013. Prior to its December 31, 2013 year end, X files a claim with its insurer for recovery of $1,500. Based on discussions with the insurer, X concludes that it is probable that the insurer will settle the claim for at least $1,200. However, as of December 31, 2013, the insurer has communicated to X that the amount of final settlement is subject to verification of the identity of the equipment damaged and receipt of additional market data regarding its value.

Conclusion: Because the insurance claim has not been resolved, a gain on the insurance claim cannot be recognized in X's December 31, 2013 year end income statement. X should record a claim receivable limited to the $1,000 net book value of the damaged asset because it is probable that there will be a recovery of the loss. The book value should be credited for $1,000 as the equipment is removed. Any remaining recovery beyond $1,000 should be recognized as a gain only when the insurance claim (contingency) has been resolved. That is, when the identity of the damaged equipment and the market data have been finalized to the satisfaction of the insurance company.

Example 2: X owns and operates a retail store in downtown Boston and maintains insurance to cover business interruption losses. Under the policy, the Company receives compensation for lost profits in the event of a business interruption, including a terrorist attack. In April 2013, X's store is damaged from the terrorist attack. As of September 30, 2013, X has filed a claim with its insurer to recover its estimated lost profit through September 30, 2013. X has not previously filed a claim under its insurance policy and is uncertain of the final settlement amount. X believes there could be a dispute regarding the scope of terrorism coverage under the policy. The parties have not agreed on a settlement as of the date that X issues its financial statements for the period ended September 30, 2013.

Conclusion: X should not recognize a gain because contingencies related to the recovery remain unresolved. X should recognize a gain when those contingencies are resolved by settlement of the claim with the insurance company.

4. Involuntary conversions under GAAP

Question: For tax purposes, the IRC section 1033 provides a special rule to deal with disasters under the involuntary conversion rules.

IRC section 1033 states the following:

- If property is damaged due to a condemnation, theft, seizure, or destruction, and a taxpayer receives insurance procedures, the gain or loss from the involuntary conversion is not taxable if reinvested in qualified replacement property within a period of time.

- The gain from receipt of insurance proceeds is non-taxable to the extent that the insurance proceeds are used to purchase qualifying replacement property (e.g., property that is similar to, or related to in use to, the property that was lost or taken) within a two-year period that ends two years after the close of the first tax year in which any part of the gain on the conversion is realized (three years for certain condemned property).

- In lieu of recording a gain, the insurance proceeds reduce the basis of the replacement property.

Do the non-recognition rules for involuntary conversions found in the IRC also apply to GAAP?

Response: No. The non-recognition of gain rules found in IRC section 1033 do not apply to GAAP. Therefore, for GAAP purposes, an involuntary conversion is treated as a sale of the converted property and a gain or loss is recognized on the income statement. Deferred income taxes must be recorded on the basis difference for GAAP and tax purposes. For tax purposes, the basis of the replacement property is lower than GAAP because of the reduction in the tax basis for the non-recognition of the gain.

ASC 605-40-25, *Revenue Recognition-Gains and Losses Recognition*, states:

> *"An involuntary conversion of a nonmonetary asset to monetary assets (e.g., cash) and the subsequent reinvestment of the monetary assets is <u>not the equivalent to an exchange transaction</u> between an entity and another entity. The conversion of a nonmonetary asset to monetary assets is a monetary transaction, whether the conversion is voluntary or involuntary, and such a conversion differs from exchange transactions that involve only nonmonetary assets. To the extent the cost of a nonmonetary asset differs from the amount of monetary assets received, the transaction results in a <u>gain or loss that shall be recognized.</u>"*

Dealing with the Timing of an Involuntary Conversion

GAAP for involuntary conversions requires the following:

- The transaction must be recorded as a sale of the asset when the asset (building, etc.) is converted to a monetary asset (e.g., when the entity receives cash or records a receivable from the insurance company).

- A gain or loss on the transaction is recorded when the entity receives cash or records a receivable for the insurance amount that is settled with the insurance company.

However, it can take an extensive amount of time to settle with the insurance company and that timeline can extend over one or more reporting periods. In such a situation, the entity is precluded from recording a receivable for the insurance settlement and a gain or loss on the transaction. Further, until the transaction is settled and a gain or loss is recognized, the entity cannot remove the underlying fixed asset from its records.

What should an entity do with the damaged asset while it waits for the insurance settlement?

Existing GAAP for involuntary conversions found in ASC 605-40-25, *Revenue Recognition-Gains and Losses Recognition*, implicitly assumes that an involuntary conversion is settled with the insurance company and recorded within the same reporting period in which the underlying event occurs. This assumption is not realistic in today's slow-moving insurance industry.

Let's look at an example:

Example:

Facts: Company X has a fire on September 30, 20X1 that damages its plant, making it inoperable.

X's year end is December 31, 20X1.

The plant's carrying value at the date of the fire was:

Cost	$1,500,000
Accumulated depreciation	(600,000)
Book value	$900,000

- At December 31, 20X1, the company is still negotiating with the insurance company and has received an advance in the amount of $100,000 to start repairing the facility. The company expects to receive approximately $500,000 in total from the insurance company but has not settled on that amount at December 31, 20X1.

- At December 31, 20X1, the company has spent about $200,000 for miscellaneous improvements to secure the property. No new renovations were started until 20X2.

- At December 31, 20X1, the company estimates that the fair value of the damaged building is $500,000, the amount it expects to receive from the insurance company.

Conclusion: Because X has not settled with the insurance company, it is precluded from recording a receivable and a gain and loss as if the property was sold. Thus, the following has to be done at December 31, 20X1:

- Insurance proceeds received in advance ($100,000) should be recorded as a deposit account as a liability.

- The $200,000 spent on repairs to date should be recorded as either repairs and maintenance, or as construction in progress (CIP) if it is part of the new construction.

- The building should be written down to $500,000 (its estimated fair value) with an impairment loss.

Entries: December 31, 20X1:	dr	cr
Cash	100,000	
Deposit liability- insurance proceeds		100,000
Construction in progress	200,000	
Cash		200,000
Impairment loss	400,000	
Plant		400,000
[$900,000 -$500,000]		

Assume further that in March 20X2, X settles with the insurance company for $525,000 and receives a check for $425,000 ($525,000 less $100,000 advance received in 20X1).

Conclusion: A gain or loss on the transaction should be recorded as follows:

Insurance proceeds	$525,000
Basis:	
Cost (1)	1,100,000
Accumulated depreciation	(600,000)
Book value	500,000
Gain on transaction	$25,000

(1) Original cost $1.5 M less impairment loss $(400,000) = $1.1 million.

Entries: March 20X2:	dr	cr
Cash	425,000	
Deposit liability- insurance proceeds	100,000	
Building		1,100,000
AD- building	600,000	
Gain on transaction		25,000

Observation: Because of the timing of settling the insurance proceeds, an entity will likely have to record an impairment loss in one period, and then record a gain on the transaction representing a sale, in the following period once the insurance proceeds are settled. The result is a mismatch of revenue and expense in that the impairment loss results in a lower basis and thus, a higher gain in the subsequent period.

Because GAAP does not allow an entity to estimate the insurance proceeds and record the receivable prior to settlement, there is a distortion of revenue and expense among periods. To date, the FASB has not focused on this issue.

Change the facts: Assume that at December 31, 20X1, the fair value of the building is estimated to be $2,000,000, which is the insurance proceeds that the company expects to receive in 20X2, even though it has not been settled at December 31, 20X1. All other facts are the same as the previous example.

Conclusion: There would be *no write down* of the building for impairment. Under ASC 360, *Impairments*, an impairment of a fixed asset (building in this case), exists if the undiscounted future cash flows from its use (and sale) are less than its carrying amount. In this case, the estimated future undiscounted cash flows consist of the insurance proceeds that are expected to be $2,000,000, which exceeds the carrying amount of $900,000. Thus, there is no impairment and no writedown of the building at the end of 20X1.

The result is as follows:

Entries: December 31, 20X1:	dr	cr
Cash	100,000	
Deposit liability- insurance proceeds		100,000
Construction in progress	200,000	
Cash		200,000
Impairment loss	0	
Plant		0

Assuming that in March 20X2, X settles with the insurance company for $2,000,000 and receives a check for $1,900,000 ($1,900,000 less $100,000 advance received in 20X1).

Conclusion: A gain or loss on the transaction should be recorded as follows:

Insurance proceeds	$2,000,000
Basis:	
Cost (1)	1,500,000
Accumulated depreciation	(600,000)
Book value	900,000
Gain on transaction	$1,100,000

Entries: March 20X2:	dr	cr
Cash	1,900,000	
Deposit liability- insurance proceeds	100,000	
Building		1,500,000
AD- building	600,000	
Gain on transaction		1,100,000

5. Income statement display of business interruption insurance recoveries

Question: How should business interruption insurance recoveries be displayed in the statement of operations?

Response: The governing authority is found in ASC 225-30, *Income Statement-Business Interruption Insurance* (formerly found in EITF Issue No. 01-13), which deals with business interruption insurance, and ASC 605, *Revenue Recognition*, for insurance proceeds related to property damage.

In other areas, ASC 410, *Asset Retirement and Environmental Obligations* and ASC 605, *Revenue Recognition*, (formerly found in FASB Interpretation No. 30), provide that any insurance recoveries are netted against the related loss on the same income statement line.

An entity *may choose how to classify business interruption insurance recoveries* in the statement of operations, as long as that classification is not contrary to existing generally accepted accounting principles.

With respect to property insurance recoveries, ASC 605, *Revenue Recognition*, (formerly found in FASB Interpretation No. 30), provides that any insurance recoveries are netted against the related loss on the same income statement line.

Specifically, ASC 605, *Revenue Recognition*, states that a gain or loss should be recognized on the difference between the carrying amount of the asset and the amount of monetary assets received (insurance recovery received) in the period of the involuntary conversion. As a result, the insurance recoveries are netted against the related loss (the carrying amount of the insured asset) and shown in the other income section of the income statement.

Business interruption insurance differs from other types of insurance coverage in that it *protects the prospective earnings or profits of the insured entity*. It provides coverage if business operations are suspended due to loss of use of property and equipment resulting from a covered cause of loss. Business interruption insurance coverage usually provides for reimbursement of certain costs and losses incurred during the reasonable period of time to rebuild, repair, or replace the damaged property. Types of costs typically covered include the following:

- Gross margin that was "lost" or not earned due to the suspension of normal operations
- A portion of fixed charges and expenses in relation to that lost gross margin
- Other expenses incurred to reduce the loss from business interruption, such as rental of a temporary facility and equipment, use of subcontractors, etc.

ASC 605 applies only to recoveries of certain types of losses and costs that have been recognized in the income statement. On the other hand, a portion of recoveries from business interruption insurance represents a reimbursement of "*lost margin*" rather than a recovery of losses or other costs incurred. As a result, there are no direct costs recorded on the income statement to which the insurance recovery relates.

Conclusion of ASC 225: An entity *may choose how to classify business interruption insurance recoveries* in the statement of operations, as long as that classification is not contrary to existing generally accepted accounting principles.

For example, in order to classify business interruption insurance recoveries as an extraordinary item, the requirements of ASC 225 related to extraordinary item classification (infrequent and unusual) must be met.

However, the following information should be disclosed in the notes to financial statements in the period(s) in which the insurance recoveries are recognized:

a. The nature of the event resulting in the business interruption losses.

b. The aggregate amount of business interruption recoveries recognized during the period and the line item(s) in the statement of operations in which those recoveries are classified (including amounts reported as an extraordinary item in accordance with ASC 225).

Observation: ASC 225 gives companies latitude in presenting a business interruption insurance recovery in the income statement. Because the underlying losses may not be recorded, such as lost revenue, there may not be a particular line item(s) to which the recovery relates. One approach to display would be to present the insurance recovery in the lines to which the "lost items" related.

Note that although ASC 225 applies to business interruption insurance recoveries, the same concept applies to other insurance recoveries, including property insurance recoveries.

Example: Assume there is a fire in a building. The building is condemned and the owner recovers $250,000 for lost rents and another $500,000 for property damage, while the property is being repaired. Other information follows:

Rent revenue	$2,000,000
Operating expenses	(900,000)
Insurance recovery ($250,000 + $500,000)	750,000
Net amounts	$1,850,000

Assume the lost rents recovery is calculated as follows:

Lost rents	$400,000
Saved utilities and other direct costs	(150,000)
Business interruption insurance recovery- lost rents	$250,000

Assume the book value of the building (without land) that is condemned is $200,000 so that there is a gain on that portion of the transaction of $300,000 as follows:

Property insurance proceeds	$500,000
Book value of real estate	(200,000)
Gain on building condemnation	$300,000

The net income to be presented follows:

Rent revenue	$2,000,000
Operating expenses	(900,000)
Business interruption insurance recovery	250,000
Gain on building condemnation	300,000
Net income	$1,650,000

Conclusion: With respect to the $250,000 business interruption insurance, ASC 225 permits a company to present the $250,000 business interruption insurance portion of the recovery in any way an entity chooses on its income statement. Following are two suggested presentation formats. The $300,000 gain on the property insurance should be shown as another income item, unless it can qualify for extraordinary gain treatment by being infrequent and unusual in nature. Assume in this case that extraordinary treatment does not apply because the criteria have not been met.

With respect to the $250,000 business interruption insurance, Option 1 is to categorize the recovery in those sections of the income statement to which the "lost items" relate. In this case, the $250,000 recovery would be split into two sections: $400,000 presented as a credit to rental income, and the other $150,000 presented as an increase to operating expenses.

Allocation of business interruption insurance

	Initial amounts	Allocation of the recovery	Income statement presentation
Rent revenue	$2,000,000	$400,000	$2,400,000
Operating expenses	(900,000)	(150,000)	(1,050,000)
Business interruption insurance recovery	250,000	(250,000)	0
Net income	$1,350,000	$ 0	$1,350,000

The income statement presentation would look like this:

X Real Estate Company
Statement of Income
For the Year Ended December 31, 20X1

Rent revenue	$2,400,000
Operating expenses	(1,050,000)
Other income:	
Gain on condemnation of building	***300,000***
Net income	$1,650,000

Option 2 is to present the business interruption insurance recovery as an other income item as follows:

X Real Estate Company
Statement of Income
For the Year Ended December 31, 20X1

Rent revenue	$2,000,000
Operating expenses	(900,000)
Net operating income	1,100,000
Other income:	
Business interruption insurance recovery	***250,000***
Gain on condemnation of building	***300,000***
Net income	$1,650,000

For tax purposes, the $500,000 of property insurance proceeds would be credited to the building asset, resulting in a $300,000 basis difference, which would be a temporary difference for deferred income tax purposes as follows:

	GAAP	Tax purposes	Temporary difference
Book value- building	$200,000	$200,000	
Entry to record sale of real estate condemned	(200,000)	0	
Entry to record reduction of basis for IRC 1033	0	(500,000)	
Basis before capitalization of construction costs	$ 0	$(300,000)	$(300,000)

Assuming that the Company's federal and state tax rate is 40%, deferred income taxes would be recorded as follows:

Entry:	dr	cr
Income tax expense- deferred federal/state (1)	120,000	
Deferred income taxes		120,000

(1): $300,000 x 40% = $120,000

Following is a disclosure that would apply to the above example:

Note X: Insurance Recovery
In 20X1, the Company incurred a fire at its apartment building located at 120 Main Street, Nowhere, Massachusetts, which resulted in the building being condemned.

Under its insurance policy, the Company received recovery of costs to reconstruct the building into its condition immediately prior to the fire, and business interruption insurance.

The Company received $500,000 as an insurance settlement to reconstruct the building. The insurance recovery, less the carrying amount of the building, resulted in a gain of $300,000 which is presented in the Other Income section of the statement of income. In 20X1, the Company started the reconstruction the building and capitalized $270,000 as part of Construction in Progress at year end.

In addition to receiving the $500,000 insurance settlement, under its business interruption insurance policy, the Company received recovery of rental revenue lost during the construction period, net of certain related costs. The total amount of insurance received was $250,000 which is presented in the Other Income section of the income statement.

Observation: In the previous example, the difference between the carrying amount of the building for GAAP and tax purposes results in a temporary difference that creates deferred income taxes. The difference is a byproduct of the basis being reduced by the $500,000 of insurance proceeds for tax purposes under the involuntary conversion rules in IRC section 1033, while being recorded as part of a gain for GAAP.

When the entity reconstructs the building, the costs would be capitalized for both GAAP and tax purposes.

What would happen if the company does not spend the $500,000 insurance proceeds within the required two-year (or three-year, in some cases) period required in IRC section 1033?

IRC section 1033 requires that the entire amount of the $500,000 insurance proceeds be spent on qualified replacement property, including reconstruction of the condemned building, within two, or three-year qualified period, depending on the circumstances. If a portion of those funds is not spent on qualified replacement property within the qualified period, the shortfall is taxable and the deferred income taxes on that portion of the temporary difference set up for the deferred gain, would be reversed.

Q. Principles-Based Accounting and Risk of Litigation

Previously in this course, the author addresses principles-based accounting in detail.

As part of the Sarbanes-Oxley Act, Congress asked the SEC and FASB to focus more on a principles-based accounting system, deviating from the current rules-based system.

What drove the push toward a principles-based system was a series of "bright-line" tests and rules that were embedded in U.S. GAAP which resulted in many companies following the form, instead of the substance of the transaction.

Examples of bright-line tests that exist in GAAP include:

- 75% and 90% tests for determining whether a lease is capitalized
- The previous 3% SPE rule for consolidating special purpose entities (SPEs), since replaced by FIN 46R.

In 2002, Congress passed the Sarbanes-Oxley Act, which required the SEC to conduct a study on the adoption of a principles-based accounting system by United States SEC companies.

In July 2003, the SEC finalized its study of a principles-based system and issued *SEC Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System.*

The conclusion reached by the Study is that the adoption of *objectives-oriented, principles-based accounting standards* in the United States would be consistent with the vision of reform that was the basis of the Sarbanes-Oxley Act.

The principles-based system debate has also been fueled by the push for U.S. companies to adopt international standards, which are based on a principles-based system.

Principles-based and the risk of litigation

Since the FASB's move toward principles-based system, critics have warned that the U.S. legal system does not allow for a conceptual approach to GAAP that a principles-based system requires. Instead, the

current U.S. GAAP system provides rules and bright-line tests to protect the company and auditor from legal challenges from the nebulous results that a principles-based system can create.

One study[39] supports the claim that a principles-based system exposes the auditor to a greater risk of litigation.

In the study, the authors examined 353 class action securities lawsuits over a 10-year period. In 189 of those cases, firms restated earnings and acknowledged that a previous earnings restatement was incorrect. In 164 of the suits, the firms did not restate earnings.

The conclusions reached in the study follow:

1. Shareholders are more likely to sue firms that use principles-based accounting standards over rules-based standards. It is easier for plaintiffs to second guess accounting decisions under the principles-based standards than using a rules-based system.

   Note: In suits that did not involve restatements, the plaintiff tended to allege violations of principles-based standards because they had no specific evidence to allege a rules-based violation, suggesting rules shield firms from litigation.

2. Rules-based standards are associated with a lower incidence of litigation but are not associated with litigation outcomes.

   a. The more rigorous rules-based standards make it more difficult for shareholders to prove wrongdoing by the firm, making it less likely they'll file a lawsuit.

   Note: In suits that did involve earnings restatements, violations of rules-based standards were associated with a lower probability of litigation.

Observation: A classic case where the principles-based system leaves too much flexibility for different interpretations of an accounting concept, rests with FIN 46R and the variable interest entity rules. FIN 46R was specifically written by the FASB under a principles-based concept so that there are few examples in the standard and little practice guidance. The result is that many practitioners are confused as to when the rules apply and when a variable interest entity (VIE) should be consolidated. Consequently, given the same set of facts, some companies consolidate their VIEs whiles others do not.

R. Earning Manipulation

Earnings management has been around since accounting's inception. Companies continue to manipulate earnings for numerous reasons including:

- To impact bonuses and compensation agreements
- To affect stock price of a business's valuation
- To achieve certain requirement benchmarks, and
- To avoid violating debt convents.

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[39] *Rules- Based Accounting Standards and Litigation,* Richard Mergenthaler, University of Iowa Tippie College of Business, et al (February 2012)

There are plenty of ways to manipulate financial statements:

- Some companies manipulate earnings by shifting income and expenses between periods and by keeping rainy day funds.

- Others manipulate the presentation of earnings such as shifting income and expense items to and from income from continuing operations and discontinued operations and extraordinary items.

- Even more companies shift items off balance sheet such as leases, variable interest entities, and other transactions.

- Then, there are those companies that manipulate cash flows to present a positive cash from operating activities to disguise a negative cash flow situation.

Either way, the manipulator has, as its prime goal, disguising the true economic financial position, income and/or cash flow of the company, in the eyes of the user.

What percentage of companies actually engage in manipulating their earnings?

In January 2014, a study[40] was published that polled about 375 CFOs, asking them the extent to which earnings were manipulated or distorted. 169 CFOs were from public companies while the remainder 206 were from nonpublic entities.

The CFOs noted that there are several key characteristics of high quality earnings:

1. At any point in time:

   - Percentage of companies that intentionally distort their earnings, using discretion found within GAAP:

     - CFOs-public companies: 20% of the time
     - CFOs- nonpublic companies: 30% of the time

   - The magnitude of the misrepresentation of earnings is large, averaging about 10% of reported earnings for public company CFOs (about 15% for nonpublic CFOs):

     - 67% of the firms that misrepresent earnings overstate earnings
     - 33% of the firms that are misrepresenting performance are low-balling their earnings or reversing a prior intentional overstatement.

2. High quality earnings have several features: They:

   - Are sustainable, repeatable, recurring and consistent (28% of respondents)
   - Are free from special or one-time items (23%)

[40] The Misrepresentation of Earnings, Ilia Dichev, Emory Universty, and John Graham, Campbell Harvey, Duke University (January 2014)

- Accurately reflect economic reality (17%)
- Come from normal (core) operations (9%)
- Are backed by cash flows (8%)

3. The factors that determine earnings quality are about half controllable (corporate governance, internal controls, proper accounting and audit function), and half non-controllable or innate (nature of the business, industry membership, macroeconomic conditions).

4. CFO motivations to use earnings to misrepresent economic performance:

- To influence stock price- 95%
- Outside pressure to hit earnings benchmarks- 94%
- Inside pressure to hit earnings benchmarks- 92%
- Influence executive compensation- 89%
- Senior management fears adverse career consequences for missing targets- 80%
- Avoid violation of loan covenants- 75%
- Pressure to smooth earnings- 70%
- Other companies misrepresent their performance- 28%

5. 60% of the CFOs said that companies may be motivated to use accounting techniques to paint a rosy picture of earnings "because it will likely go undetected."

- CFOs polled pointed out that a firm could misrepresent earnings for two to three (maybe five) years without getting caught by an analyst.

Red flags- how to detect earnings management

In the same survey, the authors asked the CFOs to identify red flags that third parties should look for to detect earnings misrepresentation. The following table summarizes those suggestions:

Earnings Misrepresentation Red Flags Per CFO Survey	
Red Flag	**% responses (based on public CFOs only)**
GAAP earnings do not correlate with cash flow from operations- earnings and cash flow from operations move in different directions for 6-8 quarters	34%
There are earnings and other deviations from industry or other norms	24%
The company consistently meets or beats earnings targets	17%
There are large, infrequent one-time or special items (such as restructuring charges, writedowns, unusual or complex items, gains or losses)	17%
Excessive use of accruals, large changes in accruals, sudden changes in reserves, significant increase in capitalized expenditures, high accrued liabilities	15%
Too smooth and too consistent earnings progression relative to the industry and economy (e.g., smooth earnings exist within an otherwise volatile industry)	14%
There are frequent changes in significant accounting policies	10%
The company uses non-GAAP or other metrics	8%
There is high executive turnover, sudden changes in top management, financial management, directors, and others	8%
There is an inventory buildup and mismatch between inventory and cost of sales	7%
There is a large volatility in earnings, especially without real change in business	7%
There are build ups in receivables, deterioration of days sales in AR, or the AR balance is inconsistent with the cash cycle	5%
There is significant use of long-term estimates, unusual reliance on accounts requiring management judgment/estimates	5%
SEC filings are becoming less transparent	4%
There are major jumps or turnarounds, a break with historical performance	4%
There is a large incentive compensation payment, misalignment of management compensation incentives, and management turnover after bonus payments	4%
There are repeated restatements of earnings/prior period adjustments	3%
Accruals, assets, and working capital are growing faster or slower than revenue	3%
There is increased debt and high liabilities	3%
There is weak sales growth vs. industry performance	3%
Source: *The Misrepresentation of Earnings*, Ilia Dichev, Emory Universty, and John Graham, Campbell Harvey, Duke University (January 2014)	

Continuing with the concept of earnings manipulation, there was another study[41] that was published a short while ago.

[41] *Predicting Material Accounting Misstatements,* Patricia M. Dechow, et al, The Haas School of Business University of California, Berkeley

In this study, the authors examined more than 2,000 SEC Accounting and Auditing Enforcement Releases (AAERs) issued between 1982 and 2005. From those examined companies, the authors obtained a sample of firms that are alleged to have misstated their financial statements.

Then, the authors examined the characteristics of the misstated companies based on five dimensions:

- Accrual quality
- Financial performance
- Non-financial measures
- Off-balance sheet activities
- Market-based measures

The conclusions reached by the study state that misstated companies have the following characteristics:

- Managers appear to be hiding diminishing performance during misstatement years.

- Accruals and reserves are high

- Misstating firms have a greater proportion of assets with valuations that are more subject to managerial discretion, have increased leasing transactions, and there are abnormal reductions in the number of employees.

- Misstating firms are raising more financing, and have higher price-to-fundamental ratios, and have strong prior stock price performance.

From the above facts, the authors developed a model to predict accounting misstatements, called the *F-Score*, which can be used as a red flag or signal of the likelihood of earnings management or "misstatement." Values greater than 1.0 suggest a higher likelihood of misstatement in the future.

- 50 percent of misstated companies had an inferior "*F score*."

- While only 20 percent of the public firms have an *F-Score* greater than 1.4, over fifty percent of misstating firms have inferior *F-Scores* of 1.4 or higher.

- The average *F-Score* for misstating firms increase for up to three years prior to the misstatement, but decline rapidly to more normal levels in the years following the misstatement.

  Note: Per the authors, Enron had an *F-Score* of 2.76. This suggests that Enron had more than twice the probability of having misstated compared to a randomly selected firm from the population.

Comparison of cash from operating activities to net income

Although the previous analysis identifies symptoms of a possible manipulation of earnings, the best indicator of such manipulation is to compare cash from operations to adjusted net income.

Step 1: Compute adjusted net income for three years:

Net income		XX
Depreciation and amortization	+	XX
Deferred income taxes	+-	XX
Gain/loss on sale of assets	+-	XX
Adjusted net income	(A)	XX

Step 2: Compute cash from operations: for three years

Net income		XX
Depreciation and amortization	+	XX
Deferred income taxes	+-	XX
Gain/loss on sale of assets	+-	XX
Adjusted net income		XX
Items to reconcile to cash from operations:		
Change in AR		XX
Change in AP		XX
Change in inventory		XX
Change in other current assets and liabilities		XX
Net cash from operating activities	(B)	XX

Conclusion: Compare adjusted net income (A) with net cash from operating activities (B) over a three-year period. If the quality of earnings is strong, the total of (A) should be close to (B) which will demonstrate that the earnings are strong enough to convert to cash. If, instead, the sum of (A) is greater than (B), that means the quality of earnings is weak and cannot be easily converted to cash. In such a case, there may have been manipulation of earnings by using accruals, reserves, or other items to manipulate earnings from period to period. In the end, all roads lead to cash!

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self - study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

1. Under GAAP prior to the issuance of ASU 2015-01, an item is categorized as extraordinary if it satisfies two criteria, one of which is _____.
   a. Unusual nature
   b. Frequency of occurrence
   c. Limited application
   d. Repetition of use

2. Which of the following is correct with respect to companies shifting losses from continuing operations to discontinued operations:
   a. Such a shift requires a settling up in the future
   b. Net income does not change but operating income, income from continued operations and core earnings may change
   c. It is a difficult form of managed earnings
   d. It is illegal in most cases

3. With respect to GAAP for discontinued operations prior to the effective date of the new ASU 2014-08, GAAP provides that the results of operations of a component that has been disposed of or classified as held for sale shall be reported in discontinued operations if certain conditions are met that include which one of the following:
   a. The operations of the component have been retained from the ongoing operations
   b. The entity will have significant continuing involvement in the operations of the component
   c. The cash flows of the component will be eliminated from the ongoing operations
   d. The entity will replace the component with a similar component or element

4. How should a loss incurred as a result of a terrorist attack be classified:
   a. As an extraordinary item
   b. As part of income from discontinued operations
   c. As part of income from continuing operations
   d. As part of retained earnings

5. With respect to insurance recoveries, how should an insurance receivable be handled:
   a. It should be booked as a gain contingency
   b. It should be recorded only when realization is probable
   c. It should not be recorded and should be accounted for on a cash basis
   d. It should be recorded once a best estimate of the amount that might be recovered is known

6. According to ASC 225 (formerly EITF Issue No. 01-13), an entity may choose how to classify business interruption insurance recoveries in the statement of operations_____:
   a. Without any restrictions
   b. As long as the recovery is insignificant
   c. As long as that classification is not contrary to existing GAAP
   d. As long as the amount is characterized as unusual

SUGGESTED SOLUTIONS

1. Under GAAP prior to the issuance of ASU 2015-01, an item is categorized as extraordinary if it satisfies two criteria, one of which is _____.
   a. **Correct. One of the two criteria is that the transaction must have an unusual nature in terms of a high degree of abnormality.**
   b. Incorrect. One of the criteria is infrequency (not frequency) of occurrence
   c. Incorrect. Limited application is not one of the criteria and the extent of application has nothing to do with whether an event is extraordinary.
   d. Incorrect. Repetition of use is not one of the two criteria, making the answer incorrect.

2. Which of the following is correct with respect to companies shifting losses from continuing operations to discontinued operations:
   a. Incorrect. One of the advantages is that, unlike accrual manipulation, there is no settling up in the future, making the answer incorrect.
   b. **Correct. One of the key advantages is that net income does not change but operating income, income from continued operations and core earnings may change because of the shifting of the item to below the line.**
   c. Incorrect. It is actually one of the easiest forms of managed earnings because all it involves is shifting the location of the item from continuing operations to discontinued operations.
   d. Incorrect. There is no indication that it is illegal in most cases because it typically involves interpreting the location in which to present the particular item on the income statement.

3. With respect to GAAP for discontinued operations prior to the effective date of the new ASU 2014-08, GAAP provides that the results of operations of a component that has been disposed of or classified as held for sale shall be reported in discontinued operations if certain conditions are met that include which one of the following:
   a. Incorrect. One of the conditions is that the operations of the component have been or will be eliminated, not retained, from the ongoing operations.
   b. Incorrect. One of the conditions is that the entity will not have significant continuing involvement in the operations of the component, making the answer incorrect.
   c. **Correct. One of the conditions is that the operations and cash flows of the component will be eliminated from the ongoing operations of the entity as a result of the disposal.**
   d. Incorrect. There is no condition that requires that the entity replace the component with a similar component or element.

4. How should a loss incurred as a result of a terrorist attack be classified:
   a. Incorrect. In general, a loss from a terrorist attack is not an extraordinary item because the infrequency of occurrence and unusual in nature criteria are not met. The reason is because it is reasonable that such an attack could occur again in the foreseeable future. Moreover, starting in 2016, ASU 2015-01 removes the concept of extraordinary items altogether from GAAP.
   b. Incorrect. There is no authority for presenting such a transaction as part of income from discontinued operations because it has nothing to do with the elimination of a particular operation.
   c. **Correct. Because the criteria for extraordinary treatment are not satisfied, the loss should be presented as part of income from continuing operations.**
   d. Incorrect. The loss should be presented on the income statement and *not part of retained earnings because there is no authority to present it in retained earnings.*

5. With respect to insurance recoveries, how should an insurance receivable be handled:
   a. Incorrect. GAAP does not permit that a gain contingency be recorded.
   b. **Correct. A receivable related to the insurance recovery should be recorded only when realization of the claim is deemed probable.**
   c. Incorrect. It should be recorded when realization is probable which is well before the cash from the insurance claim is received.
   d. Incorrect. Using a best estimate would be tantamount to recording a gain contingency. Recording a receivable related to a gain contingency is not permitted under GAAP.

6. According to ASC 225 (formerly EITF Issue No. 01-13), an entity may choose how to classify business interruption insurance recoveries in the statement of operations _____:
   a. Incorrect. There is a limitation in that the classification should not be contrary to existing GAAP. Thus, the answer is incorrect.
   b. Incorrect. The size of the insurance recovery is not a limitation to its classification, making the answer incorrect.
   c. **Correct. An entity may choose how it wants to classify business interruption insurance recoveries as long as the classification is not contrary to existing GAAP.**
   d. Incorrect. There is no limitation that the amount be characterized as unusual, making the answer incorrect.

S. Deferred Income Taxes, NOLs and Other Tax Matters

ASC 740 *Income Taxes* (formerly FASB No. 109), has been around for almost two decades. Yet, there are several key issues related to deferred income taxes that exist because of the recent economic climate and changes proposed by health care reform. In the section, the author addresses those issues which consist of:

1. Deferred income tax assets from NOLs

ASC 740, *Income Taxes* (formerly FASB No. 109), requires a company to record a deferred income tax asset for the tax benefit of a net operating loss carryforward. The asset represents the tax benefit that will be received when the company ultimately uses that NOL in future years. In order to actually use the NOL, the company must have future income to absorb that NOL.

Under existing federal tax law, a company can carry back a NOL two years, and then carry forward the unused NOL for 20 years. Of course, a company can elect to forego carryback of the NOL and instead carry forward the NOL.

Following is a simple example that demonstrates how the rules work:

Example 1: Company X generates a federal income tax loss in 20X5 in the amount of $500,000.

X carries back $200,000 of the $500,000 to years 20X3 and 20X4 by filing a Form 1139 and obtains a refund from the IRS.

The remaining $300,000 NOL is carried forward to years 20X6 and beyond and can be used through year 20X25.

For simplicity, assume there are no surtax rates and that the federal tax rate is 35%.

The entry in 20X5 follows:

	dr	cr
IRS refund receivable (1)	70,000	
Income tax expense- current federal		70,000
Deferred income tax asset (2)	105,000	
Income tax expense- deferred federal		105,000

(1): NOL carryback: $200,000 x 35% = $70,000.
(2): Unused NOL carryforward: $300,000 x 35% = $105,000.

Now, the IRS refund of $200,000 will be received by the company. As to the deferred income tax asset, the tax benefit of $105,000 will be received only if and when the company has future federal taxable income of $300,000 to utilize the NOL carryforward. Moreover, the company has 20 years in which to generate a total of $300,000 of future taxable income to use the NOL. In many cases, an active going concern will have no problem using the NOL so that the full deferred income tax asset of $105,000 will be utilized.

Use a valuation account if there is not enough future income to absorb the deferred tax asset

ASC 740, *Income Taxes* (formerly FASB No. 109), requires a company to recognize a valuation account against a deferred income tax asset if based on the weight of available evidence, it is *more likely than not* (more than 50% probability) that some portion or all of the deferred tax asset will not be realized.

The valuation allowance should be sufficient to reduce the deferred tax asset to the amount that is more likely than not to be realized.

In order to determine the amount of the valuation account, the following question must be asked:

Will the company have enough future taxable income during the NOL carryforward period to use the unused NOL?

If the answer is "yes," there is no need for a valuation account. If the answer is "no," a valuation account must be established for a portion or all of the deferred tax asset.

The only way in which a valuation account is needed is if there is more than a 50% probability that there will not be enough future income during the NOL carryforward period to utilize the unused NOL.

Future income can come from several sources as follows:

a. Reversal of existing taxable temporary differences into taxable income assuming taxable income is zero

b. Estimated future taxable income (exclusive of reversing temporary differences and carryforwards)

c. Taxable income in prior carryback year(s) if carryback is permitted under the tax law, and

d. Tax-planning strategies that the company would, if necessary, implement to utilize an expiring NOL such as:

   - Accelerate taxable amounts to utilize expiring carryforwards

   - Change the character of taxable or deductible amounts from ordinary income or loss to capital gain or loss, or

   - Switch from tax-exempt to taxable investments.

Although there are several sources of future income, in most cases involving a deferred income tax asset, future taxable income comes from two sources:

1. Estimated future taxable income during the 20-year carryforward period, and

2. Taxable temporary differences that will reverse into taxable income during the 20-year carryforward period as evidenced by the existing of deferred income tax liabilities.

In most cases, if a company has deferred income tax liabilities equal to or in excess of the deferred income tax asset related to the NOL, that fact, in and of itself, means the company will have enough future income to utilize the NOL.

Similarly, if the company can estimate that there will be sufficient future taxable income during the 20-year NOL carryforward period, that means the deferred income tax asset will be utilized and no valuation account is needed.

ASC 740, *Income Taxes* (formerly FASB No. 109) does give a list of factors that should be considered in determining whether there will be sufficient future taxable income during the NOL carryforward period to utilize the deferred income tax asset:

EVIDENCE USED TO DETERMINE WHETHER A VALUATION ACCOUNT IS NEEDED	
Negative Evidence Leading to a Conclusion that a Valuation Account is Needed	Positive Evidence Leading to a Conclusion that a Valuation Account is Not Needed
• Cumulative losses in recent years (usually the last three years including the current year)	• Existing contracts or firm sales backlog that will produce more than enough taxable income to realize the deferred tax asset based on existing sales prices and cost structures
• History of operating loss or tax credit carryforwards expiring unused	• An excess of appreciated asset value over the tax basis of the entity's net assets in an amount sufficient to realize the deferred tax asset
• Losses expected in early future years (by a presently profitable entity)	• A strong earnings history, exclusive of the loss that created the future deductible amount (tax loss carryforward or deductible temporary difference), coupled with evidence indicating that the loss (for example, an unusual, infrequent, or extraordinary item) is an aberration rather than a continuing condition
• Unsettled circumstances that, if unfavorably resolved, would adversely affect future operations and profit levels on a continuing basis in future years	
• A carryback or carryforward period that is so brief that it would limit realization of tax benefits if (1) a significant deductible temporary difference is expected to reverse in a single year, or (2) the enterprise operates in a traditionally cyclical business.	

Negative evidence, by itself, makes it difficult to reach a conclusion that a valuation is not needed. However, the existence of positive evidence might support a conclusion that a valuation allowance is not needed when there is negative evidence. In particular, ASC 740 (formerly FASB No. 109) notes that "forming a conclusion that a valuation allowance is not needed is difficult when there is negative evidence such as cumulative losses in recent years."

Following are a few examples that illustrate the author's points:

Example 1: Company X has the following information for year ended 2015:

2015 tax net operating loss	$(1,000,000)
Temporary difference:	
Accumulated depreciation at 12-31-15:	
Book	$2,000,000
Tax	3,500,000
Temporary difference	$1,500,000

The $(1,000,000) 2015 net operating loss is available for carryforward to 2035 (20 years).

The company had federal tax losses in the two carryback years (2013 and 2014) which were carried back to earlier years to obtain a federal tax refund. There is no portion of the 2015 NOL available for carryback.

The temporary difference related to accumulated depreciation (AD) will reverse in years 2016 through 2025. There are no other temporary differences.

There are no state income taxes.

A deferred income tax asset and liability was recorded with balances at 12-31-15 as follows:

Deferred income tax asset (federal):	
2013 federal tax net operating loss $1,000,000 x 35%	$350,000
[NOL expires in 2035, twenty years]	
Deferred income tax liability:	
Temporary difference: AD $1,500,000 x 35%	$(525,000)

Should X record a valuation account related to the $350,000 deferred income tax asset?

Conclusion: ASC 740, *Income Taxes* requires a company to recognize a valuation account against a deferred income tax asset if it is *more likely than not* (more than 50% probability) that some portion or all of the deferred tax asset will not be realized. In making the assessment, the Company must consider whether there will be enough future taxable income during the 20-year NOL carryforward period to utilize the $1,000,000 NOL and $350,000 deferred tax asset.

One of the sources of future taxable income is if there are existing taxable temporary differences that will reverse into taxable income during the 20-year carryforward period. In this example, the company

already knows that it has $1,500,000 of future taxable from reversal of the accumulated depreciation temporary difference. That reversal will occur in years 2016 through 2025 which is within the NOL carryforward period.

Because the company has a taxable temporary difference ($1,500,000) in excess of $1,000,000 that will reverse in the NOL carryforward period, the deferred tax asset of $350,000 will be realized. No valuation account is required.

Observation: The easiest source of future taxable income is where a company has a deferred tax liability from a temporary difference that will result in future taxable income during the NOL carryforward period. This source of future taxable income does not require any forecasts because it is based on events that have already occurred.

Example 2: Company X has the following information for year ended 2015:

2015 net operating loss- tax purposes	$(1,000,000)
Temporary difference:	
Accumulated depreciation at 12-31-15:	
Book	$2,000,000
Tax	2,600,000
Temporary difference	$ 600,000

The $(1,000,000) 2015 net operating loss is available for carryforward to 2035 (20 years).

The company had federal tax losses in the two carryback years (2013 and 2014) which were carried back to earlier years to obtain a federal tax refund. The company also had a tax loss in 2012. There is no portion of the 2015 available for carryback.

The company also had pretax book losses in years 2012 through 2014 with no signs of improvement for 2015 and beyond.

The temporary difference related to accumulated depreciation ($600,000) will reverse in years 2016 through 2025. There are no other temporary differences.

There are no state income taxes.

A deferred income tax asset and liability was recorded with balances at 12-31-15 as follows:

Deferred income tax asset (federal):	
2015 federal tax net operating loss $1,000,000 x 35%	$350,000
[NOL expires in 20354, 20 years]	
Deferred income tax liability:	
Temp difference: AD $600,000 x 35%	$(210,000)

Conclusion: The company can use the future taxable temporary difference of $600,000 as a source of future income that will utilize the $1,000,000 NOL carryforward. However, there appears to be no other sources of future income that can be justified. In particular, the company has had a series of book losses

in 2012 through 2014. ASC 740 states that "forming a conclusion that a valuation allowance is not needed is difficult when there is negative evidence such as cumulative losses in recent years." Given the fact that there is no positive evidence to support future taxable income beyond the $600,000 of future taxable income from the reversal of the temporary differences, a valuation account is required as follows:

Deferred income tax asset (federal): $1,000,000 x 35%		$350,000
Future income:		
Deferred income tax liability reversal: $600,000 x 35%		(210,000)
Valuation allowance required: $400,000 x 35%		$(140,000)
Entry:		
Income tax expense- deferred federal	140,000	
Valuation allowance		140,000

Balance sheet presentation:

Assets:	
Deferred income tax asset	*$210,000
Long-term Liabilities:	
Deferred income tax liability	**(210,000)

* DIT asset of $350,000 less valuation of $140,000 = $210,000.
** DIT liability related to accumulated depreciation temporary difference.

Observation: In using existing taxable temporary differences (deferred income tax liabilities) to justify future taxable income to utilize a deferred income tax asset from an NOL carryforward, the analysis is done based on the assumption that *there is no other taxable income or loss during the years in which the taxable temporary differences reverse*. The taxable temporary difference is scheduled without regard to any other taxable income or loss.

In Example 1, the analysis indicates that there is $1,500,000 of future taxable income that the company will have when the accumulated depreciation reverses in future years. Notice that the analysis assumes that taxable income in those future years is zero and that the only taxable income in those future years is the reversal of the taxable temporary difference of $1,500,000.

How are the deferred assets and liabilities presented on the balance sheet?

The rules under ASC 740 require that deferred tax liabilities and assets be classified on the balance sheet as current or noncurrent based on the classification of the related asset or liability for financial reporting. A deferred tax liability or asset that is not related to an asset or liability for financial reporting, including deferred tax assets related to NOL carryforwards, shall be classified according to the expected reversal date of the temporary difference.

In the previous Example 2, the $210,000 deferred income tax asset (net of the valuation), does not relate to an underlying asset or liability that created a temporary difference. Therefore, the deferred tax asset is split on the balance between current and long-term based on the estimated reversal date of the asset. That portion of the asset that is expected to reverse based on future taxable income occurring within one year is presented current, while the remainder of the deferred tax asset is presented long-term.

As for the liability, because it related to a long-term asset (accumulated depreciation), the resulting deferred tax liability is presented as a long-term liability.

What if a deferred tax asset relates to an unlimited state NOL carryforward?

There are certain states that allow net operating losses to be carried forward indefinitely. If this is the case, a deferred income tax liability related to an indefinite lived asset (such as goodwill) can be used as a source of income that can support the realization of the deferred tax asset. The reason is because the temporary difference from the indefinite lived asset has no deadline to reverse into taxable income. When the temporary difference reverses from an ultimate sale or impairment writedown, that taxable income will utilize the net operating loss given the fact that the state NOL has an unlimited carryforward period.

FASB's ASU 2015-17

Note: In November 2015, the FASB issued ASU 2015-17, *Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes.* The ASU amends ASC 740 to provide that deferred income tax assets and liabilities should be presented as noncurrent on the balance sheet instead of being presented as current or long term based on the classification of the underlying temporary difference. The FASB made this change as part of its Simplification Initiative.

For public entities, the ASU is effective for financial statements issued for annual periods beginning after December 15, 2016, and interim periods within those annual periods. For all other entities, (including nonpublic entities) the amendments in this Update are effective for financial statements issued for annual periods beginning after December 15, 2017, and interim periods within annual periods beginning after December 15, 2018.

Future income and the cumulative losses situation- three-year rule

Let's look at predicting future income. Previously, we addressed the situation in which future taxable temporary differences, such as those related to accumulated depreciation, are an easy source of future income that would absorb a deferred income tax asset.

Now let's assume there are no deferred tax liabilities related to future taxable temporary differences. Therefore, the only way to avoid having to record a valuation allowance is to estimate future taxable income (exclusive of reversing temporary differences) that the company will generate during the 20-year NOL carryforward period.

In concept, such an exercise should yield plenty of taxable income. After all, the company has 20 years of estimated taxable income to use the NOL carryforward.

Although it is true that estimating enough future taxable income over a 20-year period that is sufficient to use an unused NOL carryforward should be easy, it may be impossible to do under the "cumulative loss" rule.

Previously, the author discussed that in assessing whether a valuation allowance is needed, both positive and negative evidence must be considered. If it is more likely than not, based on the evidence, that the deferred tax asset will not be realized by future taxable income, a valuation is required for any shortfall.

ASC 740 states that cumulative losses in recent years is a negative factor that may be difficult to overcome with other positive factors.

The question is how many years of cumulative losses create a pattern of negative evidence that is so great that one cannot estimate that future taxable income will exist and therefore a valuation account is required?

In Appendix A to ASC 740, the FASB was quite careful not to create a bright-line test as it relates to cumulative losses. Although many companies and their accountants use three-years of losses (current year and two prior years) to define the term "cumulative losses," such an approach is non-authoritative but has become generally accepted. ASC 740 does not give any guidance as to how to determine cumulative losses and the number of years of losses that would suggest a negative trend.

Although not authoritative, many CPA firms and their clients are using a "soft" three-year period (current year and two prior years) to assess whether there are cumulative losses, based on the following structure:

1. "Cumulative losses" is based on the last three years of pre-tax book income (losses) consisting of the current year and two prior years.

2. Pre-tax GAAP income is used instead of taxable income.

Observation: Because the FASB places so much weight on the cumulative losses as a component of negative evidence, companies should be careful not to fall into the trap of doing a mechanical three-year computation of pre-tax GAAP losses to define cumulative losses.

What is more important is the direction in which the losses are headed and whether there are any non-recurring transactions that might distort the real upward or downward trend.

Consider the following scenarios:

Scenario 1: At December 31, 20X3, Company X has a deferred tax asset in the amount of $1,000,000 due to an unused NOL carryforward. X has no deferred tax liabilities.

Pre-tax book income is:

Year		Pre-tax book income (loss)
20X3	(current year)	$(2,000,000)
20X2		(1,200,000)
20X1		(500,000)
		$(3,700,000)

Conclusion: Cumulative losses total $(3,700,000) over the most recent three-year period and the trend appears to be leading toward greater losses in the most recent year 20X3. The fact that there are cumulative losses is strong negative evidence that it is more likely than not that the company will not have sufficient future taxable income to utilize the $1,000,000 deferred income tax asset during the NOL carryforward period. That is, the company cannot estimate future taxable income will exist. It is highly unlikely that X can gather sufficient positive evidence to override the cumulative losses negative

evidence. Consequently, X should record a $1,000,000 valuation allowance to offset the $1,000,000 deferred income tax asset.

Entry:	dr	cr
Income tax expense- deferred federal	1,000,000	
Valuation allowance		1,000,000

Estimated future taxable income (exclusive of reversing temporary differences and carryforwards)

In assessing deferred income tax assets, the goal is:

> *to determine whether there will be enough estimated future taxable income during the NOL carryforward period to utilize the deferred tax asset.*

To the extent that it is more likely than not that a portion or all of the deferred income tax asset will not be utilized by future taxable income, a valuation account is required.

Previously, we saw that one way to determine future taxable income is to look to deferred income tax liabilities that will reverse into income during the NOL carryforward period. Clearly, having deferred income tax liabilities that equal or exceed the deferred income tax asset is the easiest and most verifiable way to prove future income because it is based on transactions that have already occurred; that is, the deferred tax liability has already been measured and the timing and amount of its reversal are quantifiable.

When there is not a sufficient amount of deferred income tax liability to use the deferred income tax asset, the company should look to other sources of future taxable income. This step involves estimating the amount of taxable income the company will have during the NOL carryforward period without regard to any taxable income that would be created from the reversal of existing deferred income tax liabilities. Estimating future taxable income is difficult as it requires that use of forecasted information which is imperfect at best. Moreover, if the company has cumulative losses (assume over the past three years including the current year), it is generally assumed that the company will not have future taxable income and a valuation allowance will be required for the entire amount of the deferred tax asset.

Example 4: Let's assume that the company has no deferred tax liabilities that will reverse into taxable income. Let's further assume that there is no negative evidence of cumulative losses. That is, the deferred tax asset was created because a significant tax loss in the current year due to a sizeable M-1 tax deduction.

Pre-tax book income is:

Year		Pre-tax book income
2014	(current year)	$(200,000)
2013		100,000
2012		50,000

At December 31, 2014, the Company had an unused federal tax NOL carryforward of $230,000.

The 2014 book loss was a direct result of additional depreciation from 2014 fixed asset additions. The company uses the same book and tax depreciation.

Historically, the company has had taxable income in the $50,000 to $100,000 range depending on the amount of officer bonuses taken each year. At December 31, 2014, the company has a very strong sales backlog for the next 3 to 5 years.

There are no temporary differences.

There are no state income taxes.

A deferred income tax asset was recorded at 12-31-14 as follows:

Deferred income tax asset (federal):	
2014 federal tax net operating loss $230,000 x 34%	$78,200
[NOL expires in 2031, 20 years]	

Conclusion: The company is required to record a valuation allowance against the $78,200 deferred tax asset to the extent that it is more likely than not that a portion of all of the deferred tax asset will not be realized from future taxable income during the 20-year NOL carryforward period.

In order to avoid having to record a valuation allowance, the company must justify that the company will have future taxable income from 2015 to 2034 (20 years) of at least $230,000. If so, the NOL carryforward of $230,000 will be utilized. As for sources of future taxable income, the company has no deferred tax liabilities that will reverse into future taxable income. Thus, the company should estimate future taxable income.

In this case, the company should look at the positive and negative evidence in assessing whether there will be future taxable income.

Evidence to consider in estimating future taxable income includes:

a. The company has had a strong earnings history (exclusive of the loss) in the annual amount of $50,000 to $100,000 of taxable income.

b. 2012 book loss of $(200,000) as an aberration based on the existence of a non- recurring amount of depreciation. ASC 740 specifically states that in estimating future taxable income, a company should consider the existence of evidence indicating that the loss is an aberration rather than a continuing condition. Clearly, the 2014 loss is an aberration.

c. There is no evidence of cumulative pre-tax book losses over the past three years including 2012.

d. The company has a strong sales backlog that will produce sufficient taxable income over the next 3 to 5 years.

Based on a weight of the positive and negative evidence, the company should estimate future taxable income for years 2034 as follows:

Estimated annual federal taxable income	$50,000
# years in NOL carryforward period	x 20
Estimated future taxable income	$1,000,000
Unused NOL carryforward from 2014	$(230,000)

The company estimates that there will be $1,000,000 of future taxable income generated during the NOL carryforward period, which is sufficient to utilize the entire $(230,000) of net operating loss. The result is that there is no need to record a valuation allowance.

Using tax planning strategies to estimate future taxable income

ASC 740 (formerly FASB No. 109) provides that estimated future taxable income to utilize a deferred tax asset and whether there is a need for a valuation allowance, a company should consider tax planning strategies that it would implement that would impact that taxable income.

Tax planning strategies consist of actions (including elections for tax purposes) that:

a. are prudent and feasible with management having the ability to implement the strategy

b. an enterprise ordinarily might not take, but would take to prevent an operating loss or tax credit carryforward from expiring unused, and

c. would result in realization of deferred tax assets.

Examples of tax planning strategies include a plan to:

a. Accelerate taxable amounts to use expiring NOLs:

   - Selling appreciated assets and inventory, including inventory that would trigger a recapture of the LIFO reserve

   - Selling investments including available-for-sale securities

   - Electing out of the installment sales method to accelerate taxable income on a sale

   - Changing the tax status

   - Making an election to change a tax accounting method that triggers taxable income

b. Change the character of items from ordinary income to capital gain (loss), and

c. Switching from tax-exempt to taxable investments.

Observation: Tax planning strategies are a way of life for all taxpayers, corporate and individual, alike. Inherent in the use of a tax planning strategy is the goal to make sure that a net operating loss carryforward does not expire unused. ASC 740 requires that a company consider the use of tax planning strategies in determining the need for a valuation allowance; that is, in estimating future taxable income.

Should a deferred tax asset be recorded on carryforwards other than NOLs?

ASC 740 (formerly FASB No. 109) requires that a deferred tax asset be recorded for the tax benefit of an NOL carryforward. What happens to other types of carryforwards that reflect a future tax benefit such as:

- Unused charitable contributions carryforward
- Unused Section 179 deduction carryforward
- Unused capital loss carryforward

Response: Technically, a company is required to record the tax benefit of a carryforward as a deferred tax asset, and then determine whether a valuation account is required for the portion that may not be realized.

ASC 740-10-20, *Income Taxes*, provides the following definitions:

> *Deferred tax asset*: **"**The deferred tax consequences attributable to deductible temporary differences and *carryforwards*."
>
> *Carryforward:* "*Deductions* and credits that cannot be utilized on the tax return during a year that may be carried forward to reduce taxable income or taxes payable in a future year."

One example of a carryforward is an NOL carryforward. However, there are other carryforwards that represent unused deductions and credits that provide a future tax benefit to a future year. Examples include unused charitable contributions, Section 179 depreciation deductions, and capital loss carryovers.

> Charitable contributions: Can be carried over for five years for that portion that exceeds 10% of taxable income (without regard to the deduction for the contribution and other items).
>
> Section 179 deduction: Is limited to taxable income with the unused portion carried forward indefinitely.
>
> Capital loss carryover: Any unused capital loss is carried forward for five years from the loss year.

ASC 740 states that a deferred tax asset should be recorded on "carryforwards" without regard to the types of carryforwards. In theory, each carryforward may provide a future tax benefit that should be captured by recording the deferred tax asset.

However, a valuation account should be recorded to the extent that it is more likely than not that carryforward will not be realized during the carryforward period. Moreover, materiality should be considered. For example, is the amount of an unused charitable contribution material?

Example: Company X is a C corporation and has the following at December 31, 20X1:

	Expiration date	Amount
Unused federal NOL carryforward	20 years	$(1,000,000)
Unused charitable contributions carryfoward	5 years	(50,000)
Unused Section 179 deduction carryforward	Unlimited	(100,000)
Unused capital loss carryforward	5 years	(150,000)
Totals		$(1,300,000)

Assume:

- Federal tax rate of 34% in future years with no surtax rates and no state taxes.
- X expects to have future taxable income of $200,000 per year and that the $1,000,000 NOL was based on a non-recurring transaction.
- There is no DIT asset on the balance sheet.
- The company has a tax planning strategy under which it will not allow the capital loss carryforward to expire. That is, it will sell a capital asset and generate a capital gain within the five-year period.

Conclusion: X should record a deferred tax asset as follows:

Combined carryfowards	($1,300,000)
Tax rate	34%
DIT asset	$442,000

Entry:	dr	cr
Deferred income tax asset- federal	442,000	
Income tax expense- federal deferred		442,000

Valuation account:

Based on the assumption of future taxable income of $200,000 per year, all carryforwards should be utilized during their respective carryforward periods except the capital loss carryforward. However, the company has a tax-planning strategy that will result in a capital gain being created within the five-year carryforward period. Thus, the capital loss carryforward will be utilized.

No valuation account is required.

Observation: Obviously, materiality must be considered in deciding whether to record a deferred tax asset on a carryforward that may not be material. For example, a small amount of unused contributions may not warrant a deferred tax asset. Conversely, a large amount of unused Section 179 depreciation may require a deferred tax asset.

2. Presentation of tax benefit of NOL carryforward

Question: How should the use of a net operating loss carryover be presented on the income statement? ASC 740, *Income Taxes* (formerly FASB No. 109), requires the tax benefit of the NOL to be presented as a direct reduction in the current portion of income tax expense with a corresponding disclosure.

Example: A company has a $(300,000) NOL carryforward in 20X1 and records a deferred income tax asset as follows:

Entry: 20X1	dr	cr
DIT asset ($300,000 x 34%)	102,000	
Income tax expense- deferred		102,000

The $300,000 unused NOL is carried over from 20X1 to 20X2.

20X2 information:

Taxable income before NOL	$800,000
NOL carryforward utilized	(300,000)
Taxable income	500,000
Tax rate	34%
Current FIT provision	$170,000

Conclusion: The December 31, 20X2 entry consists of two components:

- Current accrual provision of $170,000
- Reversal of the $102,000 deferred income tax asset that is used in 20X2.

Entry: 20X2	dr	cr
Income tax expense- current provision	170,000	
Accrued FIT		170,000
Income tax expense- deferred	102,000	
Deferred income tax asset		102,000

The total federal income tax expense in 20X2 looks like this:

Current provision (net of NOL)	$170,000
Deferred	102,000
Total provision (FIT expense)	$272,000

Presentation on the statement of income:

Net income before income taxes	$XX
Income tax expense	272,000
Net income	$XX

NOTE 1: INCOME TAXES:

The provision for income includes federal taxes currently payable and deferred income taxes arising from assets and liabilities whose basis is different for financial reporting and income tax purposes. The majority of the deferred tax provision is the result of basis differences in recording depreciation and accruing certain expenses.

The provision for income taxes is summarized as follows:

Federal:		
Currently payable	$ 272,000	(1)
Deferred	102,000	
Reduction due to use of net operating loss carryforward	(102,000)	(2)
Total federal provision	272,000	
State:		
Currently payable		xx
Deferred	xx	
Total state provision	xx	
Total provision	xx	

(1) 800,000 x 34% = 272,000
(2) 300,000 x 34% = (102,000)
Net current provision 170,000

3. Tax rate to use for DITs when there are surtax rates

Question: A company is a C corporation with taxable income ranging from $50,000 to $100,000 per year. In recording deferred tax assets and liabilities, what federal tax rate should be used?

Response: ASC 740-10-30-8: states that a deferred tax liability or asset is recorded using the enacted tax rate(s) expected to apply to taxable income in the periods in which the deferred tax liability or asset is expected to be settled or realized.

In situations in which graduated (marginal) tax rates are a *"significant factor,"* ASC 740-10-30-9 states that the deferred liability or asset shall be measured using the *average graduated tax rate* applicable to the amount of estimated annual taxable income in the periods in which the deferred tax liability or asset is expected to be settled or realized.

Thus, the average graduated tax rate should be used based on the level of taxable income (including reversal of the temporary difference) in the reversal years.

Consider the following table:

Taxable income increment	Cumulative taxable income (B)	Marginal tax rate on increment	Marginal tax	Cumulative Tax (A)	Average graduated tax rate (A)/(B)
$50,000	$50,000	15%	$7,500	$7,500	15%
25,000	75,000	25%	6,250	13,750	18%
25,000	100,000	34%	8,500	22,250	22%
100,000	200,000	39%	39,000	61,250	31%
100,000	300,000	39%	39,000	100,250	33%
35,000	335,000	39%	13,650	113,900	34%
65,000	400,000	34%	22,100	136,000	34%
100,000	500,000	34%	34,000	170,000	34%
9,500,000	10,000,000	34%	3,230,000	3,400,000	34%
	>$10,000,000	35%			35%

Example: Company X has a temporary difference related to accumulated depreciation in the amount of $40,000 that will reverse evenly over the next 10 years.

Assume that X estimates that its taxable income, including the reversal of the temporary difference, will be approximately $100,000 in each of the 10 reversal years.

Conclusion: Because estimated taxable income in the 10 reversal years will be approximately $100,000, the graduated tax rates range from 15% to 34% and those rates will be significant. Therefore, GAAP requires that average graduated tax rates for the estimated amount of taxable income (including the reversal of the temporary difference) should be used to record the deferred income tax liability. The average graduated income tax rate on $100,000 of taxable income is 22%.

The deferred tax liability should be recorded as follows:

Temporary difference	$40,000
Average graduated tax rate	22%
Deferred tax liability	$8,800

Question: What about using the effective tax rate to record deferred tax liabilities or assets?

Response: ASC 740 is clear that deferred tax liabilities and assets should be recorded using enacted tax rates and not effective tax rates.

4. Problems on the uncertain tax positions front

The rules for recording uncertain tax benefit liabilities under FASB Interpretation 48 (FIN 48) have been around since 2006.

Yet, these rules continue to be controversial and reach far beyond the financial statements.

The purpose of this section is to address some of the current developments related to FIN 48 including:

- Clarification of the disclosures related to nonpublic entities
- Impact that FIN 48 liabilities have on SEC companies
- Roadmap that FIN 48 liabilities are providing to the IRS

Background

The rules for uncertain tax positions were issued approximately one decade ago in FIN 48, which is now part of ASC 740, *Income Taxes*. Although the rules for uncertain tax positions may not be applicable to many smaller, nonpublic entities, there have been questions as to whether non-public entities are required to include certain FIN 48 disclosures if an entity has no uncertain tax positions.

Question: What are the general rules for accounting for tax positions?

Response: The authority for tax positions is found in ASC 740 *Income Taxes* (formerly FASB Interpretation No. 48 (FIN 48)), which provides guidance on the treatment of derecognition, classification, interest and penalties, accounting in interim periods, disclosures and transition, as they relate to tax positions.

The rules apply to *all tax positions* accounted for under ASC 740 (formerly FASB No. 109).

A *tax position* is defined as:

> *"a position in a previously filed tax return or a position expected to be taken in a future tax return that is reflected in measuring current or deferred income tax assets or liabilities for interim or annual periods."*

A tax position results in either:

- A permanent reduction in income taxes payable
- A deferral of income taxes otherwise currently payable to future years, or
- A change in the expected realizability of deferred tax assets.

The rules found in ASC 740 apply as follows:

1. If it is *more likely than not (more than 50% probability)* that a tax position will be sustained upon IRS or state tax examination (including any appeals or litigation process), the amount of the tax effect of a tax position is retained on the financial statements.

2. If it is *not more likely than not* (not more than 50% probability) that the tax position will be sustained upon an IRS or state tax examination, all of the tax effect of the tax position is eliminated in the financial statements by recording a liability for the hypothetical additional tax that will be paid when the tax position is disallowed upon IRS or state examination.

The rules for uncertain tax positions apply to *federal, state and local and foreign income taxes, but do not apply to* sales and use taxes, franchise taxes, real estate and personal property taxes, and fees that are not taxes. Moreover, it is assumed that a company goes through an IRS or state tax examination, including, if applicable, appeals.

Example 1: Tax Deduction:

Company X computes its 20X7 tax provision as follows:

	Taxable Income	Tax rate	Tax (Fed/state)
Net sales	$1,000,00		
Operating expenses:			
Travel	*(2,500)*		
All other	(597,500)		
Total operating expenses	(600,000)		
NIBT	400,000	40%	160,000
M-1: Depreciation	(50,000)	40%	(20,000)
Taxable income	$350,000	40%	$140,000

Entry:

Income tax expense	160,000	
Deferred income tax liability		20,000
Accrued tax liability		140,000

Company X takes a $2,500 tax deduction for certain items that may be nondeductible travel related to a shareholder's spouse. The tax benefit of the item embedded within the tax provision is $1,000 ($2,500 x 40%).

X believes that if it were audited by the IRS and Massachusetts Department of Revenue, it is more likely than not (more than 50% probability) that the entire deduction is sustainable even if X has to go to appeals or even tax court.

Conclusion: Because X believes it is more likely than not that the deduction would be sustained in the event of examination, including any required appeal or tax court decision, X would retain the tax benefit of the tax deduction on its financial statements. That means that X would not record an additional liability for the additional tax that would be paid if the deduction were disallowed upon examination.

Change the facts:

What if the more-likely-than-not threshold is not met for sustaining the deductibility of the $2,500?

Assume X believes that upon examination, the entire $2,500 deduction would be disallowed. In this case, it is *not more likely than not* that the $2,500 deduction would be sustained resulting in an additional tax in the amount of $1,000, for which an additional liability is recorded as follows:

The revised entry looks like this:

Revised Entry:		
Income tax expense	161,000*	
Deferred income tax liability		20,000
Accrued tax liability		140,000
Liability for unrecognized tax benefit		**1,000**

* Book income ($400,000) plus unrecognized deduction ($2,500) = $402,500 x 40% = $161,000.

Question: What types of entities are subject to the rules found in FIN 48?

Response: FIN 48 applies to all entities including:

- For-profit
- Not-for-profit
- Pass-through entities (S corporations, LLCs and partnerships, and
- Entities taxed in a manner similar to pass-through entities such as REITs and registered investment companies.[42]

Note: Not-for-profit and pass-through entities, and tax-exempt organizations are subject to FIN 48 because they can pay taxes in certain situations. For example, an S corporation can be subject to a built-in gain tax under IRC section 1374. Similarly, a not-for-profit entity can be subject to a tax on unrelated business income.

A reporting entity must consider the tax positions of all entities within a related- party group of entities regardless of the tax status of the reporting entity.

ASU 2009-06 amended FIN 48 to include under the definition of a tax position an entity's tax status such as an entity's status as a pass-through entity (S corporation) or a tax-exempt not-for-profit entity. For example, one such tax position is the company's position that it is properly in compliance with the IRC to be taxed as an S corporation, or it is an LLC that is taxed as a partnership instead of a corporation.

Question: What are the disclosures required by FIN 48?

Response: FIN 48 requires the following disclosures which apply to all entities:

1. The entity's policy on classification of interest and penalties assessed by taxing authorities.

2. As of the end of each annual reporting period presented:

[42] Entities whose liability is subject to 100 percent credit for dividends paid (REITs and registered investment companies).

a. The total amounts of interest and penalties recognized in the statement of operations and the total amounts of interest and penalties recognized in the statement of financial position, assessed by taxing authorities.

b. For positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date:

- The nature of the uncertainty
- The nature of the event that could occur in the next 12 months that would cause the change
- An estimate of the range of the reasonably possible change or a statement that an estimate of the range cannot be made

c. A description of tax years that remain open subject to examination by major tax jurisdictions.

3. Public companies *only* shall include the following additional disclosures as of the end of each annual reporting period presented:

a. A tabular reconciliation of the total amounts of unrecognized tax benefits at the beginning and end of the period which shall include at a minimum:

- The gross amounts of the increases and decreases in unrecognized tax benefits as a result of tax positions taken during a prior period.
- The gross amounts of increases and decreases in unrecognized tax benefits as a result of tax positions taken during the current period.
- The amounts of decreases in the unrecognized tax benefits relating to settlements within taxing authorities.
- Reductions to unrecognized tax benefits as a result of a lapse of the applicable statute of limitations.

b. The total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate.

Example Disclosures:

Following are sample disclosures. In parentheses, the author has included the disclosure reference from the table above.

Example 1 Disclosure: Public Company

Note X: Tax Uncertainties
The Company files income tax returns in the U.S. federal jurisdiction, and various states (not required).

The Company is subject to U.S. federal and state income tax examinations for tax years 20X4, 20X5, 20X6 and 20X7.

The Internal Revenue Service (IRS) commenced an examination of the Company's U.S. income tax returns for 20X3 and 20X4 in the first quarter 20X7 which is expected to be completed by the end of 20X8. As of December 31, 20X7, the IRS has proposed certain significant tax adjustments to the Company's research credits. Management is currently evaluating those proposed adjustments to determine if it agrees. If accepted, the Company anticipates that it is reasonably possible that an additional tax payment in the range of $80,000 to $100,000 will be made by the end of 20X8.

A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows (public company disclosure only).

Balance at January 1, 20X7	$ 0
Additions based on tax positions related to the current year	210,000
Additions for tax positions of prior years	30,000
Reductions for tax positions of prior years	(50,000)
Reductions due to settlements with taxing authorities	(40,000)
Reductions due to lapse in statute of limitations	(10,000)
Balance at December 31, 20X7	$140,000

The Company's policy is to record interest expense and penalties assessed by taxing authorities in operating expenses.

For years ended December 31, 20X7, 20X6 and 20X5, the Company recognized approximately $12,000, $15,000 and $17,000, respectively of interest and penalties expense. At December 31, 20X7 and 20X6, accrued interest and penalties were $50,000 and $45,000, respectively.

Included in the balance at December 31, 20X7 and 20X6 are $30,000 and $25,000, respectively, of tax positions that relate to tax deductions that upon audit could be disallowed, resulting in a higher effective tax rate. Management believes that it is more likely than not that these tax positions would be sustained in the event of audit (public company disclosure only).

Example 2 Disclosure: Non-Public Company

Note X: Tax Uncertainties
The Company's policy is to record interest expense and penalties assessed by taxing authorities in operating expenses.

For years ended December 31, 20X7 and 20X6, the Company recognized approximately $5,000 and $6,000, respectively of interest and penalties expense. At December 31, 20X7 and 20X6, accrued interest and penalties were $2,000 and $3,000, respectively.

The Company is subject to U.S. federal and state income tax examinations for tax years 20X4, 20X5, 20X6 and 20X7.

The Internal Revenue Service (IRS) commenced an examination of the Company's U.S. income tax returns for 20X3 and 20X4 in the first quarter 20X7 which is expected to be completed by the end of 20X8. As of December 31, 20X7, the IRS has proposed certain significant tax adjustments to the Company's research credits. Management is currently evaluating those proposed adjustments to determine if it agrees. If accepted, the Company anticipates that it is reasonably possible that an additional tax payment in the range of $80,000 to $100,000 will be made by the end of 20X8.

Example 3 Disclosure: Non-Public Company- Abbreviated Disclosure

Most nonpublic companies do not have tax positions that require the recording of an unrecognized liability. In such cases, the disclosures are as follows:

Note X: Tax Uncertainties

The Company's policy is to record interest expense and penalties assessed by taxing authorities in operating expenses.

For years ended December 31, 20X7 and 20X6, there was no interest and penalties expense and no accrued interest and penalties recorded.

The Company is subject to U.S. federal and state income tax examinations for tax years 20X4, 20X5, 20X6 and 20X7.

5. Fixing the disclosures in uncertain tax positions for nonpublic entities

Since the issuance of FIN 48, the FASB has issued additional guidance with FASB Staff Position (FSP) FIN 48-1, and ASU 2009-6: *Income Taxes: Implementation Guidance on Accounting for Uncertainty in Income Taxes and Disclosure Amendments for Nonpublic Entities (ASC 740).*

ASU 2009-6 amends FIN 48 to eliminate certain disclosures for non-public companies and to clarify the scope to which FIN 48 applies.

FIN 48, as amended by ASU 2009-6, requires numerous disclosures related to tax positions.

Among those disclosures are *three specific disclosures* that have caused controversy in practice, particularly with respect to those companies that have no unrecognized tax positions recorded on their balance sheets.

Those three disclosures are:

1. The company's policy on classification of interest expense and penalties assessed by taxing authorities

2. The total amounts of interest and penalties recognized in the statement of operations, and the total amounts of interest and penalties recognized in the statement of financial position assessed by taxing authorities, and

3. A description of tax years that remain open subject to examination by major tax jurisdictions

Following are sample disclosures. In parentheses, the author has included the disclosure reference from the table above.

Note X: Tax Uncertainties

The Company's policy is to record interest expense and penalties assessed by taxing authorities in operating expenses.

For years ended December 31, 20X7 and 20X6, there was no interest and penalties expense and no accrued interest and penalties recorded.

The Company is subject to U.S. federal and state income tax examinations for tax years 20X4, 20X5, 20X6 and 20X7

In May 2010, the AICPA's Financial Reporting Executive Committee (FinREC) issued a technical practice aid, TPA 5250-15. "*Application of Certain FASB Interpretation No. 48 (codified in FASB ASC 740-10) Disclosure Requirements to Nonpublic Entities That Do Not Have Uncertain Tax Positions*,"

In that TPA, the AICPA concluded that when a nonpublic entity did not have uncertain tax positions the disclosure found in ASC 740-10-50-15(e) of the number of years that remain open subject to tax examination was still required to be disclosed.

Since issuance of the TPA, critics have argued that the conclusion reached in the TPA is flawed and inconsistent with ASU 2009-6.

In the Basis of Conclusions section of ASU 2009-6, the FASB states:

> BC13. The board concluded that the disclosure requirements in paragraph 740-10-50-15(c.) through (e) still provide value to users of nonpublic entity financial statements even without the disclosure of total unrecognized tax balances. As a result, the Board decided not to require nonpublic entities to disclose total unrecognized tax positions at the balance sheet dates.
>
> BC14. One respondent asked if a disclosure would be required *if management determined that there are no unrecognized tax benefits to record*. The Board concluded that *such a disclosure would not be required because it will set a precedent* for requiring a similar disclosure for all accounting standards for which there was no material effect on the financial statements.

Although BC14 does not explicitly identify what "a disclosure" references, at a minimum it references the disclosure of the number of tax years that remain open as follows:

> *A description of tax years that remain open subject to examination by major tax jurisdictions*

The FASB states that if there are no material uncertain tax positions recorded, the disclosure of "a description of tax years that remain open subject to examination by major tax jurisdiction" is *not required*.

But TPA 5250-15 erroneously contradicted the FASB's conclusion by stating that the disclosure of the number of years open IS required even if an entity has no uncertain tax positions recorded. Some respondents have stated that the AICPA was not inconsistent with the FASB's position because the Basis of Conclusions section is not formally part of the FASB's Codification.

The FASB and the Private Company Council (PCC) discussed FIN 48 at a February 2015 PCC meeting. At that meeting, the FASB reaffirmed its position in Paragraph B14 by stating that *it did not intend to require disclosure of tax examination years that are open when a nonpublic entity does not have any (material) uncertain tax positions.*

The result is that:

> *a nonpublic entity that has no uncertain tax positions liability recorded is not required to disclose the number of tax years open for examination.*

As a result, the AICPA has deleted TPA 5250-15 and has scheduled a reissue of the TPA shortly. That revised TPA will be consistent with ASU 2009-6 and will state that a description of tax years that are open subject to examination by major tax jurisdiction will not be required if an entity has no material unrecognized tax positions.

Are other tax related disclosures required if the item does not exist?

Once again, the three disclosures that are referenced above are:

1. The Company's policy on classification of interest expense and penalties assessed by taxing authorities

2. The total amounts of interest and penalties recognized in the statement of operations and the total amounts of interest and penalties recognized in the statement of financial position, assessed by taxing authorities, and

3. A description of tax years that remain open subject to examination by major tax jurisdictions

As the author just reviewed, if an entity has no material unrecognized tax positions, the third disclosure (description of tax years open) is not required.

But what about the other two disclosures related to interest and penalties? Are they required if an entity has no interest and penalties related to taxes?

Remember that Paragraph B14 of ASU 2009-6 states:

> BC14. One respondent asked if a disclosure would be required *if management determined that there are no unrecognized tax benefits to record*. The Board concluded that *such a disclosure would not be required because it will set a precedent* for requiring a similar disclosure for all accounting standards for which there was no material effect on the financial statements.

The FASB notes that a disclosure is not required (of open tax years) if there are no unrecognized tax obligations or benefits. The FASB goes on to state that to require such an irrelevant disclosure would not be required because it will "*set a precedent*" meaning it would result in entities including disclosures on elements that do not exist.

In other words, the FASB is saying that it does not want to set a precedent for requiring disclosures where an item to which the disclosure relates is not material to the financial statements.

The same conclusion should apply to disclosures (1) and (2) above involving interest and penalties on taxes. If an entity has no interest or penalties related to their taxes, there is no requirement to disclose item (1) (the company's policy to record interest expense and penalties assessed, and item (2) (The total amounts of interest and penalties recognized in the statement of operations and the total amounts of interest and penalties recognized in the statement of financial position assessed by taxing authorities).

Are any of the unrecognized tax benefit obligation disclosures required for an entity using tax basis financial statements?

As to the disclosure of the number of years open for examination, no disclosure is required if using tax basis financial statements. The reason is because such a disclosure is not required unless an entity has an unrecognized tax benefit liability, which is not recorded for tax basis financial statements.

As to the disclosures about interest and penalties, such disclosures would only be required in a year in which an entity that uses the tax basis of accounting, has interest and penalties related to a tax obligation that are either recorded as expense or accrued. Otherwise, no disclosures would be required.

6. Significance of unrecognized tax benefit liabilities to company financial statements

How significant are unrecognized tax benefit liabilities on company balance sheets?

For most nonpublic entities, the recording of unrecognized tax benefit liabilities is a nonstarter. Such nonpublic entities and their accountants and audits avoid recording liabilities like the plague.

For public entities, where transparency is at a higher level, the recording of unrecognized tax benefit liabilities is a regular event.

The question is how significant are these liabilities?

In March 2014, The Georgia Tech College of Business published a study entitled *Understanding Unrecognized Tax Benefits.*

In the Study, the authors examined the unrecognized tax benefits for the firms in the S&P 100. The goal of the study was to clarify the accounting and measure of the liabilities relative to each entity's assets, income tax expense and net income.

The results of the study conclude the following:

- The median unrecognized tax benefit liabilities was .8% of total assets, but increased to as high as 9.6% for certain companies.
- 78% of the unrecognized tax benefit would reduce net income if it were recognized (reversed).
- In general, unrecognized tax benefit liabilities represent an after-tax reserve that is quite subjective and can have a material effect on income if it were to be recognized (reversed).

The following table presents the liabilities for selected S&P 100 companies:

Unrecognized Tax Benefit Liabilities- Selected S&P 100 Companies			
Company	**Liability Balance at 2012**	**% total assets**	**% average NI (last 3 years)**
Accenture	$1.6 billion	9.6%	33%
IBM	5.7 billion	4.8%	32%
Dell	2.4 billion	5.1%	97%
Oracle	3.3 billion	4.2%	40%
BOA	3.7 billion	.2%	274%
HP	2.6 billion	2.4%	132%
JP Morgan	7.2 billion	.3%	22%
Median all companies		***.8%***	***11.8%***
Source: *Georgia Tech Financial Analysis Lab, Understanding Unrecognized Tax Benefits* (March 2014)			

The above table illustrates the impact that unrecognized tax benefit liabilities has on certain entities. For some companies, the impact is that the liabilities is a large percentage of total assets such as Accenture's 9.6%. For others, the impact is that the liability, if recognized through a reversal, represents a high percentage of net income. For example, Bank of America's $3.7 billion liability represents 274% of

average net income. Because the liability is quite subjective, if it were to reverse in part, it would have a significant impact of increasing net income.

Consider the disclosure found in the notes to Honeywell:

Balance at beginning of year	$815
Gross increases related to current period tax positions	25
Gross increases related to prior periods tax positions	44
Gross decreases related to prior periods tax positions	(62)
Decreases related to settlements with tax authorities	(40)
Expiration of the statute of limitations for the assessment of taxes	(64)
Foreign currency translation	4
Balance at end of year	$722

Source: *Georgia Tech Financial Analysis Lab, Understanding Unrecognized Tax Benefits* (March 2014)

Looking at the Honeywell disclosure above, Honeywell has $722 million of unrecognized tax benefit liabilities recorded on its balance sheet at year end. Notice the activity in and out of this liability account consisting of changes in volatile estimates computed based on a high degree of subjectivity.

In reviewing the results of the study, one conclusion can be easy reached. Unrecognized tax benefit liabilities represent to some companies, a significant liability as a percentage of total assets. Further, such liabilities are very subjective in nature and can be easily manipulated as reserve or "cushion" accounts.

7. The flaws of FIN 48- the IRS is watching

When FIN 48 was issued, its critics warned the FASB that FIN 48 would give the IRS an easy roadmap to audit questionable tax positions.

Embedded in the notes to financial statements of public companies is a disclosure of the activity in the unrecognized tax benefit liability, which FIN 48 requires, and is presented in the following format:

NOTE X: Unrecognized Tax Benefit Liability

A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

Balance at January 1, 20X1	$XX
Additions based on tax positions related to the current year	XX
Additions for tax positions of prior years	XX
Reductions for tax positions of prior years	(XX)
Reductions due to settlements with taxing authorities	(XX)
Reductions due to lapse in statute of limitations	(XX)
Balance at December 31, 20X1	$XX

Due to the required disclosures under FIN 48, there is far greater transparency into a company's tax positions than ever before. Under FIN 48, a company is required to record a tax liability if the probability is 50 percent or less that a particular tax position will be sustained in an IRS or state tax audit. That liability is required and is reflective of the uncertainty that exists in a tax position. Thus, the total liability represents the cumulative uncertainty of sustaining the tax benefit of all tax positions. That liability is not only presented separately on a company's balance sheet, but also must be reconciled in the notes to financial statements. In essence, FIN 48 lays out important information about a company's tax positions which can be used against it by the IRS or a state tax authority.

If a company has a sizeable balance in its unrecognized tax benefit liability account, that fact suggests that there are several significant positions that may be challengeable by the IRS and other tax jurisdictions. A company is essentially saying that it has taken tax positions which it may not be able to support and justify if the company is audited by the IRS or a state tax authority. Those tax authorities have access to the footnotes that include information on the unrecognized tax benefits.

Who is going after companies' tax positions under FIN 48?

The list of third parties interested in a company's FIN 48 information includes not only the IRS, but also state departments of revenue. Both the IRS and states have a vested interest in knowing a company's tax positions to assist in uncovering potential understated tax liabilities.

IRS's disclosures of uncertain tax positions- Schedule UTP

There are few instances where the Internal Revenue Service or other taxing authorities cross over to use GAAP information to assist them in conducting federal and state tax audits. The issuance of FIN 48 has given the IRS an opening to use FIN 48 working papers and disclosure information to identify uncertain tax positions.

With respect to the accountant's or auditor's tax accrual workpapers, the IRS has had a long-standing policy of restraint in seeking tax accrual workpapers,[43] requesting them in rare and unusual circumstances or where the taxpayer was involved in certain listed transactions.

In situations in which the IRS has demanded tax accrual workpapers, they have won in court such as in the case of *United States v. Textron, Inc*. (577, .3d 21 (1st Cir 2009), in which the court held that tax accrual workpapers are not privileged work product.

In early 2010, the IRS issued Announcement 2010-9 to address disclosures of uncertain tax positions on an entity's federal tax return. Subsequently, the IRS issued Announcement 2010-75 to replace 2010-9.

In Announcement 2010-75, the IRS stated that it was releasing a schedule in which certain taxpayers would be required to disclose uncertain tax positions related to their Form 1120 corporate tax return or other returns. The Schedule UTP, *Uncertain Tax Position Statement*, is effective from 2010 through 2014 based on a phase-in depending on the entity's asset size.

More specifically, the following rules apply under the Announcement:

1. A corporation must file Schedule UTP with its 2014 income tax return if:

[43] IRS Announcement 2002-63.

a. The corporation files Form 1120, U.S. Corporation Income Tax Return; Form 1120-F, U.S. Income Tax Return of a Foreign Corporation; Form 1120-L, U.S. Life Insurance Company Income Tax Return; or Form 1120-PC, U.S. Property and Casualty Insurance Company Income Tax Return

b. The corporation has assets that *equal or exceed $10 million*

c. The corporation or a related party issued *audited financial statements* reporting all or a portion of the corporation's operations for all or a portion of the corporation's tax year, and

d. The corporation has *one or more tax positions* that must be reported on Schedule UTP.

2. On the Schedule UTP, the taxpayer must:

- Disclose a concise description of each uncertain tax position, and

- Rank all of the reported tax positions based on the federal income tax reserve recorded for the position taken on the tax return, and designate the tax positions to which the reserve exceeds 10 percent of the aggregate amount of reserve for all tax positions reported.

3. The types of tax positions that require disclosure on the Schedule UTP include:

- Uncertain tax positions for which a taxpayer has recorded a reserve in its *audited* financial statements, and

- Uncertain tax positions for which the corporation did not record a reserve because the corporation expects to litigate the tax position.

4. The Schedule is not applicable to pass-through entities although the IRS has authority to extend the application of Schedule UTP to pass-through entities or tax-exempt organizations.

Will the IRS use the tax accrual workpapers and financial statement disclosures related to uncertain tax positions to assist it in auditing a company's tax return?

In Announcement 2010-76, the IRS stated that it has expended its policy of restraint by requiring the completion of the Schedule UTP but will forego seeking particular documents that relate to uncertain tax positions and the workpapers used to prepare the Schedule UTP.

Although the IRS may not seek use of tax accrual workpapers, the IRS has announced that it is using the footnote disclosures required by FIN 48 to audit uncertain tax positions. In 2007, the IRS Large Business and International Division (LB&I) issued *FIN 48 Implications LB&I Field Examiners' Guide.*

Moreover, recent cases in which the IRS has sought copies of tax accrual workpapers, the decisions have been split.

- On June 29, 2010, the U.S. Court of Appeals for the District of Columbia Circuit found that documents the government subpoenaed from Dow Chemical Company's independent auditors

were protected from discovery under the work-product doctrine. *U.S. v. Deloitte*, LLP, 106 AFTR 2d 2010-5053.

- The IRS won a victory in *U.S. v. Textron Inc*., 577 F.3d 21 (1st Cir. 2009), where the U.S. Court of Appeals for the First Circuit rejected the taxpayer's argument that its tax accrual workpapers were entitled to work-product protection.

- More recently, the issue was revisited in response to the IRS's summons of KPMG's tax accrual workpapers related to *Wells Fargo*. In June 2013, the U.S. District Court for the District of Minnesota ruled that Wells Fargo's measurement of and analysis with respect to its so-called uncertain tax positions, or UTPs, is entitled to work product protection, but that the identification of the types of UTPs is not. The court determined that the work product doctrine did not protect from disclosure the identification of UTPs and related factual information because that information is created in the ordinary course of business.

Question: Are FIN 48 Disclosures a Roadmap for the IRS?

IRS Answer: The disclosures required under FIN 48 should give the Service a somewhat better view of a taxpayer's uncertain tax positions; however, the disclosures still do not have the specificity that would allow a perfect view of the issues and amounts at risk. For example, there may be a contingent tax liability listed in the tax footnotes of a large multi-national taxpayer with a description called "tax credits," however, tax credits could be US, foreign, or state tax credits. So the "tax credits" in this example, may or may not have a US tax impact.

Even with the lack of specificity, tax footnotes included in financial statements, including FIN 48 disclosures, should be carefully reviewed and analyzed as part of the audit planning process. For example, if a taxpayer reflecting a contingent tax liability in the year under audit for Subpart F income does not reflect Subpart F in the tax return, questions could develop about why Subpart F income does not appear in the tax return, but is mentioned in the tax footnotes as creating a contingent tax liability.

State tax agencies and the search for nexus

State tax agencies also have a strong interest in FIN 48 information. With sizeable budget shortfalls, going after companies that have underreported state taxes provides the states with the opportunity to retrieve significant tax revenue. In particular, states are using FIN 48 information to attack two particular areas of vulnerability for companies:

- *Factors that lead to nexus within a particular state, and*
- *Computation of apportionment.*

Because of the current state tax environment in which many states are creating their own rules as to whether there is state nexus, it may be difficult to conclude whether there is a more-than-50-percent likelihood that a company's position will be challenged.

Observation: One approach a company can take to avoid disclosing information about its tax positions is to remove the disclosure from its financial statements and reference a GAAP departure in the auditor's report.

Recent study says IRS is paying attention to corporate filings as part of its audits

Regardless of what the IRS says about its focus or lack thereof in FIN 48 disclosures, a recent study suggest the IRS is particularly focused on corporate disclosures.

In October 2014, a group of educators published a study entitled, *IRS Attention*.[44]

The study examined IRS download (through IP addresses) timing and frequency patterns of firms' annual reports from EDGAR, which has the mandatory SEC disclosures, and concludes the following:

a. Despite the IRS having large amounts of private information on companies, IRS agents are pulling information from the EDGAR database of required public filings based on certain areas of interest.

    - There is a high pattern of downloads from "9 to 5" with a significant dropoff after those hours and on weekends.

    - The patterns indicate that human beings, rather than computer algorithms are pulling information from EDGAR during IRS hours.

    - The average downloaded 10-K is more than one year old (448 days average) suggesting that the financial statements are being used for tax enforcement purposes and not for information content purposes.

b. The IRS attention is strongly driven by firm characteristics such as:

    - Firm size
    - Foreign profitability
    - NOLs

c. There is a strong correlation between IRS attention to certain information and uncertain tax positions supporting the conclusion that the FIN48 disclosures provide a roadmap to the IRS.

    - The IRS attention after the effective date of FIN 48 has been four times greater than other U.S. government agencies.

    - The IRS has particular interest in 10-K filings particular since companies have been reporting uncertain tax positions under FIN 48.

d. Four financial statement measures appears to be used by the IRS and are correlated with information used by the IRS in its audits:

    - Cash effective tax rate (Taxes paid/Pretax income)

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[44] IRS Attention, Zahn Bozanic, Jeffrey L. Hoopes, Jacob R. Thornock, and Braden M. Williams,

- GAAP effective tax rate, including the breakdown of current, deferred and foreign/domestic taxes

- Book/tax differences

- Unrecognized tax benefits liabilities (UTB)

Note: A lower cash effective rate (cash ETR) is correlated with higher IRS attention.

Cash effective tax rate:

$$\frac{\text{Income taxes paid} \quad XX}{\text{Pretax income} \quad XX} = \text{Cash effective tax rate}$$

e. There is a strong correlation between IRS attention and the geographic footprint disclosed in the 10-K such as:

- Number of subsidiaries in tax havens
- Number of subsidiaries in foreign countries
- Number of geographic segments disclosed in the financial statements

Note: IRS attention has increased in measures of multinational operations but not for the measures of tax complexity.

f. Certain information found in the 10-K discloses important information that is used in tax avoidance and that is not reported to the IRS elsewhere such as:

- Narrative descriptions of company goals
- Management style
- Intentions behind M&A activities
- Estimations about future business prospects
- Supply chain
- Business operations
- Products
- Strategy
- Competition

g. IRS focus on disclosures increased after the effective date of Schedule M-3 and UTP.

8. FASB continues to increase income tax disclosures

If FIN 48 disclosures were not enough, the FASB is at it again. This time, the FASB has proposed increasing disclosures of undistributed foreign earnings as part of its disclosure framework project.

Although the framework project is supposed to streamline disclosures, requiring additional disclosures of undistributed foreign earnings appears to be going in the opposite direction.
In its February 2015 meeting, the FASB decided that entities would be required to disclose the following:

a. Income before taxes disaggregated between domestic and foreign earnings. Foreign earnings would be further disaggregated for any country that is significant to total earnings.

b. Domestic tax expense recognized in the period for taxes on foreign earnings.

c. Undistributed foreign earnings that are no longer asserted to be indefinitely reinvested during the current period and an explanation of the circumstances that cause the entity to make that assertion. Separate disclosure should be made for any country that is significant to the disclosed amount.

d. A further disaggregation of the current requirement to disclose the temporary difference for the cumulative amount of indefinitely reinvested foreign earnings if any country represents at least 10 percent of the disclosed amount.

The FASB decided not to require disclosure of:

a. Disaggregation of deferred tax liabilities (DTL) recorded for unremitted foreign earnings by country.

b. An estimate of the unrecognized DTL on the basis of simplified assumptions.

c. Past events or current conditions that have changed management's plans for undistributed foreign earnings.

Observation: According to several studies, U.S. company profits and cash held off shore exceed $2 trillion. Those companies are not motivated to repatriate the profits and cash to the U.S. given the existing corporate tax rate of 35%. One firm estimated that the amount of foreign earnings remaining off shore increased by 93% from 2008 to 2013.[45]

9. Impact of reduction in tax rates on deferred taxes

For the past decade, there have been numerous proposals and suggestions that U.S. corporate tax rates should be reduced as part an overall tax reform.

In the joint committee report entitled, *The Moment of Truth: Report of the National Commission on Fiscal Responsibility and Reform*,[46] the committee recommended that the top corporate Federal tax rate be reduced from 35 percent to a rate within the range of 23-29 percent. Recently, the Treasury and White House mentioned a 25 percent target rate.

The current U.S. corporate tax rate is 35%, which is considered one of the highest among all countries.

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[45] Audit Analytics 2014, as reported by Thompson Reuters.
[46] Report issued by the National Commission on Fiscal Responsibility and Reform

When one adds a state tax rate in the 5 to 10% range, net of the federal tax benefit, most corporations have a federal and state effective tax rate that exceeds 40%.

According to the Tax Foundation:[47]

- The United States has the third highest general top marginal corporate income tax rate (federal and state) in the world at 39.1%, exceeded only by Chad and the United Arab Emirates, and the highest federal corporate income tax rate (among the 34 industrialized nations of the Organization for Economic Cooperation and Development (OECD).

- The worldwide average top corporate income tax rate is 22.6% (30.6% weighted by GDP).

- By region, Europe has the lowest average corporate tax rate at 18.6% (26.3% weighted by GDP); Africa has the highest average tax rate at 29.1%.

- Larger, more industrialized countries tend to have higher corporate income tax rates than developing countries.

- The worldwide (simple) average top corporate tax rate has declined over the past decade from 29.5% to 22.6%.

- Every region in the world has seen a decline in their average corporate tax rate in the past decade.

Corporate Tax Rates By Country	
Country	**Corporate Tax Rate**
United Arab Emigrates	55%
Chad	40%
United States	**35%**
Japan*	37%
France	34.4%
India	34%
Australia	30%
UK	21%
Italy	27.5%
Greece	26%
Mexico	30%
Spain	28%
Austria	25%
Israel	26.5%
Sweden	22%
Ireland	12.5%
Switzerland	8.5%
Bahamas	0%

[47] Tax Foundation, *Corporate Income Tax Rates Around the World, 2014*

British VI	0%
Bermuda	0%
Worldwide average	**22.6%**

* Japan has approved tax reform that will lower its corporate rate.

Source: Tax Foundation and Source: Organization for Economic Co-operation and Development (*OECD*)

As corporate tax revenues decline and U.S. companies continue to hold more than $2 trillion of cash offshore, there is impetus to reduce the U.S. corporate tax rate from 35% to a rate that is in the 25 to 28% range.

Background

ASC 740 (formerly FASB 109), *Income Taxes*, is the GAAP authority for the accounting for income taxes:

The basic rules are as follows:

1. Total income taxes consist of the current portion and the deferred portion:

   Current portion: Recognized based on the estimated taxes payable or refundable on tax returns for the current year as a tax liability or asset.

   Deferred portion: Recognized as a deferred tax liability or asset for the estimated future tax effects attributable to temporary differences and carryforwards.

2. Temporary differences are the difference between the book and tax basis of an asset or liability that will result in taxable or deductible amounts in future years when the reported amount is recovered or settled.

3. Deferred tax assets and liabilities are computed based on *enacted tax rates expected to apply* to taxable income in the periods in which the deferred tax liability or asset is expected to be settled or realized.

Example 1: Company X is a C corporation is a first year entity and has the following M-1 reconciliation:

Pretax book income	$5,000,000
M-1:	
Depreciation	(1,000,000)
Taxable income	4,000,000
	35%
Current federal income tax	$1,400,000
Accumulated depreciation: 12-31-20X1:	
Book	$2,000,000
Tax	3,000,000
Temporary difference	1,000,000
Tax rate	35%
Deferred tax liability	$350,000

Entry:

Income tax expense- current	1,400,000	
Income tax expense- deferred	350,000	
Accrued FIT		1,400,000
Deferred FIT		350,000

Example 2: Company Z has the following information for year ended 2015:

2015 tax net operating loss	$(1,000,000)
Temporary difference:	
Accumulated depreciation at 12-31-15:	
Book	$2,000,000
Tax	3,500,000
Temporary difference	$1,500,000

The $(1,000,000) 2015 net operating loss is available for carryforward to 2035 (20 years).

The company had federal tax losses in the two carryback years (2013 and 2014) which were carried back to earlier years to obtain a federal tax refund. There is no portion of the 2015 NOL available for carryback.

The temporary difference related to accumulated depreciation (AD) will reverse in years 2016 through 2025. There are no other temporary differences.

There are no state income taxes.

A deferred income tax asset and liability was recorded with balances at 12-31-15 as follows:

Deferred income tax asset (federal):
2013 federal tax net operating loss $1,000,000 x 35% $350,000
[NOL expires in 2035, twenty years]

Deferred income tax liability:
Temporary difference: AD $1,500,000 x 35% $(525,000)

What would be the impact of a reduction in the corporate tax rate from 35% to 28%?

Putting aside the political aspects of corporate tax rates, the question is what happens to deferred income tax balances if corporate rates decline from 35% to 28%?

In February 2015, the Georgia Tech Financial Analysis Lab issued a study entitled, *The Effects of Tax Reform on Deferred Taxes: The Winners and Losers.*

In the study, the authors examined 809 U.S. companies and the impact of US corporate income tax reform on deferred taxes and which companies and industries will gain and lose if tax reform were to come to fruition.

The focus of the study was to address the adjustment, if any, that would occur to deferred tax assets and liabilities if tax rates were to be reduced from 35% to 28%.

Deferred tax assets and liabilities are recorded at the margin tax rate expected to be in effect when the temporary differences that create the deferred taxes reverse in future years.

A change in the corporate rate to 28% would result in a reduction in both deferred tax assets and liabilities, resulting a change in assets, liabilities and stockholders' equity in most companies.

For a sample of 809 U.S. companies with revenue greater than $500 million with reported deferred tax balances, the authors of the study present the financial statement effects of lowering the corporate income tax rate from 35% to 28%.

The results of the study reveal the following:

1. If rates were to decline from 35% to 28%, the 809 sampled companies would receive an overall *net increase in stockholders' equity of $104 billion* broken out as follows:

   a. 548 of the companies sampled with deferred tax liabilities would receive a $142 billion reduction in liabilities and increase in stockholders' equity.

      - Liabilities would decline by 2%
      - Stockholders' equity would increase by 3.3%
      - Financial leverage (liabilities to equity ratio) would decline by 5.5%

   b. 261 of the companies would see a decline of $38 billion in deferred tax assets and decrease in stockholders' equity.

      - Assets would decline by .4%

- Stockholders' equity would decrease by 1.2%
- Financial leverage (liabilities to equity ratio) would increase by 1.2%

2. Winners and losers from tax reform:

   a. Winners from tax reform, consisting of industries with large deferred tax liabilities that will be reduced include:

      - Utilities and Energy sectors
      - Electric, gas and water utilities
      - Oil and gas exploration
      - Transportation, including railroad companies

   b. Losers from tax reform, consisting of industries with large deferred tax assets that will be reduced include:

      - Mortgage, finance and banking sectors:
      - Financial companies
      - Commercial banks
      - Consumer finance companies
      - Leisure equipment
      - Durables
      - Pharmaceuticals
      - Biotechnology
      - Auto components
      - Computer hardware and software

3. Companies that are net losers from tax reform (e.g., deferred tax assets and stockholders' equity would decline) could violate existing loan covenants.

4. Entities with the largest reduction in liabilities (winners) follows:

Biggest Winners from Reduction in Corporate Rates to 28%			
Company	**Reduction in deferred tax liabilities**	**% reduction in total liabilities**	**Increase in stockholders' equity**
Comcast	$(6.3) billion	(5.9)%	12.5%
Time Warner	(2.3) billion	(5.7)%	33.9%
Hilton International	(967) million	(4.4)%	22.2%
Hertz	(584) million	(2.7)%	21.1%
N star	(303) million	(6.8)%	12.2%
Median- all sampled		**(2.0)%**	**3.3%**

Source: Georgia Tech Financial Analysis Lab study, *The Effects of Tax Reform on Deferred Taxes: The Winners and Losers.*

Biggest Losers from Reduction in Corporate Rates to 28%			
Company	**Reduction in deferred tax Assets**	**% reduction in total assets**	**Decrease in stockholders' equity**
Fannie Mae	$9.5 billion	(.3)%	(99.7)%
Orbitz	32 million	(2.9)%	(77)%
Federal Home Loan Mtg	4.5 billion	(.2)%	(35.4)%
Delta	1.3 billion	(2.6)%	(11.6)%
Citigroup	10.6 billion	(.6)%	(5.2)%
Median all sampled		**(.4)%**	**(1.2)%**
Source: Georgia Tech Financial Analysis Lab study, *The Effects of Tax Reform on Deferred Taxes: The Winners and Losers.*			

Question: If the corporate tax rate were to decline from 35% to 28%, where would the adjustment of the deferred tax asset or liability be presented on financial statements?

Response: ASC 740-10-45-15 states "when deferred tax accounts are adjusted as required by paragraph 740-10-35-4 for the effect of a change in tax laws or rates, the effect shall be *included in income from continuing operations* for the period that includes the enactment date."

Therefore, if the corporate tax rate is reduced to 28%, the deferred tax asset and/or liability would be adjusted to the lower rate with the offsetting entry to income tax expense.

Consider the following example:

Example: Company Z has the following information for year ended 2016:

2016 tax net operating loss	$(1,000,000)
Temporary difference:	
Accumulated depreciation at 12-31-16:	
Book	$2,000,000
Tax	3,500,000
Temporary difference	$1,500,000

The $(1,000,000) 2016 net operating loss is available for carryforward to 2036 (20 years).

The temporary difference related to accumulated depreciation (AD) will reverse in years 2017 through 2026. There are no other temporary differences.

There are no state income taxes.

A deferred income tax asset and liability was recorded with balances at 12-31-16 as follows:

Deferred income tax asset (federal):		
2016 federal tax net operating loss	$1,000,000 x 35%	$350,000
[NOL expires in 2036, twenty years]		
Deferred income tax liability:		
Temporary difference: AD $1,500,000 x 35%		$(525,000)

Effective January 1, 2017, the U.S. corporate tax rate is reduced from 35% to 28%.

Conclusion: Effective January 1, 2017, the deferred tax asset and liability are recomputed at the new 28% rate as follows:

Deferred tax asset:		
Originally computed:	1,000,000 x 35%	$350,000
Revised	1,000,000 x 28%	280,000
Adjustment		**$70,000**

Deferred tax liability:	Originally computed 35%	Revised 28%
Temporary difference:		
Accumulated depreciation at 12-31-16:		
Book	$2,000,000	$2,000,000
Tax	3,500,000	3,500,000
Temporary difference	1,500,000	1,500,000
	35%	28%
	$525,000	$420,000
Adjustment	**$105,000**	

Entry: (January 1, 2017)

Deferred tax liability	105,000	
Deferred tax asset		70,000
Income tax expense- deferred		(1) 35,000

(1) shown as a separate component of income tax expense

In 2017, the $35,000 deferred tax adjustment is shown as a separate component of income tax expense as follows:

NOTE X: Income Taxes:

A summary of the current and deferred portions of federal income tax expense follows:

Current portion	$XX
Deferred	XX
Adjustment due to change in tax rates	***(35,000)***
Total income tax expense	XX

If there is a valuation allowance account, it too should be adjusted to reflect the reduction in the federal marginal tax rate with the offset to income tax expense as part of continued operations.

T. FASB'S Focus on Cash Flows

More than 25 years after the issuance of FASB No. 95, *Statement of Cash Flows*, the classification of certain transactions within the statement of cash flows continues to be an unresolved issue.

In November 1987, FASB issued FASB No. 95, *Statement of Cash Flows, which is now* codified in ASC 230, *Statement of Cash Flows*.

The FASB staff's research indicates that there is diversity in practice with respect to the classification of certain cash receipts and payments. The staff's research also indicated that the primary reasons for the diversity in classification is the result of lack of specific accounting guidance and inconsistent application of the existing principles within ASC 230.

At its April 28, 2014 meeting, the FASB voted to add a project to its agenda. The project, *Clarifying Certain Existing Principles on Statement of Cash Flows*, was intended to reduce diversity in practice in financial reporting by clarifying certain principles in ASC 230.

At its April 1, 2015 meeting, the FASB decided that clarifying certain existing principles within ASC 230 would only incrementally reduce diversity in practice about the classification of cash receipts and cash payments.

Therefore, the FASB decided to have the Emerging Issues Task Force (EITF) consider *nine specific cash flow issues* as follows:

- Settlement of insurance claims
- Debt prepayment or extinguishment costs
- Restricted cash
- Settlement of zero coupon bonds
- Distributions received from equity method investees
- Settlement of life insurance contracts
- Contingent consideration payments made after a business combination
- Beneficial interests in securitization transactions

- Application of the predominance principle

According to Audit Analytics, more than 600 companies have filed restatements in the past five years that involve classifications on the statement of cash flows.

In 2009, only 65 restatements (8.7% of the total) were attributable to cash flow statement errors, while that number has increased to a total of 174 in 2013, more than 20% of all restatements.[48]

Simultaneously with the FASB starting its cash flows project, the SEC is also addressed the cash flow issue.

In December 2014, the SEC noted its concern about the number of restatements pertaining to cash flow statement errors.

In a speech[49], an SEC representative observed the following:

a. While the total number of restatements over the past five years has been relatively consistent, restatements due to errors in the statement of cash flows continue to increase year over year.

b. The SEC staff noted that the majority of errors were due to relatively less complex applications of GAAP such as failure to appropriately account for capital expenditures purchased on credit.

c. The SEC suggested that companies take a new look at their controls in preparing and reviewing the statement of cash flows, including risk assessment and monitoring.

Given the increase in the number of misstatements on the statement of cash flows, along with the SEC's public concerns about the errors, the FASB's project is likely to be welcomed by the financial community.

In December 2015, the FASB voted to issue an exposure draft sometime in 2016.

U. Accounting, Auditing and Tax Issues Related to Marijuana

As of early 2016, there are 27 states and the District of Columbia that have legalized some form of marijuana use. The state laws range from:

- Decriminalizing possession to legalizing marijuana sale
- Legalizing marijuana sale
- Production and use for medical purposes
- Legalizing marijuana sale, production and use for recreational use.

Many states are reviewing the laws in light of Colorado's and Oregon's recent approval for recreational use. Those states include California, Illinois, Massachusetts, Michigan and New York.

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[48] Per Audit Analytics as reported by Compliance Week, April 2015.

[49] Remarks Before the 2014 AICPA National Conference on Current SEC and PCAOB Developments, Kirk Crews, SEC, December 8, 2014.

With the growth in the acceptable sale of marijuana in some form, restricted or otherwise, an entire industry of professionals, specializing in marijuana, is being created. Those professionals include accountants and auditors that understand the accounting, auditing and tax issues surrounding marijuana's use and sale.

The purpose of this section is not to advocate the use or sale of any type of drug. Yet, accountants must be aware of trends in the accounting field, one of which involves the legalization of marijuana use and sale.

As of June 2015, several states have authorized the use and sale of marijuana at some level:

State	**Status**
Colorado- Legalized recreational use	Legalized recreational use
Washington State	Legalized recreational use
Alaska	Legalized recreational use
Oregon	Legalized recreational use
Washington D.C.	Decriminalized recreational use
Guam	Legalized recreational use
Massachusetts	Legalized for medical use

Source: *An Issue Brief on State Marijuana Laws and the CPA Profession*, AICPA, January 2015

The trend is toward more states legalizing the sale of marijuana is some form due to the attractive tax revenues that states can derive from their sale.

The result is that the marijuana business is quickly becoming a high-growth segment in several state economies. As the demand for business services grows, CPAs are being asked to perform accounting, auditing, tax and consulting services for marijuana growers and sellers.

Because the marijuana business is certainly not main stream, there are certain risks inherent in the business that accountants must be aware of.

What are some of the issues an accountant or auditor must contend with in servicing a marijuana client?

The accountant must be aware of some of the industry-specific risks:

Federal illegality despite being legal at the state level

Although certain states have made the use and sale of marijuana legal, it is still *illegal at the Federal level* as a Schedule I drug under the Controlled Substances Act of 1970. The Supreme Court has ruled that federal law takes precedent over state law.

There is always the risk that the Federal government could enforce the federal laws by raiding the business. Further, being illegal provides an overall cloud of illegality on an interstate level with suppliers, and users out of state.

Note: The Justice Department under the current administration is generally taking a hands-off approach to these state law experiments, but the Obama administration has expressed no strong desire to change the legal status of marijuana at the federal level and has warned of possible enforcement activity if the marijuana activities involve criminal elements, sales to minors, sales across state lines, other illegal drugs, or use of public lands or federal property.

The Internal Revenue Service follows the federal law in viewing these businesses as illegal businesses for tax purposes. This creates a number of tax issues for representing these clients, as well as criminal exposure and possible ethical issues with respect to the professional licenses that a particular tax advisor may hold.

Doing business without a bank account or credit cards

Most banks will not accept bank accounts or provide credit card services related to the marijuana business because of the federal law and money laundering regulations. Consequently, it is difficult to open bank accounts or utilize credit card services.

The result is that:

1. Most marijuana businesses are working on a literal cash basis and retaining large sums of cash.

2. Security issues are always a concern with that much cash being held outside a bank account.

3. Many marijuana businesses must pay their bills, including payroll, with money orders and cash.

Risk of engaging in an illegal activity

Although marijuana business might be legal at the state level in which an accountant practices, the accountant has to be concerned about the *federal illegality* and its impact on the accountant's reputation, ethics, and legal exposure.

1. Under federal law, a person who aids, abets, counsels, commands, induces or procures the commission of a federal offense is punishable as a principal.

2. What has not been determined is whether rendering tax advice or preparing tax returns, or performing accounting services qualifies as aiding or abetting an illegal activity.

   Note: The Obama administration and the Justice Department have taken a hands-off approach to addressing the illegal nature of the marijuana business that is legal is certain statements. That approach has continued and there are no signs that the Justice Department is likely to change its focus. What is unknown is what would happen under the next administration in 2017.

3. There is the risk that CPAs (and lawyers) who service clients in legal states such as Colorado, Washington and others, could receive cancellation notices for their professional liability insurance.

4. Contracts can be deemed unenforceable for being against public policy and involving an illegal activity at the federal level.

5. There is the ongoing risk of dealing in a cash business including the risk of embezzlement and underreporting income.

Marijuana ethics issues for the CPA

In January 2015, the AICPA issued a white paper entitled, *An Issue Brief on State Marijuana Laws and the CPA Profession.*

In the Brief, the AICPA addresses some of the ethical issues surrounding accountants who choose to service clients in the marijuana business.

The AICPA notes the following:

1. CPAs should check with their State Board of Accountancy when they consider providing services to a marijuana-related business due to the fact that the business is illegal at the federal level.

   According to the AICPA:

   "It is possible that a CPA from a state that allows marijuana use who has provided services to a 'marijuana business' could face licensing difficulties if he or she seeks a reciprocal license in a state where marijuana is illegal. It's not yet clear how State Boards of Accountancy will apply "*good moral character*" requirements or impose discipline when it comes to supporting marijuana-related businesses, or if they will take a position at all."

2. CPAs who are contemplating providing services to marijuana-related businesses should consider whether a State Board would consider it to be an "*act discreditable*" when a CPA provides services to businesses that violate federal drug laws, even in a state that allows those businesses to operate legally.

   Note: The AICPA Brief observes that in the states that have passed laws or referendums allowing medicinal or recreational marijuana use, State Boards of Accountancy have not yet provided any guidance for CPAs looking to provide services to businesses that grow/sell marijuana. This dynamic puts CPAs in a gray legal area. They need to satisfy the requirements of their State Boards of Accountancy for 'good moral character' and the 'acts discreditable' requirements in their respective states, while at the same time considering the potential business opportunities."

Tax risks

One of the greatest risks that an accountant can encounter with a marijuana client is the risk from IRS and state audits and the misapplication of Section 280E of the Internal Revenue Code.

1. IRC Section 280E *denies tax credits and deductions* to businesses who traffic *in controlled substances* such as marijuana.

   a. The exception is that such businesses *may deduct cost of goods* sold for growing and selling marijuana under 280E but *cannot deduct other expenses*.

Note: Costs are capitalized to inventory (and deductible as cost of goods sold) under Section 471 (inventory) and 263A (uniform capitalization rules). Companies are incentivized to fully capitalize costs are these sections using full absorption so that such costs are ultimately deductible as part of cost of goods sold.

b. Other costs for selling, marketing and G&A (that are not capitalized under 263A) are not deductible under 280E.

Note: In January 2015, the IRS issued an internal legal memorandum that addresses how Section 280E should be applied to the marijuana industry. Its focus is to explain how the IRS should determine cost of goods sold for purposes of Section 280E deductibility.

In the memorandum, the IRS noted that marijuana retailers and producers must compute cost of goods sold under the pre-Section 280E inventory rules (e.g., pre 263A). Those rules mean that the business is permitted to deduct the purchase price of the marijuana (net of discounts), plus transportation and other costs necessarily as part of the acquisition. In addition, the producer may include in cost of goods sold any direct costs such as seeds, direct labor related to planting, harvesting, sorting, and cultivating the plants. Certain indirect costs may be included in cost of goods sold provided they are "incidental and necessary to production", along with depreciation, factory insurance, and other factory costs.

Such businesses may not allocate to cost of goods sold any costs associated with purchasing, handling, storage, and administrative costs to COGS.

2. There is a difficulty paying certain taxes electronically due to lack of a bank account or credit cards.

Note: The IRS requires certain taxes to be paid electronically such as C corporation estimates. However, it is difficult for marijuana businesses to get bank accounts or utilize credit cards from which to pay the taxes. The IRS has tried to impose substantial penalties on marijuana businesses that tried to pay their taxes in cash, even though the businesses state that that they could not file electronically.

Allgreens LLC sued the IRS in Tax Court challenging the IRS's determination that the inability to get a bank account did not excuse the failure to pay employee withholding taxes electronically. In a settlement of the case, the IRS agreed to abate the penalties, but stated that the settlement should not be viewed as precedent for future cases.

3. No medical expense deduction:

a. For the individual utilizing marijuana for medical purposes, the federal law treatment of marijuana also creates problems for the medical expense deduction. Revenue Ruling 97- 9 determined that amounts paid for marijuana for medicinal use are not deductible, even if permitted under state law, since they were not legally procured under federal law. A similar analysis would probably apply to health flexible spending accounts, health savings accounts, health reimbursement accounts, and Archer Medical Savings Accounts.

4. The difficulties of performing a complete and accurate tax return:

a. With a pure cash business, there is the risk of:

- Failure to issue 1099s
- Having underreported income
- Client underreporting sales tax due to missing cash deposits
- Client taking deductions that should not be taken under 280E

Accounting and auditing issues

If an accountant is required to audit, review or compile the financial statements of a marijuana retailer or producer, there are certain issues that are peculiar to the engagement as follows:

1. Planning and client acceptance:

   a. Because the marijuana business is an emerging market, it is important for the accountant/auditor to do the following:

      - Client acceptance: Evaluate the reputation risk, professional liability and overall risk of performing the engagement.

      - Understand the entity and business: Including the legal and regulatory environment, uncertainties and estimates, cash issues, and financing issues.

      - Scope limitations: If an audit, any scope limitations particularly with respect to inventory and revenue.

2. Accounting issues:

   a. The financial statements should have the following disclosures:

      - Nature of business including a description that the business is legal at the state level, but illegal at the federal level.

      - Concentration of risks and uncertainties related to:
        - The illegal nature of the business and regulatory environment in which it operates, and

        - The fact that the business is a cash business

        - The fact that the business has no bank account yet has a concentration of cash that is not protected and deposited in a bank.

      - Contingency- reasonably possible that the business could be shut down by the federal government due to its illegal nature.

3. Reporting issues:

a. *Noncompliance with laws and regulations*: The accountant or auditor should address the issue as to whether the business is in compliance with laws and regulations and its impact on the financial statements.

b. *Emphasis of matter or other matter paragraph*. The accountant or auditor may wish to include an emphasis-of-matter or other-matter paragraph in his or her report describing the business.

4. Management representation letter:

   a. If a review or audit is performed, the accountant or auditor should obtain a representation letter from management that specifically confirms that the *business is not in compliance with laws and regulations*, it is engaged in an illegal activity, revenues and inventories are complete, etc.

5. Engagement letter:

   a. In the accountant's/auditor's engagement letter, the letter should have language that indemnifies the accountant for known misrepresentations by management.

6. Possible scope limitations: Because of the cash business, it might be difficult to:

   a. Measure the completeness of revenue.

   b. Determining the completeness of inventory.

7. Going concern

   a. In limited cases, due to the fact that the entity is engaged in an illegal activity, going concern could be an issue because the business could be shut down at any point in time.

Is an accountant or auditor permitted to issue a report on an illegal activity?

Nothing in compilation, review or auditing standards precludes an accountant from performing an engagement and issuing a report on an illegal activity as long as there is no scope limitation.

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self - study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

1. In accordance with ASC 740, a company is required to record a valuation account against a deferred income tax asset if it is that some portion or all of the deferred tax asset will not be realized:
   a. Probable
   b. Reasonably possible
   c. More likely than not
   d. Highly likely

2. With respect to deferred tax assets, in accordance with ASC 740, future income can come from which of the following:
   a. Estimated future taxable income, including the reversal of temporary differences and carryforwards
   b. Switching from tax-exempt to taxable investments as part of a tax-planning strategy
   c. Reversal of existing taxable temporary differences assuming taxable include is greater than book income
   d. Current year tax losses

3. Under existing GAAP per ASC 740, how should a deferred tax liability be classified on the balance sheet:
   a. Always shown as current and long-term based on the estimated reversal date
   b. Current and long-term based on the classification of the related asset or liability
   c. Always long-term
   d. Always current

4. Company X is a C corporation with estimated annual taxable income of $100,000 in periods in which its deferred tax liability is expected to be settled. Which of the following federal tax rates should X use to record the deferred tax liability:
   a. 35%
   b. 25%
   c. 22%
   d. 34%

5. According to the author, which of the following would be the impact of lowering the corporate tax rate:
   a. Deferred tax assets would be adjusted downward
   b. Deferred tax assets would be adjusted upward
   c. There would be no effect on deferred tax assets, but there is an impact on the accrued federal tax liability
   d. A larger valuation account would be required for deferred tax assets

6. Julio is a CPA and has a new client, a marijuana grower and seller in the state of Washington. Which of the following is correct with respect to the new client:
   a. The new client's business is illegal is both Washington and for federal purposes
   b. The business is illegal for federal purposes
   c. The new business is legal for federal purposes but illegal in the state of Washington
   d. The business is illegal at both the state and federal level

7. Richard Gere is a CPA and his client is Redundant Inc. Redundant has recorded deferred tax asset on an unused NOL carryforward using the statutory rate of 35%. Congress passes a law in which the statutory rate declines to 25% effective January 1, 2017. What should Redundant do to its deferred tax asset:
   a. Nothing. It must retain the original NOL until it ultimately reverses
   b. The company must adjust the NOL to a revised deferred tax asset based on the lower rate of 25%.
   c. The company must adjust the NOL over a four-year phase-in period.
   d. The company must record a tax allowance for the 10% rate differential.

SUGGESTED SOLUTIONS

1. In accordance with ASC 740, a company is required to record a valuation account against a deferred income tax asset if it is that some portion or all of the deferred tax asset will not be realized.
   a. Incorrect. In reviewing the rules in ASC 740, the probable threshold is not used in determining whether a valuation account is required. The probable threshold is used in the contingency rules.
   b. Incorrect. The reasonably possible threshold is not used in determining whether a valuation account is required. Reasonably possible is a term used in the contingency rules, not the valuation account.
   c. **Correct. ASC 740 uses the more-likely-than-not (more than 50% probability) threshold to determine whether a valuation account is required.**
   d. Incorrect. ASC 740 and GAAP, in general, does not use highly likely as a threshold for determining whether a valuation account is required.

2. With respect to deferred tax assets, in accordance with ASC 740, future income can come from which of the following:
   a. Incorrect. Estimated future taxable income should exclude the reversal of temporary differences and carryforwards.
   b. **Correct. Tax planning strategies that a company would implement to utilize an expiring NOL is one example of future income. Switching from tax-exempt to taxable investments is one of those strategies.**
   c. Incorrect. Reversal of existing taxable temporary differences is a source of future income, but it is based on the assumption that taxable income is zero and not that taxable income is greater than book income.
   d. Incorrect. A current year tax loss does not create future income.

3. Under existing GAAP per ASC 740, how should a deferred tax liability be classified on the balance sheet:
   a. Incorrect. The classification is not based on the estimated reversal date unless the deferred tax liability does not relate to an asset or liability.
   b. **Correct. GAAP requires the classification of the deferred tax liability (or asset) follow the classification of the related asset or liability that caused the temporary difference.**
   c. Incorrect. GAAP does not provide for always classifying the deferred tax liability (or asset) as long-term.
   d. Incorrect. There is no GAAP requirement that a deferred tax liability or asset always be classified as current.

4. Company X is a C corporation with estimated annual taxable income of $100,000 in periods in which its deferred tax liability is expected to be settled. Which of the following federal tax rates should X use to record the deferred tax liability:
   a. Incorrect. The average graduated tax rate should be used which, in this case, is 22%.
   b. Incorrect. The 25% rate is the rate on taxable income between $50,000 and $75,000. The average graduated tax rate should be used because graduated tax rates are a significant factor. The rate used should be 22% which is the average graduated tax rate on $100,000 of taxable income.
   c. **Correct. The average graduated tax rate on $100,000 of taxable income should be used, which is 22%.**

d. Incorrect. 34% is the tax rate on taxable income within the $75,000 and $100,000. GAAP requires that the average graduated tax rate of 22% be used.

5. According to the author, which of the following would be the impact of lowering the corporate tax rate:
   a. **Correct. If the federal rate were to be reduced, all deferred tax assets that were previously recorded at a higher 35% tax rate would have to be adjusted downward to reflect the lower tax benefit that would be received in future years.**
   b. Incorrect. Deferred tax assets would be adjusted downward, not upward. If rates increase, the deferred tax assets would be adjusted upward.
   c. Incorrect. The deferred tax asset would be reduced making the statement incorrect.
   d. Incorrect. Reducing the deferred tax asset would affect the asset directly and not the valuation account.

6. Julio is a CPA and has a new client, a marijuana grower and seller in the state of Washington. Which of the following is correct with respect to the new client:
   a. Incorrect. The state of Washington is one of the states which makes the sale of marijuana legal making the answer incorrect.
   b. **Correct. It is still illegal to sell marijuana under the federal Controlled Substances Act of 1970 making the answer correct.**
   c. Incorrect. The answer is the opposite in that the new business is illegal for federal purposes but legal at the state of Washington level making the answer incorrect.
   d. Incorrect. It is legal in the state of Washington making the answer incorrect.

7. Richard Gere is a CPA and his client is Redundant Inc. Redundant has recorded deferred tax asset on an unused NOL carryforward using the statutory rate of 35%. Congress passes a law in which the statutory rate declines to 25% effective January 1, 2017. What should Redundant do to its deferred tax asset:
   a. Incorrect. The asset must be adjusted. Otherwise it is overstated by 10%. Thus the answer is incorrect.
   b. **Correct. GAAP states that when there is a change in tax law or rate, the deferred tax asset must be adjusted to the new lower rate with the offset being tax expense as part of income from continuing operations.**
   c. Incorrect. GAAP does not provide for a four-year phase-in period.
   d. Incorrect. GAAP requires that the deferred tax asset be adjusted directly so that use of a tax allowance account is not warranted.

V The Statement of Cash Flows- Coming Under Scrutiny by the Investment Community

Over the past decade, the statement of cash flows has come under scrutiny by investors and other third parties. Once focusing on the statement of income as the primary course of assessing financial performance, greater emphasis has been placed on cash flow.

Of particular concern is that most third-party users have no idea how to interpret the statement of cash flows, in particular, use of the indirect method.

A quick review

ASC 230, *Statement of Cash Flows* (formerly FASB No. 95) permits a company to present cash flows from operating activities using either the direct or indirect method. Although the direct method is the preferable method, ASC 230 gives the company the choice between these two methods.

The indirect method starts with net income and reconciles back to cash from operating activities by converting net income from accrual to cash basis.

Indirect method:

Cash flows from operating activities:	
Net income	$xx
Adjustments to reconcile net income to cash flows from operating activities:	
Depreciation	xx
Deferred income taxes	xx
Accounts receivable	xx
Inventories	xx
Prepaid expenses and other items	xx
Accounts payable	xx
Accrued expenses	xx
Net cash provided by operating activities	$xx

Direct method:

Cash flows from operating activities:	
Collections from customers	$xx
Collections of other income	xx
Cash paid to suppliers and employees	xx
Interest paid	xx
Income taxes paid	xx
Net cash provided by operating activities	$xx

If the direct method is used, a separate schedule that reconciles net income to net cash provided by operating activities must be presented as follows:

Reconciliation of Net Income to Net Cash Provided by Operating Activities:
Cash flows from Operating Activities:

Net income	$xx
Adjustments to reconcile net income to cash flows from operating activities:	
Depreciation	xx
Deferred income taxes	xx
Accounts receivable	xx
Inventories	xx
Prepaid expenses and other items	xx
Accounts payable	xx
Accrued expenses	xx
Net cash provided by operating activities	$xx

What's the problem with existing practice?

With the Wall Street scandals that occurred in the early 2000s, investors and analysts started paying attention to the statement of cash flows with particular focus on the operating activities section of the statement.

In recent studies performed by the FASB, a continuous comment received by the investment community is that they do not like or understand the statement of cash flows.

Common criticisms include:

1. Investors do not understand the indirect method of presenting cash flows from operating activities. Yet, most companies continue to use the indirect method instead of the direct method.

2. Investors are unable to understand the completeness of transactions including non-cash transactions that are not included on the statement.

3. Users are confused about classifications of items on the statement of cash flows among operating, investing and financing activities. Companies are shifting transactions into operating activities that typically belong in investing or financing activities.

4. Too many transactions are being presented net as compared with gross, such as borrowing and repayment of debt within the same period.

Based on the most recent issue of the AICPA's Accounting Trends & Techniques, from a sample of 600 companies, 98 percent continue to use the indirect method as its primary method of displaying operating cash flows. That percentage has not changed since the initial date of the statement of cash flows.

Observation: In the FASB-IASB joint project on financial performance, one of the proposed changes is to require use of the direct method and eliminate use of the indirect method.

Selected statement of cash flows issues:

Not only is the investment community focusing on the statement of cash flows, but also the peer reviewers. Deficiencies in the statement of cash flows continue to be at the top of the list of peer review issues. In this section, the author discusses a few of the more confusing issues.

a. Classification of increase in cash value of life insurance in statement of cash flows

Question: How should the increase in the cash value of life insurance be presented on the statement of cash flows?

Response: There is no formal authority. Some practitioners believe that the increase in cash value is the equivalent to a purchase of an investment and, thus, should be presented as an outflow within the investing activities section. Others believe that it belongs as a conversion of life insurance expense from accrual to cash basis, and should be presented as a reconciling item in the operating section. The AICPA has provided an unofficial response as follows:

> *"If the increase in cash value is less than the premium paid, the entire increase should be presented as an outflow in the investing activities.*
>
> *If the increase in cash value is greater than the premium paid, the premium paid is an investing outflow with the remainder presented as a reconciling item within the operating activities section."*

Author's Observation: Because the AICPA's position is unofficial, a practitioner can use any one of the above options. The author believes that the entire increase should be presented as a reconciling item, in the operating activities section, converting the life insurance expense (credit) from accrual to cash basis.

Example of author's recommended presentation:

Cash flow from operating activities:	
Net income	$xx
Items not affecting cash:	
Depreciation	xx
Deferred income taxes	xx
Increase in accounts receivable	xx
Decrease in accounts payable	xx
Increase in cash value of life insurance	***xx***
Cash from operating activities	xx

b. Cash flow disclosure issues

Question: What are the disclosures required by ASC 230 (formerly FASB No. 95) relating to statement of cash flows?

Response: ASC 230 requires that the following items be disclosed within the notes to financial statements or elsewhere:

- Cash equivalents policy
- Interest and income taxes paid
- Non-cash investing and financing activities
- If the direct method is used, a reconciliation of the indirect method must be presented.

Question: Assume the following facts related to income taxes for 20X2:

Accrued taxes look like this for two different scenarios:

Scenario 1:

	dr (cr)
Accrued federal income taxes:	
Beginning balance (20X1 overpayment)	$125,000
Current year accrual for federal taxes	(300,000)
Payments- 20X2 estimates	100,000
Ending balance	$ 75,000
20X2 federal estimates were:	
20X1 overpayment applied to 20X2	$125,000
20X2 estimates	100,000
	$225,000

How much should the company disclose as income taxes paid on the cash flow statements or related notes?

Response: ASC 230 does not define income taxes paid. Therefore, it is up to the company to decide how to define this term. For example, is it the actual cash paid out for the year ($100,000) or the total taxes paid including overpayments from the previous year applied ($225,000)? The author believes that the answer is the actual amount of cash paid within the fiscal year which, in this case, is $100,000. However, one might argue that by disclosing only $100,000, the user of the financial statements does not receive all the information necessary to evaluate cash flows. Let's change the facts above to the following analysis of the accrual:

Scenario 2:

	dr (cr)
Accrued federal income taxes:	
Beginning balance (20X1 overpayment)	$225,000
Current year accrual for federal taxes	(300,000)
Payments- 20X2 estimates	0 .
Ending balance	$(75,000)
20X2 federal estimates were:	
20X1 overpayment applied to 20X2	$225,000
20X2 estimates	0 .
	$225,000

The company has an overpayment of $225,000 applied toward 20X2, and no estimated tax payments made in 20X2. If the company decides to take a literal interpretation of ASC 230 and disclose only cash paid for taxes in 20X2, the amount of income taxes paid would be $0. Yet, how does this example really differ from scenario 1. Both examples have taxes paid that total $225,000 yet, in scenario 1 the amount of taxes disclosed as paid is $100,000, while in scenario 2 it is $0.

The author's only solution to resolve this inconsistency would be to disclose income taxes paid based on the amount paid in for taxes which in this case is $225,000. Absent this approach, companies will continue to show inconsistencies in practice.

c. Non-cash investing and financing transactions

Question: How should non-cash investing and financing activities be presented?

Response: ASC 230 states that non-cash investing and financing activities should be disclosed, not presented within the statement of cash flows. The theory behind this requirement is that the statement should only present actual transactions that flow through the “checkbook.” Unless a transaction actually flows through the "checkbook," it does not appear on the statement.

How should the following transactions be presented in the statement of cash flows?

1) A company purchases real estate for $500,000 by borrowing $500,000 from the seller at the closing.

   Response: Disclose as a non-cash investing and financing transaction. This transaction *should not* be presented on the body of the statement.

2) A company purchases real estate for $500,000. The purchase funds are obtained from a bank. The bank gives the buyer a check made payable to the buyer, who, in turn, endorses the check over to the seller at the closing.

   Response: This transaction should be presented on the statement as follows:

   $(500,000) investing activity outflow
   $500,000 financing activity inflow

Note: Although, at first glance, this transaction appears identical to the previous example, it isn't. Because the check is payable to the borrower, in substance, the borrower receives the cash and then pays the seller (endorses the check). It is as if the borrower deposits the check for the borrowed funds, and subsequently writes out a check for $500,000 to the seller.

3) A company purchases a motor vehicle for $25,000 by paying cash of $5,000 and financing the remaining $20,000.

   Response: This is a partial cash transaction that should be presented as follows:

$(5,000)	investing activity outflow
$20,000	non-cash disclosure

4) A company has a $100,000 note payable due to its shareholder. The bank requires the company to capitalize the note as part of stockholder's equity.

   Response: The conversion of the stockholder loan to equity is a non-cash financing activity which should be disclosed only.

d. Capital leases

Question: A company enters into an agreement to lease certain equipment. The lease qualifies as a capitalized lease. The company makes the following entries during the year.

Capitalized lease	150,000
Obligation under cap. lease	150,000
(To set up the new capitalized lease)	

Interest expense	8,000
Obligation under cap. lease	12,000
Cash	20,000
(To record payment of lease obligation)	

How should these transactions be presented on the statement of cash flows?

Response: The purchase of a capitalized lease of $150,000 is the equivalent of purchasing a fixed asset by borrowing. Such a transaction is treated as a non-cash investing and financing transaction requiring disclosure only.

The $12,000 payment against the obligation is treated as repayment of debt and presented as an outflow in the financing activities section.

e. Cash flows presentation of a company purchase

Question: How should the following transactions be presented on the statement of cash flows?

1) A company purchases the following net assets of Company X in a transaction accounted for using the purchase method. The entire transaction is paid for by cash.

Inventories	$100,000
Fixed assets	200,000
Goodwill	300,000
Accounts payable assumed	(50,000)
Net purchase price	$550,000

Response: ASC 230 requires that a purchase of net assets be presented as one net outflow in the investing activities section as follows:

Investing activities:	
Purchase of net assets of Company X	$(550,000)

2) Same facts as #1 except that the net purchase price was paid for as follows:

Cash	$100,000
Note to seller	450,000
Total purchase price	$550,000

Response: This is a partial cash transaction that should be treated as follows:

Investing activities:	
Cash paid for purchase of net assets of Company X	$(100,000)

Disclosure:
In 20X1, the company purchased the net assets of Company X by borrowing $450,000 of the purchase price from the seller.

f. Intercompany accounts

The company has an affiliated company which is involved in several transactions during the year. An analysis of the intercompany account is as follows:

Intercompany Account:	dr (cr)
Beginning balance- receivable	$100,000
Management fees charged by the affiliate	(50,000)
Borrowed funds from affiliate, in cash	(300,000)
Ending balance-liability	(250,000)

Response: An intercompany transaction should be handled like any other transaction. The origin of the transaction determines how it is presented on the statement. In this situation, the loan activity consists of two transactions charge for intercompany management fees of $50,000 and cash loans of $300,000, which should be presented as follows.

Operating activities:	
Net income	$xx
Adjustments:	
Depreciation	xx
Change in inventory	xx
Decrease in intercompany receivable	**50,000**
Investing activities:	
Collection of intercompany receivable	**50,000****
Financing activities:	
Loan received from affiliate	**250,000****

** The portion of the cash received that brings the intercompany balance to zero $(50,000) is considered a collection of a loan receivable. The cash received that creates the loan payable $(250,000) is a borrowing resulting in an inflow of a financing activity.

g. Revolving line of credit

A company has a revolving line of credit with a bank. Activity follows:

Beginning balance	$500,000
Gross borrowings	20,000,000
Gross repayments	(19,500,000)
Ending balance	$1,000,000

Response: The question is whether this transaction may be presented as a net increase of financing activities of $500,000, or gross as a $20,000,000 financing inflow and a $19,500,000 financing outflow. ASC 230 requires that transactions be presented gross instead of net. There is an **exception whereby certain transactions may be presented net if:**

- Amounts turnover quickly
- Amounts are large
- Maturities are short, e.g., investments, or loans with an original maturity of three months or less

Therefore, demand and revolving lines of credit qualify for net treatment under this provision. The company should present **net cash inflow of $500,000 in the financing activities section.**

h. Sale of assets

A company sells a fixed asset as follows:

Cash	100,000
Book value of asset	80,000
Gain	20,000

Response: This transaction is presented in two places in the statement:

a) Investing activities:

Proceeds from sales of fixed assets	**100,000**

b) Operating activities: indirect method:

Net income	xx
Adjustments:	
Gain on sale of assets	**(20,000)**

i. Cash flow reporting for insurance proceeds

Question: How should insurance proceeds received in connection with a claim for damage or destruction of property, plant and equipment be presented in the statement of cash flows?

Response: An inconsistency in cash flow reporting practices is the categorization of insurance proceeds related to property, plant and equipment. In practice, some companies report such proceeds as inflows in the operating activities section of the statement, which is incorrect and overstates cash flows from operating activities.

ASC 230 requires that insurance proceeds received that are a direct result to investing activities, such as damage or destruction to equipment, should be recorded in the investing activities section of the statement of cash flows. The theory is that such proceeds are the same as a sale of assets.

More specifically, ASC 230 defines *cash inflows from operating activities* to include:

> "All other cash receipts that do not stem from transactions defined as investing or financing activities, such as amounts received to settle lawsuits, proceeds of insurance settlements *except for those that are directly related to investing or financing activities, such as from destruction of a building*, and refunds from suppliers."

The ASC 230 definition states that insurance settlement proceeds are included in operating activities, except for settlements related to the destruction of or damage to a building or equipment, which are included in investing activities.

Thus, insurance related to inventory, and business interruption insurance proceeds should be presented in the operating activities section of the Statement. Because many claims are a combination of damage to equipment, inventory, as well as a portion of business interruption insurance, these proceeds should be split between operating and investing activities.

Insurance proceeds related to:	Presented in:
PP&E damaged or destroyed	Investing activities
Inventory damaged or destroyed	Operating activities
Business interruption insurance	Operating activities

Consider the following example:

Example: In 20X2, Company X has a fire that damages its manufacturing plant and equipment, and inventory. The Company receives an insurance recovery settlement in the amount of $5 million for the following claim:

Equipment destroyed	$3,000,000
Inventory damaged or destroyed	1,200,000
Business interruption, including lost profits during the down time	800,000
	$5,000,000

The carrying value of the assets destroyed was $1,200,000 for inventory and $1,700,000 for equipment, resulting in a $1,300,000 gain on the transaction as follows:

Insurance proceeds- equipment and inventory	$4,200,000
Carrying value:	
Inventory	(1,200,000)
Equipment	(1,700,000)
Gain	$1,300,000
Business interruption insurance income	$800,000

At December 31, 20X2, the company received $4,000,000 of the insurance proceeds with the remaining $1,000,000 received in 20X3. The $1,000,000 receivable relates to the equipment.

Entries related to the transaction follow:

Entry in 20X2	dr	cr
Cash	4,000,000	
Insurance receivable	1,000,000	
Inventory		1,200,000
Equipment (cost less accumulated)		1,700,000
Gain on insurance proceeds		1,300,000
Business interruption insurance income		800,000
Entry in 20X3		
Cash	1,000,000	
Insurance receivable		1,000,000

The presentation should be made as follows:

Company X
Statements of Income
For the Years Ended December 31, 20X3 and 20X2

	20X2	20X3
Net sales	$XX	$XX
Cost of sales	XX	XX
Gross profit on sales	XX	XX
Operating expenses	XX	XX
Net operating income	XX	XX
Other income:	XX	XX
Gain on insurance recovery- equipment-inventory	**1,300,000**	XX
Business interruption insurance	**800,000**	XX
Net income before taxes	XX	XX
Income taxes	XX	XX
Net income	$XX	$XX

Company X
Statements of Cash Flows
For the Years Ended December 31, 20X3 and 20X2

	20X2	20X3
Cash provided by operating activities:		
Net income	$XX	$XX
Adjustments:		
Depreciation and amortization		
Deferred income taxes		
Gain on insurance recovery- equipment-inventory	**(1,300,000)**	**0**
	XX	XX
Proceeds from insurance related to inventory	**$1,200,000**	**0**
Cash provided by operating activities	XX	XX
Cash provided by investing activities:		
Proceeds from insurance related to equipment	**3,000,000**	0
Increase (decrease) in insurance settlement receivable	**(1,000,000)**	**1,000,000**
Cash provided by operating activities	XX	XX

Note: In the previous example, the change in the insurance settlement receivable is presented in investing activities because it relates to the equipment portion of the settlement. Because the proceeds are recorded in investing activities, the corresponding receivable should also be recorded in investing activities. If a portion of the receivable is related to the inventory or business interruption insurance recovery, the change in that receivable should be presented in the operating activities section.

Cash flow games

Companies continue to abuse the cash flow process by manipulating the presentation of the statement of cash flows. The reason is because cash flow has become, in the eyes of most investors and lenders, a primary measure of financial performance that is more important than GAAP income. While most third parties do not fully comprehend the complexities of GAAP, they tend to focus on cash flow, which is understandable and generally cannot be manipulated in the same manner as GAAP income.

In general, the most important measure presented on the statement of cash flows is *cash from operating activities.*

Most of the abuses in the statement of cash flows involve shifting positive sources of investing and financing activities into the operating activities section, and negative uses from operating into the investing and financing activities sections, with both actions increasing cash from operations.

Cash flow from operating activities		**-- USES**
Cash flow from investing activities	**+ SOURCES**	
Cash flow from financing activities	**+ SOURCES**	

How do companies do it?

ASC 230, *Statement of Cash Flows* (formerly FASB No. 95), has several fundamental flaws in it that allow companies to shift net positive cash flow from investing and financing activities to the operating activities section of the cash flow statement. Of course, there are instances in which companies have simply violated ASC 230 rules by misclassifying cash flows outside the authority of ASC 230, *Statement of Cash Flows*. Nevertheless, ASC 230 provides ample loopholes through which cash from operating activities can be manipulated legitimately.

Following are some of the more common approaches:

a. Use cash overdrafts
b. Vendor financing and extended payment terms
c. Securitize or factor trade receivables
d. Shift the securities classification to trading securities, then sell them
e. Purchase a company

a. Use cash overdrafts to shift cash to operating activities

One way to increase operating cash flow is to use cash overdrafts.

GAAP provides that a cash overdraft that is a result of float, is treated the same as accounts payable and is an adjustment to cash from operations. If instead, there is also a bank overdraft balance, the negative bank balance is treated as a loan and presented in the financial activities section of the cash flow statement.

Consider the following example:

Company X has the following change in cash accounts at year end:

	12-31-X1	12-31-X2	Change
Cash balance per general ledger	$25,000	$(85,000)	$(110,000)
Balance sheet presentation:			
Current assets:			
Cash	$25,000	$ 0	$(25,000)
Current liabilities:			
Cash overdraft	$ 0	$(85,000)	$(85,000)

The bank reconciliation at December 31, 20X2 was as follows:

Bank reconciliation:	Scenario #1	
Bank balance	$50,000	
Outstanding checks	(135,000)	
Cash balance per books	$(85,000)	
Presentation on cash flow statement:		
Change in cash	$(25,000)	(1)
Operating activities	(85,000)	(2)
Financing activities	0	
Total change	$(110,000)	

(1) Change in cash is the $25,000 beginning balance less ending balance of zero.
(2) Change in cash overdraft is zero balance in 20X1 less $85,000 negative balance at 12-31-X2.

Operating activities:	
Net income	$XX
Reconciling items:	
Depreciation	XX
Accounts receivable	XX
Inventory	XX
Accounts payable	XX
Cash overdraft	**85,000**
Investing activities:	XX
Financing activities:	
Cash overdraft from bank	**0**
Decrease in cash	(25,000)
Cash balance:	
Beginning of year	25,000
End of year	$ 0

Conclusion: The cash overdraft represents mail float and should be presented in the operating activities section in the statement of cash flows. The change in cash is $25,000 which is the change from $25,000 to zero, and excludes the negative cash balance which is not considered cash. The negative cash balance change (change in balance from zero in 20X1 to $(85,000) in 20X2 is a cash overdraft, presented as an adjustment in the operating activities section. (Note that the overdraft balance represented mail float and not a bank loan since there is a positive bank balance of $50,000.)

Change the facts: Same facts as previous example except that there is also a negative bank balance of $(40,000), representing a short-term bank loan, as shown in the following reconciliation:

Bank reconciliation: 12-31-X2	
Bank balance	$(40,000)
Outstanding checks	(45,000)
Cash balance per books	$(85,000)
Presentation on cash flow statement	
Change in cash	$(25,000) (1)
Operating activities	(45,000) (2)
Financing activities	(40,000) (3)
Total change	$(110,000)

(1) Change in cash is the $25,000 beginning balance less ending balance of zero.
(2) Cash overdraft (($0 less $85,000) = $85,000) less portion in financing activities $(40,000) equals remainder portion included in operating activities ($45,000).
(3) Portion of overdraft related to negative bank balance ($40,000) represents a loan from the bank and is presented in financing activities section of the Statement.

Operating activities:	
Net income	$XX
Reconciling items:	
Depreciation	XX
Accounts receivable	XX
Inventory	XX
Accounts payable	XX
Cash overdraft	**45,000**
Cash from operating activities	XX
Investing activities:	XX
Financing activities:	
Cash overdraft from bank	**40,000**
Decrease in cash	(25,000)
Cash balance:	
Beginning of year	25,000
End of year	$ 0

Conclusion: The cash overdraft represents mail float and should be presented in the operating activities section in the statement of cash flows. To the extent the overdraft represents a negative balance in the bank account ($40,000 in this example) the change in the overdraft should be shown as an inflow from financing activities as it represents a loan from the bank.

Games played with cash overdrafts

An effective game to shift cash flow to operating activities is to create a negative cash balance; yes, create a negative cash balance. Once that is achieved, any change in the negative cash balance that increases the negative amount, increases cash from operations. Remember that third party users focus on the increase in cash from operations and not necessarily the cash balance.

Let's look at an example:

Example 1:

	12-31-X1	12-31-X2	Change
Cash	$100,000	$20,000	$80,000
Accounts receivable	200,000	300,000	(100,000)
Inventory	5,400,000	5,000,000	400,000
Fixed assets	3,000.000	4,000,000	(1,000,000)
	$8,700,000	$9,320,000	
Accounts payable	$1,500,000	$1,900,000	400,000
Notes payable	5,400,000	5,120,000	(280,000)
Equity	1,800,000	1,800,000	0
Net income	0	500,000	500,000
	$8,700,000	$9,320,000	$ 0

Fixed asset change:

Purchases of fixed assets	$(1,300,000)
Depreciation	300,000
Net change	$(1,000,000)

Statement of Cash Flows
Year Ended December 31, 20X2

Cash from operating activities:	
Net income	$500,000
Items not affecting cash:	
Depreciation	300,000
Accounts receivable	(100,000)
Inventory	400,000
Accounts payable	400,000
Cash from operating activities	**1,500,000**
Cash from investing activities:	
Purchases of fixed assets	(1,300,000)
Cash from financing activities:	
Repayment of long-term debt	(280,000)
Net decrease in cash and cash equivalents	**(80,000)**
Cash and cash equivalents:	
Beginning of year	100,000
End of year	$20,000

Example 2: Same facts as Example 1, except Company has cash segregated into two separate bank accounts, each in a different bank.

General ledger balance:	12-31-X1	12-31-X2
Cash- Bank #1 account	$350,000	$420,000
Cash- Bank #2 account	(250,000)	(400,000)
	$100,000	$20,000

Cash in Bank #1 has a positive balance while Cash in Bank #2 has a negative balance. Because each account is in a separate bank, there is no legal right of offset.

	12-31-X1	12-31-X2	Change
Cash- Bank #1 account	**$350,000**	**$420,000**	**$(70,000)**
Accounts receivable	200,000	300,000	(100,000)
Inventory	5,400,000	5,000,000	400,000
Fixed assets	3,000.000	4,000,000	(1,000,000)
	$8,950,000	$9,720,000	
Cash overdraft- Bank #2 account	**$250,000**	**$400,000**	**150,000**
Accounts payable	1,500,000	1,900,000	400,000
Notes payable	5,400,000	5,120,000	(280,000)
Equity	1,800,000	1,800,000	0
Net income		500,000	500,000
	$8,950,000	$9,720,000	$ 0

Fixed asset change:

Purchases of fixed assets	$(1,300,000)
Depreciation	300,000
Net change	$(1,000,000)

Statement of Cash Flows
Year Ended December 31, 20X2

Cash from operating activities:	
Net income	$500,000
Items not affecting cash:	
Depreciation	300,000
Accounts receivable	(100,000)
Inventory	400,000
Cash overdraft	**150,000**
Accounts payable	400,000
Cash from operating activities	**1,650,000**
Cash from investing activities:	
Purchases of fixed assets	(1,300,000)
Cash from financing activities:	
Repayment of long-term debt	(280,000)
Net increase in cash and cash equivalents	**70,000**
Cash and cash equivalents:	
Beginning of year	350,000
End of year	$420,000

The above examples represents a shell game, under which cash is segregated into two accounts, each with a separate bank and with no legal right of offset. Because one account has a positive balance, and the other a negative balance, the balances cannot be netted since there is no right of offset. At year end, Account #2 has a significant overdraft balance which is funded by Account #1 right after year end.

Under GAAP, the change in Account #2's balance (the overdraft account) of $150,000 is shown as a positive adjustment in operating activities. Under Example 1, this overdraft was part of cash and not reflected in the operating activities section of the Statement.

Thus, by separating the bank accounts, the overdraft account increases cash from operations by $150,000 ($1,500,000 to $1,650,000) which is a positive result for lenders and other third parties. And, it is all legal

A comparison of the statement of cash flows for Example 1 versus Example 2 follows:

Statement of Cash Flows
Year Ended December 31, 20X2

	Example 1	Example 2
Cash from operating activities:		
Net income	$500,000	$500,000
Items not affecting cash:		
Depreciation	300,000	300,000
Accounts receivable	(100,000)	(100,000)
Inventory	400,000	400,000
Cash overdraft	**0**	**150,000**
Accounts payable	400,000	400,000
Cash from operating activities	**1,500,000**	**1,650,000**
Cash from investing activities:		
Purchases of fixed assets	(1,300,000)	(1,300,000)
Cash from financing activities:		
Repayment of long-term debt	(280,000)	(280,000)
Net increase (decrease) in cash and cash equivalents	**(80,000)**	**70,000**
Cash and cash equivalents:		
Beginning of year	100,000	350,000
End of year	$20,000	$420,000

b. Vendor financing

Another method by which to increase cash from operations is to use vendor financing instead of bank financing. Vendor financing is typically found in two formats:

1. Stretching trade payables through prearranged delayed payment terms
2. Vendor notes such as floor-plan financing, which is secured by the inventory

ASC 230 provides that vendor financing is presented in the operating activities section, instead of the financing activities section. Obvious, the change in trade payables due to stretching the payables, is presented as an adjustment to cash from operations. Thus, all forms of vendor financing (through trade payables or separate notes) are presented in the operating activities section.

What happens when such notes are paid off?

The change in vendor financing due to repaying the debt, is treated as a reduction in operating activities, not financing activities.

Example: Company X needs approximately $500,000 of cash and has two scenarios.

Under Scenario 1, X obtains $500,000 of vendor financing secured by inventory purchased.

Under Scenario 2, X obtains a bank line of credit secured by the inventory, among other assets.

Conclusion: Both scenarios are presented on the statement of cash flows as follows:

Statement of Cash Flows
Year Ended December 31, 20X2

	Scenario 1	Scenario 2
Cash from operating activities:		
Net income	$XX	$XX
Items not affecting cash:		
Depreciation	XX	XX
Accounts receivable	XX	XX
Inventory	XX	XX
Vendor financing	**500,000**	**XX**
Accounts payable	XX	XX
Cash from operating activities	XX	XX
Cash from investing activities:		
Purchases of fixed assets	XX	XX
Cash from financing activities:		
Increase in bank line of credit	**XX**	**500,000**
Repayment of long-term debt	XX	XX
Net increase in cash and cash equivalents	XX	XX
Cash and cash equivalents:		
Beginning of year	XX	XX
End of year	$XX	$XX

Under ASC 230, vendor financing is presented as part of operating activities so that the $500,000 of vendor financing is presented as an increase in cash from operations. Compare this to the second scenario under which the company borrows the $500,000 from the bank under a line of credit secured by the inventory and other entity assets. In the second scenario, the bank loan of $500,000 is recorded as part of financing activities.

Notice that the two transactions are essentially the same; loans secured by the inventory purchased. Yet, they are treated differently on the statement of cash flows. If available, a company increases its cash from operations by borrowing from a vendor instead of the bank.

c. Securitization or factoring of trade receivables

Companies have *two options* by which to receive cash from their receivables prior to collecting them:

1. Securitize or factor receivables, which entails selling receivables in bulk prior to their collection, or

2. Borrow against the receivables.

Although both options involve receipt of cash, the accounting for both forms of transactions are profoundly different:

1. Cash received from the securitization or factoring of trade receivables is presented as an inflow in the operating activities section.

2. Debt secured by receivables, such as a revolving line of credit, is presented in the financing activities section.

Example: Company X has $3,000,000 of trade receivables.

X considers two scenarios to receive cash from receivables.

Scenario 1: X factors the receivables, selling all of them at a discount of $2,800,000.

Scenario 2: X borrows $2,800,000 against the $3,000,000 of receivables.

Statement of Cash Flows
Year Ended December 31, 20X2

Cash from operating activities:	Scenario 1	Scenario 2
Net income	**$(200,000) (1)**	$XX
Items not affecting cash:		
Depreciation	XX	XX
Accounts receivable	**3,000,000 (1)**	**XX**
Inventory	XX	XX
Accounts payable	XX	XX
Cash from operating activities	XX	XX
Cash from investing activities:		
Purchases of fixed assets	XX	XX
Cash from financing activities:		
Bank loan	**XX**	**2,800,000**
Repayment of long-term debt	XX	XX
Net increase in cash and cash equivalents	$XX	$XX
Cash and cash equivalents:		
Beginning of year	XX	XX
End of year	$XX	$XX

(1): Cash collected is $2,800,000 resulting in a discount fee of $200,000 recorded as an expense.

Conclusion: By factoring receivables, a company receives an instant increase in cash from operations as compared with the result by borrowing against the receivables that is recorded as an increase in financing activities.

Observation: Readers of financial statements should be wary of companies that factor their receivables. Typically, factoring is a sign that a company is struggling for cash because it is an expensive form of financing. Further, the increase in cash from operations received from factoring comes at a price. The cash received is nothing more than an advance on future cash flows. That is, the factoring is advanced collections of receivables that need to be replaced in the subsequent period. Many companies that factor their receivables in one period, experience a dry cash flow period in the next period as they record sales, but have yet to collect the receivables related to those sales.

d. Converting investments to trading securities and selling them

Another technique used to increase cash from operating activities is to manipulate the categories of investments found in ASC 320, *Investments-Debt and Equity Securities* (formerly FASB No. 115).

If the investments are securities (e.g., traded on a public exchange), the rules of ASC 320 place investments in securities into *three categories* and with separate rules for each category.

The **three (3) categories** are as follows:

1. Debt securities held to maturity- Debt securities that management plans to hold until maturity.

2. Trading securities- Both debt and equity securities that are bought and held for the purpose of selling them in the near term (generally within one year).

3. Available for sale securities- Both debt and equity securities that are not categorized as either held to maturity or trading securities, are automatically categorized as available-for-sale. In this category, management has essentially not decided what it plans to do with the securities.

At the time of purchase, a security is placed into one of the three categories based on management's positive intent and ability. Once a security is placed in a particular category, it generally can be changed only where there are significant unforeseeable circumstances.

The following table summarizes the accounting treatment for investments.

	----------Securities----------		
	Debt securities held to maturity	**Trading securities**	**Available for sale securities**
Type	Debt	Debt and equity	Debt and equity
Intent	Hold to maturity	Sell in the near term	Undecided
Record at	Cost	Fair value	Fair value
Unrealized gains or losses	Not applicable	Presented on income statement	Presented in stockholders' equity, net of tax
Balance sheet	Based on maturity date	Current even if sale is expected beyond one year	Based on management's intent at year end
Statement of cash flows	Activity (purchases and sales) presented in investing activities	Activity (purchases and sales) presented in operating activities	Activity (purchases and sales) presented in investing activities

Notice that all activity related to the held to maturity and available for sale categories is presented in investing activities while purchases and sales of trading securities are presented in the operating activities section of the statement of cash flows.

This different treatment among the three categories provides an opportunity for abuse.

Consider the following plan:

1. Investments are purchased and categorized as either held to maturity or available for sale.

2. If investments incur unrealized losses, the investments are retained inside the available for sale or held to maturity category so that the losses do not reach the income statement.

3. When it is time to sell the securities, management shifts the investments into the trading securities category. In doing so, the net proceeds are recorded as a cash inflow from operating activities.

4. Alternatively, even if the security is not sold, a mere change in the category into the trading securities category is made at fair value thereby allowing the company to recognize the unrealized gain immediately upon transfer.

Thus, the entity receives the best of both worlds: When the investment is purchased, the negative cash flow is presented in the investing activities section. When it is sold, the cash inflow increases cash from operations. The gain or loss is recorded in operating activities at the time of sale, regardless of the category.

Example: In 20X1, Company X purchases an investment in common stock of a public company (a security).

Details follow:

At December 31, 20X1: Purchase price $100,000. At the time of the purchase, the company categorized the investment as available for sale as it had no idea what its objective is for the investment.

In February 20X2, the company decides to change the category to trading security as the company's intent is to sell the security. The company immediately sells the security for $105,000.

Statement of Cash Flows
Year Ended December 31, 20X2 and 20X1

	20X2	20X1
Cash from operating activities:		
Net income	$XX	$XX
Items not affecting cash:		
Depreciation	XX	XX
Gain on sale of trading securities	**(5,000)**	XX
Inventory	XX	XX
Accounts payable	XX	XX
Proceeds from sale of trading securities	**105,000)**	XX
Cash from operating activities	XX	XX
Cash from investing activities:		
Purchase of investments	XX	**(100,000)**
Purchases of fixed assets	XX	XX
Cash from financing activities:		
Repayment of long-term debt	XX	XX
Net increase in cash and cash equivalents	$XX	$XX
Cash and cash equivalents:		
Beginning of year	XX	XX
End of year	$XX	$XX

Conclusion: By purchasing the security and categorizing it as "available for sale" the company is able to present the cash outflow in the investing activities category in the statement of cash flows.

In 20X2, the company changes its intent and converts the category to "trading securities." Once in the trading securities category, all cash flows related to the investment are presented in the operating activities section. Thus, the sale proceeds of $105,000 are presented as a cash inflow in operating activities along with the $5,000 gain being an adjustment.

This game is a perfect presentation to overstate cash from operations.

How does the company justify the change in the category from available for sale to trading securities?

ASC 320 is quite explicit that changes within the categories should be rare. However, it does not prevent a company from taking such action. Using the above example, one argument for changing the category is that the investment was purchased a short time earlier (December 31, 20X1) and the company plans to sell it in the near term (within one year). Thus, the intent identified in 20X1 (available for sale) is now one of selling the security (trading security).

e. Purchasing a company

A company that purchases the net assets of another (including trade receivables and inventory) gets an instant spike to its cash from operating activities. The windfall is because the purchase of receivables and inventory are netted out and presented in the investing activities category. Then, when the receivables are collected and inventory sold, the company gets a positive change that is presented in the operating activities section.

Example:

In 20X1, a company purchases the following net assets of Company X for $1,400,000 cash.

Accounts receivable	$250,000
Inventories	300,000
Fixed assets	500,000
Goodwill	400,000
Accounts payable	(50,000)
Net purchase price	$1,400,000

Conclusion: The net purchase price of $1,400,000 is presented as one line item in the investing activities section in the statement of cash flows.

Cash from investing activities:	
Purchase of net assets of Company Y	**(1,400,000)**

By presenting the net purchase price of $1,400,000 in the investing activities section, certain assets and liabilities which are typically presented in the operating activities section, such as receivables, inventories, and accounts payable, are presented in investing activities. Thus, cash from operating activities is not reduced for the purchase of receivables, inventory, and accounts payable.

Then, when those assets are liquidated, the net change in those assets and liabilities is presented as a net increase in the operating activities section. The result is that the company gets the benefit of the reduction in the net balances in receivables, inventories and accounts payable, being presented as a cash inflow from operating activities, while the original purchase of these net assets, was presented as a negative outflow from investing activities.

Assume the following additional activity occurring in 20X1.

	AR	Inventory	AP
Beg balance 1-1-X1	$ 0	$ 0	$ 0
Purchase as part of business	250,000	300,000	(50,000)
Other changes, net	**(150,000)**	**(100,000)**	**20,000**
End balance 12-31-X1	$100,000	$200,000	$(30,000)

Statement of Cash Flows
Year Ended December 31, 20X1

Cash from operating activities:	
Net income	$XX
Items not affecting cash:	
Depreciation	XX
Change in accounts receivable	**150,000**
Change in inventory	**100,000**
Change in accounts payable	**(20,000)**
Cash from operating activities	XX
Cash from investing activities:	
Purchase of net assets of Company Y	**(1,400,000)**
Purchases of fixed assets	XX
Cash from financing activities:	
Repayment of long-term debt	XX
Net increase in cash and cash equivalents	$XX
Cash and cash equivalents:	
Beginning of year	XX
End of year	$XX

In the above example, you will notice that in investing activities, there is one line for the purchase of the net assets of Company Y in the amount of $(1,400,000). This negative number includes the purchase of accounts receivable ($250,000), inventories ($300,000), and accounts payable ($50,000). A net cash outflow for these three working capital accounts is $(500,000) which is included in investing activities even though the remaining activity for these three working capital accounts is presented in the operating activities section. Therefore, the Company has been able to shift $500,000 of negative cash from the operating activities section to the investing activities section.

Once the accounts receivable, inventories and accounts payable are purchased, those accounts are liquidated with the change being presented in operating activities. The company receives a one-time windfall to operating activities from the liquidation of receivables, inventory and accounts payable when the purchase of these net assets was not recorded in operating activities.

f. Presentation of customer notes receivable

Another game played to increase cash from operations relates to customer notes receivable. Current GAAP provides that changes in notes receivable should be presented in the investing activities section of the statement of cash flows. Companies are using this general rule with respect to certain customer notes receivable generated in connection with the sale of goods and services. These notes act more like trade receivables than traditional notes receivable, and generally should be presented in the operating activities section of the statement, not the investing activities section.

Examples of such notes include:

- Notes receivable arising from a floor-planning financing arrangement
- Installment sale receivables
- Franchise receivables
- Lease receivables arising from sales-type lease transactions

Many companies are including the change in notes receivable in the investing activities section of the statement of cash flows, instead of the operating activities section. In doing so, cash from operations may increase significantly.

Example:

Assume the following:

Net sales	$10,000,000
Operating expenses	7,000,000
Net income	$3,000,000

Of the $10,000,000 of sales, $6,000,000 is collected in cash and the remaining $4,000,000 remains in notes receivable.

Scenario 1: The $4,000,000 of change in notes receivable is presented in the operating activities section. The statement of cash flows is presented as follows:

Cash from operating activities:	
Net income	$3,000,000
Adjustments:	
Change in notes receivable	(4,000,000)
Cash used in operating activities	$(1,000,000)

Scenario 2: The $4,000,000 of change in notes receivable is presented in the investing activities section. The statement of cash flows is presented as follows:

Cash from operating activities:	
Net income	$3,000,000
Adjustments:	0
Cash used in operating activities	3,000,000
Cash used in investing activities	
Change in notes receivable	(4,000,000)

By presenting the change in notes receivable in the investing activities section, it appears that the company has generated $3,000,000 of operating cash flow and then invested it in investing activities.

Does ASC 230 (formerly FASB No. 95) require that the change in customer notes receivable be classified in the operating activities section?

ASC 230, *Statement of Cash Flows* (formerly FASB No. 95) is not clear if customer notes receivable should be presented in the operating activities section, although ASC 230 deals with a similar situation related to installment sales by stating:

> *"A somewhat difficult classification issue arises for installment sales…for which…cash inflows….may occur several years after the date of transaction….The board agreed that all cash collected from customers should be classified as operating cash flows."*

Although ASC 230 addresses the collection of an installment sale, it does not specifically address the change in other types of notes receivable. Instead, it does state that all cash collected from customers should be classified as operating cash flows, including notes receivable.

Presentation of cash from operations versus working capital flow

Is there a better way to show cash from operations?

From the previous examples, it is obvious that a company can manipulate its cash from operations simply by shifting the timing of purchase or liquidations of working capital components. Take actions to accelerate collections of receivables, defer purchases of inventory, or delay payment of payables, and you have an instant increase in cash from operations.

Also, short-term manipulation of working capital components has an adverse long-term impact on cash flow. For example, if a company accelerates collections of receivables to increase cash from operations, it will certainly have negative cash flow in the subsequent period because there will be no receivables to liquidate until they are replenished with additional sales. Similarly, delaying purchases of inventory cannot last long and will result in future negative cash flows when the company is forced to purchase larger quantities of inventory to replenish unreasonably low levels. The same is true with delays in payment of payables which cannot continue and results in the need to double payments in the next period to catch up.

The point is that playing games with working capital elements (accounts receivable, inventory or payables) does not last, and must reverse in the following periods. It is a mathematical certainty.

So, what is the best way to measure cash flow from operations?

The author believes the only true way to look at cash from operations is to focus on ***working capital flow from recurring operations.***

Consider the following formula which may look familiar:

Net income	$XX
Add/deduct non-recurring items:	
Other income/expenses	(XX)
Interest and dividend income	(XX)
Gains on sales of assets	(XX)
Net operating income	XX
Items not affecting cash from operations:	
Depreciation and amortization	XX
Deferred income taxes	XX
Other items	XX
Working capital flow from recurring operations	***$XX***

Does the above formula look familiar? It is similar to the old working capital flow formula used under statement of changes in financial position. The only difference is that the author is removing non-recurring income and expense items to arrive at operating income.

Notice that the above formula does not take into account changes in accounts receivable, inventories, and payables. The reason is because these working capital elements are not meaningful in assessing cash from operations because a manipulation of any one element results in a distortion in cash flow from operations.

Working capital flow is a critical measurement because it represents future cash flow.

There is a general rule that all roads lead to cash to the extent that working capital flow ultimately translates into cash flow once working capital components are converted into cash.

Working capital flow from recurring operations = FUTURE CASH FLOW

Which of the following companies, A or B, has stronger cash from operations?

	Company A	**Company B**
Net income	$100,000	$100,000
Add/deduct non-recurring items:		
Other income/expenses	(10,000)	(10,000)
Interest and dividend income	(5,000)	(5,000)
Gains on sales of assets	(15,000)	(15,000)
Net operating income	70,000	70,000
Items not affecting cash from operations:		
Depreciation and amortization	300,000	20,000
Deferred income taxes	60,000	7,000
Other items	70,000	13,000
Working capital flow from recurring operations	**500,000**	**110,000**
Changes in:		
Accounts receivable	(280,000)	230,000
Inventory	(270,000)	300,000
Accounts payable	(50,000)	80,000
Cash from operations	**$(100,000)**	**$720,000**

Conclusion: The first reaction is that obviously Company B has stronger cash from operations, with $720,000 as compared with Company A's negative cash flow of $(100,000).

However, a closer look may result in a different conclusion.

Company A has a positive working capital flow of $500,000 versus B's of $110,000. A's negative cash from operations $(100,000) is a direct result of changes in its working capital components: accounts receivable $(280,000), inventory $(270,000) and accounts payable $(50,000). Conversely, B's positive cash flow is a direct result of cash generated from liquidation of its receivables ($230,000) and inventory ($300,000), and delayed payment of its accounts payable ($80,000).

What does it all mean?

A's negative cash from operations of $(100,000) is actually stronger than B's positive cash flow of $720,000. The reason is because B has had to liquidate its net working capital components (accounts receivable, inventory and accounts payable) to generate a positive cash from operations. In fact, of the $720,000 of cash from operations, $610,000 of that amount ($720,000 - $110,000) is generated from changes in receivables, inventory, and payables. When a company liquidates its working capital components, it is cashing in future cash flow. That is, additional cash will be generated from receivables only if the company generates additional sales to replenish the receivables. Similarly, if the company has liquidated its inventory down to a low level, it must purchase additional inventory in future periods to replace that inventory liquidation. And with respect to payables, if the company has generated $80,000 of cash by not paying payables, it must pay those payables in future periods. Thus, it is easy to predict that B's positive cash flow of $720,000 in this present period will translate into weak or negative cash flow in the next period as it no longer has net working capital components to feed the future cash flow.

The opposite is true with respect to Company A. A's negative cash flow of $(100,000) was created by $(600,000) of negative cash flow from accounts receivable, inventory, and payables.[50] This means the company is building receivables and inventory, and paying off payables. Although growth in receivables and inventory may mean these assets are not being managed efficiently, it typically is a result of the company building assets through higher sales and inventory purchases. This fact will likely translate into large amounts of positive cash flow in the subsequent period as the company finally liquidates these assets into cash.

Another way to dissect cash from operations is to break it down into sustainable and unsustainable cash flow as follows:

		A	**B**
Working capital flow	Sustainable	$500,000	$110,000
Change in accounts receivable, inventory, accounts payable	Unsustainable	(600,000)	610,000
Cash from operations		**$(100,000)**	**$720,000**

Working capital from operations is sustainable cash flow in that it will ultimately convert into cash. Conversely, changes in working capital components (e.g., accounts receivable, inventory, and accounts payable) represent unsustainable cash flow in that it reverses in the following period. For company A, the change in net working capital of $(600,000) will reverse as positive cash flow in future period(s) once those net working capital components are liquidated into cash. With respect to B, the positive change of net working capital accounts, $610,000, will also reverse as negative cash flow in the next period as the company has no working capital left to liquidate into cash.

The driver of sustainable cash is working capital flow from recurring operations and not cash from operations.

[50] Changes in AR ($280,000) + change in inventory ($270,000) + change in AP ($50,000) = $(600,000).

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self - study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

1. Under ASC 230 (formerly FASB No. 95), how should non-cash investing and financing activities be:
   a. Disclosed
   b. Presented within the statement of cash flows as an "investing activity"
   c. Presented within the statement of cash flows on a net basis
   d. Presented within the statement of cash flows on as both an investing and financing activity

2. If a company purchases several net assets in a transaction accounted for using the purchase method, and the entire transaction is paid for by cash, how should the transaction be presented on the statement of cash flows:
   a. In the operating activities section
   b. As an outflow in the financing activities section
   c. As one net outflow in the investing activities section
   d. Disclosed

3. Facts: A company has an intercompany account with an affiliate as follows:

Intercompany account:	
Beginning receivable	$50,000
Product sale posted to the intercompany	100,000
Borrowed funds in cash	(400,000)
Ending payable	$(250,000)

   How should the transaction activity be presented on the statement of cash flows:
   a. The total change of $300,000 should be shown in financing activities
   b. $(100,000) in operating activities and $400,000 in financing activities
   c. $(100,000) in operating activities, $150,000 in investing activities, and $250,000 in financing activities
   d. (100,000) in investing activities and $400,000 in financing activities

4. Which of the following should be recorded in the investing activities section of the statement cash flows:
   a. Insurance proceeds received as a direct result of investing activities
   b. Cash activity related to a revolving line of credit
   c. Proceeds from a bank loan
   d. The purchase of a capital lease

5. Which of the following should be presented in the investing activities section of the statement of cash flow:
   a. Amounts received to settle lawsuits
   b. Business interruption insurance proceeds
   c. Insurance proceeds from inventory damaged or destroyed
   d. Insurance proceeds from property, plant and equipment damaged or destroyed

6. Which of the following is typically the most important measure presented on the statement of cash flows:
   a. Cash from operating activities
   b. Free cash flow
   c. Investment income
   d. Working capital

7. One effective game that can be played with cash overdrafts is to shift cash flow to operating activities by:
   a. Creating a negative cash balance
   b. Setting up accounts in the same bank
   c. Stretching trade payables through prearranged delayed payment terms
   d. Using floor-plan financing

8. Vendor financing is typically found in what format:
   a. Borrowing against receivables
   b. Segregating cash into two accounts at separate banks
   c. Selling receivables in bulk prior to their collection
   d. Stretching trade payables through prearranged delayed payment terms

9. What is a common approach used to legitimately manipulate cash from operating activities:
   a. Securitizing or factoring trade receivables
   b. Selling a company
   c. Shifting the securities classification to available-for-sale securities
   d. Vendor purchases

10. Purchases and sales of are presented in the operating activities section of the statement of cash flows.
   a. Available-for-sale securities
   b. Debt securities held to maturity
   c. Non-securities
   d. Trading securities

SUGGESTED SOLUTIONS

1. Under ASC 230 (formerly FASB No. 95), how should non-cash investing and financing activities be:
   a. **Correct. ASC 230 states that non-cash investing and financing activities should be disclosed. The theory behind this requirement is that the statement should only present actual transactions that flow through the "checkbook."**
   b. Incorrect. Presenting the noncash transaction as an investing activity would only identify only one side of the two-sided transaction.
   c. Incorrect. Presenting the non-cash transactions on a net basis would result in the transactions netting out to zero, thereby not being included on the statement at all.
   d. Incorrect. Mechanically, presenting the transaction as both an investing and financing activity would properly identify both sides of the transaction. However, ASC 230 specifically precludes non-cash investing and financing activities from being included in the statement and, instead must be disclosed only.

2. If a company purchases several net assets in a transaction accounted for using the purchase method, and the entire transaction is paid for by cash, how should the transaction be presented on the statement of cash flows:
   a. Incorrect. Purchases of assets are not presented in the operating activities section as such a transaction does not relate to cash flows involving the income statement.
   b. Incorrect. Purchases of assets are not presented in financing activities. Instead, in general, debt and equity transactions are presented in financing activities.
   c. **Correct. ASC 230 requires that a purchase of net assets be presented as one net outflow in the investing activities section.**
   d. Incorrect. Non-cash investing and financing activities should be disclosed. When various net assets are purchased for cash, disclosure is not required as the entire transaction is funded by cash.

3. Facts: A company has an intercompany account with an affiliate as follows:

   Intercompany account:

Beginning receivable	$50,000
Product sale posted to the intercompany	100,000
Borrowed funds in cash	(400,000)
Ending payable	$(250,000)

   How should the transaction activity be presented on the statement of cash flows:
   a. Incorrect. The transaction has multiple elements that have to be segregated and presented in separate sections of the statement, making the answer incorrect
   b. Incorrect. Although the $(100,000) should be presented in operating activities due to it relating to the income statement, the remainder $400,000 should be split between investing and financing activities, making the answer incorrect.
   c. **Correct. The $(100,000) related to the product sale is presented in operating activities. Out of the $400,000 of borrowed funds, $150,000 is considered a collection of a note receivable in investing activities ($50,000 beginning balance plus $100,000 receivable from the product sale). The remainder $250,000 is a loan included in financing activities.**

d. Incorrect. The $(100,000) relates to a product sale and belongs in operating activities, not investing activities. The $400,000 loan should be split between collection of a loan receivable (investing activities for $150,000) and a loan of $250,000 which is a financing activity.

4. Which of the following should be recorded in the investing activities section of the statement cash flows:
   a. **Correct. ASC 230 requires that insurance proceeds received that are a direct result to investing activities, such as damage or destruction to equipment, should be recorded in the investing activities section of the statement. The theory is that such proceeds are the same as a sale of assets.**
   b. Incorrect. Demand and revolving lines of credit qualify for net treatment and should therefore be presented as net cash inflow in the financing activities section.
   c. Incorrect. Loan proceeds are shown in the financing activities section of the statement of cash flows, making the answer incorrect.
   d. Incorrect. The purchase of a capital lease is the equivalent of purchasing a fixed asset by borrowing. Such a transaction is treated as a non-cash investing and financing transaction requiring disclosure only.

5. Which of the following should be presented in the investing activities section of the statement of cash flow:
   a. Incorrect. ASC 230 defines cash inflows from operating activities to include amounts received to settle lawsuits.
   b. Incorrect. Business interruption insurance proceeds are presented in operating activities.
   c. Incorrect. Insurance proceeds from inventory damaged or destroyed is presented in operating activities.
   d. **Correct. Insurance proceeds from property, plant and equipment damaged or destroyed is presented in investing activities. ASC 230 defines cash inflows from operating activities to include "all other cash receipts that do not stem from transactions defined as investing or financing activities … except for those that are directly related to investing or financing activities, such as from destruction of a building, and refunds from suppliers."**

6. Which of the following is typically the most important measure presented on the statement of cash flows:
   a. **Correct. The author does, in fact, note that the most important measure presented on the statement of cash flows is <u>cash from operating activities</u>, making the answer correct. One of the reasons for cash from operating activities being so important is because cash from operating activities is an area of abuse as companies try to shift cash flow into operating activities from investing and financing activities. Also, many analysts focus on cash flow from operating activities as a key measurement.**
   b. Incorrect. Free cash flow is not a presented on the statement of cash flows. Many analysts are using free cash flow to track cash flow and other financial measurements in relation to GAAP income.
   c. Incorrect. Investment income is presented on the income statement but not on the statement of cash flows.
   d. Incorrect. Although working capital is an important measure, it is not presented as an element on the statement of cash flows.

7. One effective game that can be played with cash overdrafts is to shift cash flow to operating activities by:
   a. **Correct. By creating a negative cash balance, there can be an increase in cash flow from operating activities. Once this result is achieved, any change in the negative cash balance that increases the negative amount, increases cash from operations.**
   b. Incorrect. The shell game involves segregating cash into two accounts, each with a separate bank, not the same bank, and with no legal right of offset. Because one account has a positive balance and the other a negative balance, the balances cannot be netted since there is no right of offset.
   c. Incorrect. Stretching trade payables may increase cash from operations but has no direct effect on cash overdraft.
   d. Incorrect. Vendor financing is typically found in vendor notes such as floor-plan financing, which is secured by the inventory. Loans received from vendor financing increase cash from operations but does not impact cash overdrafts.

8. Vendor financing is typically found in what format:
   a. Incorrect. Borrowing against receivables is typically not vendor financing, but rather traditional asset-based or commercial borrowing.
   b. Incorrect. Separating cash into two accounts is typically used to create a cash overdraft which, in turn, may increase cash from operations. It has nothing to do with vendor financing.
   c. Incorrect. Selling receivables is a form of factoring, not vendor financing.
   d. **Correct. Vendor financing is typically found in two formats: stretching trade payables through prearranged delayed payment terms and vendor notes such as floor-plan financing, which is secured by the inventory.**

9. What is a common approach used to legitimately manipulate cash from operating activities?
   a. **Correct. Securitizing or factoring trade receivables is a way to increase operating activities cash flow and is legitimate.**
   b. Incorrect. Selling a company does not result in an increase in cash flow from operating activities. Instead, it increases investing activities. Oddly, <u>purchasing</u> a company is one way to increase operating cash flow. In the year of purchase, the purchased receivables and inventory are shown in investing activities. In the next year, the liquidation of receivables and inventory purchased is treated as an inflow in the cash from operating activities section.
   c. Incorrect. Shifting the securities classification to <u>trading</u> securities, and not available-for-sale securities, and then selling them is one way to increase operating cash flow. When the security is sold, the proceeds are shown as an increase in cash from operations.
   d. Incorrect. Vendor financing, and not vendor purchases, manipulate cash from operating activities. Proceeds received from <u>vendor</u> financing, such as floor plan financing, are treated as an inflow from operating activities. Inflows from other types of financing are presented as inflows from financing activities.

10. Purchases and sales of are presented in the operating activities section of the statement of cash flows.
    a. Incorrect. All activity related to available-for-sale securities is presented in the investing activities section of the statement of cash flows.
    b. Incorrect. All activity related to debt securities held to maturity is presented in the investing activities section of the statement of cash flows.
    c. Incorrect. Purchases and sales of non-securities are presented in the investing activities section of the statement of cash flows.
    d. **Correct. Purchases and sales of trading securities are presented in the operating activities section of the statement of cash flows. The primary reason is because the unrealized and realized gains and losses relates to trading securities are recognized on the income statement under GAAP. Thus, any cash flows relates to those transactions are show in the operating activities section of the cash flow statement.**

II. Accounting Standards Updates (ASUs):

Effective July 1, 2009, changes to the source of authoritative U.S. GAAP, the *FASB Accounting Standards Codification*™ (FASB Codification), are communicated through an Accounting Standards Update (ASU). ASUs are published for all authoritative U.S. GAAP promulgated by the FASB, regardless of the form in which such guidance may have been issued prior to release of the FASB Codification (e.g., FASB Statements, EITF Abstracts, FASB Staff Positions, etc.). ASUs also are issued for amendments to the SEC content in the FASB Codification as well as for editorial changes.

An ASU is a transient document that: (1) summarizes the key provisions of the project that led to the ASU, (2) details the specific amendments to the FASB Codification, and (3) explains the basis for the Board's decisions. Although ASUs will update the FASB Codification, the FASB does not consider ASUs as authoritative in their own right.

Prior to the release of the FASB Codification as the single source of authoritative U.S. GAAP, the FASB amended pre-Codification standards and issued them in an "as amended" form. The FASB does not amend ASUs. It will only amend the FASB Codification.
Following is a summary of recently issued ASUs.

Recently Issued ASUs 2009 to 2016	
ASU	**Description**
Accounting Standards Update No. 2009-01	Topic 105—Generally Accepted Accounting Principles—amendments based on—Statement of Financial Accounting Standards No. 168—The *FASB Accounting Standards Codification*™ and the Hierarchy of Generally Accepted Accounting Principles
Accounting Standards Update No. 2009-02	Omnibus Update—Amendments to Various Topics for Technical Corrections
Accounting Standards Update No. 2009-03	SEC Update—Amendments to Various Topics Containing SEC Staff Accounting Bulletins (SEC Update)
Accounting Standards Update No. 2009-04	Accounting for Redeemable Equity Instruments—Amendment to Section 480-10-S99 (SEC Update)
Accounting Standards Update No. 2009-05	Fair Value Measurements and Disclosures (Topic 820)—Measuring Liabilities at Fair Value
Accounting Standards Update No. 2009-06	Income Taxes (Topic 740)—Implementation Guidance on Accounting for Uncertainty in Income Taxes and Disclosure Amendments for Nonpublic Entities
Accounting Standards Update No. 2009-07	Accounting for Various Topics—Technical Corrections to SEC Paragraphs (SEC Update)
Accounting Standards Update No. 2009-08	Earnings per Share—Amendments to Section 260-10-S99 (SEC Update)
Accounting Standards Update No. 2009-09	Accounting for Investments—Equity Method and Joint Ventures and Accounting for Equity-Based Payments to Non-Employees—Amendments to Sections 323-10-S99 and 505-50-S99 (SEC Update)
Accounting Standards Update No. 2009-10	Financial Services—Broker and Dealers: Investments—Other—Amendment to Subtopic 940-325 (SEC Update)
Accounting Standards Update No. 2009-11	Extractive Activities—Oil and Gas—Amendment to Section 932-10-S99 (SEC Update)
Accounting Standards Update No. 2009-12	Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)
Accounting Standards Update No. 2009-13	Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements—a consensus of the FASB Emerging Issues Task Force
Accounting Standards Update No. 2009-14	Software (Topic 985): Certain Revenue Arrangements That Include Software Elements—a consensus of the FASB Emerging Issues Task Force

Accounting Standards Update No. 2009-15	Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance or Other Financing—a consensus of the FASB Emerging Issues Task Force
Accounting Standards Update No. 2009-16	Transfers and Servicing (Topic 860): Accounting for Transfers of Financial Assets
Accounting Standards Update No. 2009-17	Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities
Accounting Standards Update No. 2010-01	Equity (Topic 505): Accounting for Distributions to Shareholders with Components of Stock and Cash—a consensus of the FASB Emerging Issues Task Force
Accounting Standards Update No. 2010-02	Consolidation (Topic 810): Accounting and Reporting for Decreases in Ownership of a Subsidiary—a Scope Clarification
Accounting Standards Update No. 2010-03	Extractive Activities—Oil and Gas (Topic 932): Oil and Gas Reserve Estimation and Disclosures
Accounting Standards Update No. 2010-04	Accounting for Various Topics—Technical Corrections to SEC Paragraphs (SEC Update)
Accounting Standards Update No. 2010-05	Compensation—Stock Compensation (Topic 718): Escrowed Share Arrangements and the Presumption of Compensation (SEC Update)
Accounting Standards Update No. 2010-06	Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements
Accounting Standards Update No. 2010-07	Not-for-Profit Entities (Topic 958): Not-for-Profit Entities: Mergers and Acquisitions
Accounting Standards Update No. 2010-08	Technical Corrections to Various Topics
Accounting Standards Update No. 2010-09	*Subsequent Events (Topic 855): Amendments to Certain Recognition and Disclosure Requirements.*
Accounting Standards Update No. 2010-10	Consolidation (Topic 810): Amendments for Certain Investment Funds
Accounting Standards Update No. 2010-11	Derivatives and Hedging (Topic 815): Scope Exception Related to Embedded Credit Derivatives
Accounting Standards Update No. 2010-12	Income Taxes (Topic 740): Accounting for Certain Tax Effects of the 2010 Health Care Reform Acts (SEC Update)
Accounting Standards Update No. 2010-13	Compensation—Stock Compensation (Topic 718): Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Currency of the Market in Which the Underlying Equity Security Trades—a consensus of the FASB Emerging Issues Task Force
Accounting Standards Update No. 2010-14	Accounting for Extractive Activities—Oil & Gas—Amendments to Paragraph 932-10-S99-1 (SEC Update)
Accounting Standards Update No. 2010-15	Financial Services—Insurance (Topic 944): How Investments Held through Separate Accounts Affect an Insurer's Consolidation Analysis of Those Investments—a consensus of the FASB Emerging Issues Task Force
Accounting Standards Update No. 2010-16	Entertainment—Casinos (Topic 924): Accruals for Casino Jackpot Liabilities—a consensus of the FASB Emerging Issues Task Force
Accounting Standards Update No. 2010-17	Revenue Recognition—Milestone Method (Topic 605): Milestone Method of Revenue Recognition—a consensus of the FASB Emerging Issues Task Force
Accounting Standards Update No. 2010-18	Receivables (Topic 310): Effect of a Loan Modification When the Loan Is Part of a Pool That Is Accounted for as a Single Asset—a consensus of the FASB Emerging Issues Task Force
Accounting Standards Update No. 2010-19	Foreign Currency (Topic 830): Foreign Currency Issues: Multiple Foreign Currency Exchange Rates (SEC Update)
Accounting Standards Update No. 2010-20	Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses
Accounting Standards Update No. 2010-21	Accounting for Technical Amendments to Various SEC Rules and Schedules Amendments to SEC Paragraphs Pursuant to Release No. 33-9026: Technical Amendments to Rules, Forms, Schedules and Codification of Financial Reporting Policies (SEC Update)
Accounting Standards Update No. 2010-22	Accounting for Various Topics—Technical Corrections to SEC Paragraphs (SEC Update)

Accounting Standards Update No. 2010-23	Health Care Entities (Topic 954): Measuring Charity Care for Disclosure—a consensus of the FASB Emerging Issues Task Force
Accounting Standards Update No. 2010-24	Health Care Entities (Topic 954): Presentation of Insurance Claims and Related Insurance Recoveries (a consensus of the FASB Emerging Issues Task Force)
Accounting Standards Update No. 2010-25	Plan Accounting—Defined Contribution Pension Plans (Topic 962): Reporting Loans to Participants by Defined Contribution Pension Plans (a consensus of the FASB Emerging Issues Task Force)
Accounting Standards Update No. 2010-26	Financial Services—Insurance (Topic 944): Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts (a consensus of the FASB Emerging Issues Task Force)
Accounting Standards Update No. 2010-27	Other Expenses (Topic 720): Fees Paid to the Federal Government by Pharmaceutical Manufacturers (a consensus of the FASB Emerging Issues Task Force)
Accounting Standards Update No. 2010-28	Intangibles—Goodwill and Other (Topic 350): When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts (a consensus of the FASB Emerging Issues Task Force)
Accounting Standards Update No. 2010-29	Business Combinations (Topic 805): Disclosure of Supplementary Pro Forma Information for Business Combinations (a consensus of the FASB Emerging Issues Task Force)
Accounting Standards Update No. 2011-01	Receivables (Topic 310): Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20
Accounting Standards Update No. 2011-02	Receivables (Topic 310): A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring
Accounting Standards Update No. 2011-03	Transfers and Servicing (Topic 860): Reconsideration of Effective Control for Repurchase Agreements
Accounting Standards Update No. 2011-04	Fair Value Measurement (Topic 820)- Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs
Accounting Standards Update No. 2011-05	Comprehensive Income (Topic 220): Presentation of Comprehensive Income
Accounting Standards Update No. 2011-06	Other Expenses (Topic 720): Fees Paid to the Federal Government by Health Insurers (a consensus of the FASB Emerging Issues Task Force)
Accounting Standards Update No. 2011-07	Health Care Entities (Topic 954): Presentation and Disclosure of Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts for Certain Health Care Entities (a consensus of the FASB Emerging Issues Task Force)
Accounting Standards Update No. 2011-08	Intangibles- Goodwill and Other (Topic 350) Testing Goodwill for Impairment
Accounting Standards Update No. 2011-09	Compensation—Retirement Benefits—Multiemployer Plans (Subtopic 715-80) Disclosures about an Employer's Participation in a Multiemployer Plan
Accounting Standards Update No. 2011-10	Property, Plant, and Equipment (Topic 360): Derecognition of in Substance Real Estate—a Scope Clarification (a consensus of the FASB Emerging Issues Task Force)
Accounting Standards Update No. 2011-11	Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities
Accounting Standards Update No. 2011-12	Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05
Accounting Standards Update No. 2012-01	Health Care Entities (Topic 954): Continuing Care Retirement Communities—Refundable Advance Fees
Accounting Standards Update No. 2012-02	Intangibles—Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment
Accounting Standards Update No. 2012-03	Technical Amendments and Corrections to SEC Sections: Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 114, Technical Amendments Pursuant to SEC Release No. 33-9250, and Corrections Related to FASB Accounting Standards Update 2010-22 (SEC Update)
Accounting Standards Update No. 2012-04	Technical Corrections and Improvements
Accounting Standards Update No. 2012-05	Statement of Cash Flows (Topic 230): Not-for-Profit Entities: Classification of the Sale Proceeds of Donated Financial Assets in the Statement of Cash Flows (a consensus of the FASB Emerging Issues Task Force)

Accounting Standards Update No. 2012-06	Business Combinations (Topic 805): Subsequent Accounting for an Indemnification Asset Recognized at the Acquisition Date as a Result of a Government-Assisted Acquisition of a Financial Institution (a consensus of the FASB Emerging Issues Task Force)
Accounting Standards Update No. 2012-07	Entertainment—Films (Topic 926): Accounting for Fair Value Information That Arises after the Measurement Date and Its Inclusion in the Impairment Analysis of Unamortized Film Costs (a consensus of the FASB Emerging Issues Task Force)
Accounting Standards Update No. 2013-01	Balance Sheet (Topic 210): Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities
Accounting Standards Update No. 2013-02	Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income
Accounting Standards Update No. 2013-03	Financial Instruments (Topic 825): Clarifying the Scope and Applicability of a Particular Disclosure to Nonpublic Entities
Accounting Standards Update No. 2013-04	Liabilities (Topic 405): Obligations Resulting from Joint and Several Liability Arrangements for Which the Total Amount of the Obligation Is Fixed at the Reporting Date (a consensus of the FASB Emerging Issues Task Force)
Accounting Standards Update No. 2013-05	Foreign Currency Matters (Topic 830): Parent's Accounting for the Cumulative Translation Adjustment upon Derecognition of Certain Subsidiaries or Groups of Assets within a Foreign Entity or of an Investment in a Foreign Entity (a consensus of the FASB Emerging Issues Task Force)
Accounting Standards Update No. 2013-06	Not-for-Profit Entities (Topic 958): Services Received from Personnel of an Affiliate (a consensus of the FASB Emerging Issues Task Force)
Accounting Standards Update No. 2013-07	Presentation of Financial Statements (Topic 205): Liquidation Basis of Accounting
Accounting Standards Update No. 2013-08	Financial Services—Investment Companies (Topic 946): Amendments to the Scope, Measurement, and Disclosure Requirements
Accounting Standards Update No. 2013-09	Fair Value Measurement (Topic 820): Deferral of the Effective Date of Certain Disclosures for Nonpublic Employee Benefit Plans in Update No. 2011-04
Accounting Standards Update No. 2013-10	Derivatives and Hedging (Topic 815): Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes (a consensus of the FASB Emerging Issues Task Force)
Accounting Standards Update No. 2013-11	Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists (a consensus of the FASB Emerging Issues Task Force)
Accounting Standards Update No. 2013-12	Definition of a Public Business Entity—An Addition to the Master Glossary
Accounting Standards Update No. 2014-01	Investments—Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects (a consensus of the FASB Emerging Issues Task Force)
Accounting Standards Update No. 2014-02	Intangibles—Goodwill and Other (Topic 350): Accounting for Goodwill (a consensus of the Private Company Council)
Accounting Standards Update No. 2014-03	Derivatives and Hedging (Topic 815): Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps—Simplified Hedge Accounting Approach (a consensus of the Private Company Council)
Accounting Standards Update No. 2014-04	Receivables—Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure (a consensus of the FASB Emerging Issues Task Force)
Accounting Standards Update No. 2014-05	Service Concession Arrangements (Topic 853) (a consensus of the FASB Emerging Issues Task Force)
Accounting Standards Update No. 2014-06	Technical Corrections and Improvements Related to Glossary Terms
Accounting Standards Update No. 2014-07	Consolidation (Topic 810): Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements (a consensus of the PCC)
Accounting Standards Update No. 2014-08	Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360): Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity

Accounting Standards Update No. 2014-09	Revenue from Contracts with Customers (Top 606)
Accounting Standards Update No. 2014-10	Development Stage Entities
Accounting Standards Update No. 2014-11	Transfers and Servicing (Topic 860): Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures
Accounting Standards Update No. 2014-12	Compensation—Stock Compensation (Topic 718): Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period (a consensus of the FASB Emerging Issues Task Force)
Accounting Standards Update No. 2014-13	Consolidation (Topic 810): Measuring the Financial Assets and the Financial Liabilities of a Consolidated Collateralized Financing Entity (a consensus of the FASB Emerging Issues Task Force)
Accounting Standards Update No. 2014-14	Receivables- Troubled Debt Restructurings by Creditors (Subtopic 310-40): Classification of Certain Government-Guaranteed Mortgage Loans upon Foreclosure (a consensus of the FASB Emerging Issues Task Force)
Accounting Standards Update No. 2014-15	Presentation of Financial Statements- Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern
Accounting Standards Update No. 2014-16	Derivatives and Hedging (Topic 815): Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share Is More Akin to Debt or to Equity (a consensus of the FASB Emerging Issues Task Force)
Accounting Standards Update No. 2014-17	Business Combinations (Topic 805): Pushdown Accounting (a consensus of the FASB Emerging Issues Task Force)
Accounting Standards Update No. 2014-18	Business Combinations (Topic 805): Accounting for Identifiable Intangible Assets in a Business Combination (a consensus of the Private Company Council)
Accounting Standards Update No. 2015-01	Income Statement- Extraordinary and Unusual Items (Subtopic 225-20): Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items
Accounting Standards Update No. 2015-02	Consolidation (Topic 810): Amendments to the Consolidation Analysis
Accounting Standards Update No. 2015-03	Interest—Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs
Accounting Standards Update No. 2015-04	Compensation—Retirement Benefits (Topic 715): Practical Expedient for the Measurement Date of an Employer's Defined Benefit Obligation and Plan Assets
Accounting Standards Update No. 2015-05	Intangibles – Goodwill and Other -Internal-Use Software (Subtopic 350-40) Customer's Accounting for Fees Paid in a Cloud Computing Arrangement
Accounting Standards Update No. 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)
Accounting Standards Update No. 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
Accounting Standards Update No. 2015-08	Business Combinations (Topic 805): Pushdown Accounting—Amendments to SEC Paragraphs Pursuant to Staff Accounting Bulletin No. 115 (SEC Update)
Accounting Standards Update No. 2015-09	Financial Services—Insurance (Topic 944): Disclosures about Short-Duration Contracts
Accounting Standards Update No. 2015-10	Technical Corrections and Improvements
Accounting Standards Update No. 2015-11	Inventory (Topic 330): Simplifying the Measurement of Inventory
Accounting Standards Update No. 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)
Accounting Standards Update No. 2015-13	Derivatives and Hedging (Topic 815): Application of the Normal Purchases and Normal Sales Scope Exception to Certain Electricity Contracts within Nodal Energy Markets (a consensus of the FASB Emerging Issues Task Force)

Accounting Standards Update No. 2015-14	Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date
Accounting Standards Update No. 2015-15	Interest—Imputation of Interest (Subtopic 835-30): Presentation and Subsequent Measurement of Debt Issuance Costs Associated with Line-of-Credit Arrangements—Amendments to SEC Paragraphs Pursuant to Staff Announcement at June 18, 2015 EITF Meeting (SEC Update)
Accounting Standards Update No. 2015-16	Business Combinations (Topic 805): Simplifying the Accounting for Measurement-Period Adjustments
Accounting Standards Update No. 2015-17	Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes
Accounting Standards Update No. 2016-01	Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities

Selected Accounting Standards Updates (ASUs):

Following is an analysis of selected ASUs that were recently issued.

ASU 2015-05- Intangibles – Goodwill and Other -Internal-Use Software (Subtopic 350-40) Customer's Accounting for Fees Paid in a Cloud Computing Arrangement

Issued: April 2015

Effective date: ASU 2015-05 is effective as follows:

For public business entities, the ASU is effective for annual periods, including interim periods within those annual periods, *beginning after December 15, 2015*.

For all other entities, the ASU is effective for annual periods *beginning after December 15, 2015*, and interim periods in annual periods beginning after December 15, 2016. Early adoption is permitted for all entities.

Objective: ASU 2015-05 is issued as part of the FASB's *Simplification Initiative*. The objective of the Simplification Initiative is to identify, evaluate, and improve areas of GAAP for which cost and complexity can be reduced while maintaining or improving the usefulness of the information provided to users of financial statements.

The objective of ASU 2015-05 is to provide guidance to customers about whether a cloud computing arrangement includes a software license.

Background: Currently, GAAP does not include specific guidance about a customer's accounting for fees paid in a cloud computing arrangement.

Examples of cloud computing arrangements include:

- Software as a service
- Platform as a service
- Infrastructure as a service, and
- Other similar hosting arrangements.

The FASB received input from stakeholders that the absence of explicit guidance has resulted in some diversity in practice and has created unnecessary costs and complexity to evaluate the accounting for those fees.

As a result of input, the FASB added guidance to Subtopic 350-40, *Intangibles—Goodwill and Other—Internal-Use Software*, to assist entities in evaluating the accounting for fees paid by a customer in a cloud computing arrangement.

The larger question is whether customer fees paid in a cloud computing arrangement represent a license to use software or fees for a service contract.

ASC 350-40-05-2, *Intangibles-Goodwill and Other- Internal-Use Software*, defines internal-use software as having *both* of the following characteristics:

a. The software is acquired, internally developed, or modified solely to meet the entity's internal needs, and

b. During the software's development or modification, no substantive plan exists or is being developed to market the software externally.

ASC 350-40-35-4 states that internal-use software licensed or acquired is amortized on a *straight-line basis* unless another systematic or rational basis is more representative of the software's use.

With respect to cloud services, the FASB's existing guidance is limited and found in ASC 985-605-55-121 through 55-123, *Software-Revenue Recognition*; however that guidance pertains to revenue received by cloud service providers to determine whether an arrangement includes the sale or license of software. It does not address the accounting for cloud services fees paid from the customer's perspective.

ASU 2015-05 provides guidance to customers about whether a cloud computing arrangement is a license for internal use, or whether it is a service contract:

- If a cloud computing arrangement *includes a software license*, then the customer should account for the software license element of the arrangement consistent with the *licensing of internal-use software*, which is generally capitalized and amortized.

- If a cloud computing arrangement *does not include a software license*, the customer should account for the arrangement as a *service contract*.

ASU 2015-05 does not change GAAP for a customer's accounting for service contracts. In addition, the guidance in ASU 2015-05 supersedes ASU 350-40-25-16, *Intangibles- Goodwill and Other- Internal-Use Software*. Consequently, all software licenses within the scope of Subtopic 350-40 will be accounted for consistent with other licenses of intangible assets.

Rules:

1. The scope of internal-use software found in ASC 350-40-15-4 does not apply to software that a customer obtains access to in a hosting arrangement if it *does not meet* the following *two criteria*:

a. The customer has the contractual right to take *possession of the software* at any time during the hosting period *without significant penalty*, and

b. It is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software.

2. The term *without significant penalty* contains two distinct concepts:

   a. The ability to take delivery of the software without incurring significant cost, or

   b. The ability to use the software separately without a significant diminution in utility or value.

3. Hosting arrangements that do not meet both criteria in (1)(a) and (b) above, are considered *service contracts* and do not constitute a purchase of, or convey a license to, software.

4. ASU 2015-05 supersedes the following paragraph found in ASC 350-40-25-16:

   REMOVED:
   Entities often license internal-use software from third parties. Though Subtopic 840-10 excludes licensing agreements from its scope, entities shall analogize to that Subtopic when determining the asset acquired in a software licensing arrangement.

Note: The ASU states that some cloud computing arrangements include one or more licenses to software as well as a promise to provide services, in which case the customer should allocate the contract consideration between the license(s) and the service element(s).

Note: In determining the two criteria in (1)(a) and (b), the FASB followed the guidance found in ASC 985-605, *Software*, with respect to revenue recognition by software vendors. Those two criteria are:

a. The customer has the contractual right to take *possession of the software* at any time during the hosting period *without significant penalty*, and

b. It is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software.

ASU 2015-03: Interest- Imputation of Interest (Subtopic 835-30)- Simplifying the Presentation of Debt Issuance Costs

Issued: April 2015

Effective date: ASU 2015-03 is effective as follows:

1. For public business entities, for financial statements issued for fiscal *years beginning after December 15, 2015*, and interim periods within those fiscal years

2. For all other entities, for financial statements issued for fiscal years *beginning after December 15, 2015*, and interim periods within fiscal years beginning after December 15, 2016. Early application is permitted for the financial statements that have not been previously issued.

Objective: The ASU is being issued as part of the FASB's *Simplification Initiative*. The objective of the Simplification Initiative is to identify, evaluate, and improve areas of generally accepted accounting principles (GAAP) for which cost and complexity can be reduced while maintaining or improving the usefulness of the information provided to users of financial statements.

Background: Debt issuance costs are generally considered to be specific third-party incremental costs that are directly attributable to issuing a debt instrument, either in the form of:

- Issuing bonds
- Closing a bank or private loan

Such costs may include:

- Legal fees
- Commissions or financing fees
- Appraisal costs
- Accounting and auditing fees
- Points
- Title insurance
- Any other costs incurred in order to complete specific financing

Debt issuance costs generally *exclude* internal general and administrative costs and overhead of the borrowing entity.

Under existing GAAP prior to the effective date of ASU 2015-03, deferred issuance costs are:

- Capitalized as an asset on the balance sheet, and
- Amortized to interest expense using the effective interest method.

Rules:

1. ASU 2015-03 *does not apply* to the following:

   a. The amortization of premium and discount of assets and liabilities that are reported at *fair value*, and

   b. The debt issuance costs of liabilities that are reported at *fair value*.

2. The following elements shall be reported in the balance sheet as a *direct deduction from the face amount of a note*:

   a. The discount or premium resulting from the determination of present value in cash or noncash transactions, and

b. Debt issuance costs related to a note (NEW)

Note: The ASU states that similar to a discount or premium resulting from the determination of present value in cash or noncash transactions, debt issuance costs are not an asset or liability separable from the note that gives rise to it.

3. The discount, premium, or debt issuance costs *shall not be classified* on the balance sheet as a deferred charge or deferred credit.

4. Amortization of discount or premium and debt issuance costs shall be reported as follows on the income statement:

   a. Amortization of discount or premium: As *interest expense* in the case of liabilities or as *interest income* in the case of assets.

   b. Amortization of debt issuance costs: As *interest expense*.

5. An entity shall disclose the following on the financial statements or in the notes to the statements:

   a. A description of a note (receivable or payable) which shall include the *effective interest rate*.

   b. The face amount of the note.

ASU No. 2014-18: Business Combinations (Topic 805): Accounting for Identifiable Intangible Assets in a Business Combination (a consensus of the Private Company Council)

Issued: December 2014

Effective date: The decision to adopt the accounting alternative in this ASU must be made upon the occurrence of the first transaction within the scope of this accounting alternative in fiscal years *beginning after December 15, 2015*, and the effective date of adoption depends on the timing of that first in-scope transaction.

Early application is permitted for any interim and annual financial statements that have not yet been made available for issuance.

Objective: The objective is to offer an accounting alternative for private companies to elect not to allocate a portion of the acquisition price to certain intangibles other than goodwill.

Background:

The Private Company Council (PCC) added this issue to its agenda in response to feedback from some private company stakeholders indicating that the benefits of the current accounting for identifiable intangible assets acquired in a business combination may not justify the related costs.

By providing an accounting alternative, this Update reduces the cost and complexity associated with the measurement of certain identifiable intangible assets without significantly diminishing decision-useful information to users of private company financial statements.

Rules:

1. The ASU, at an entity's election, apply to *all entities except for public business entities and not-for-profit entities* as defined in the Master Glossary of the FASB Accounting Standards Codification®.

2. The accounting alternative applies when an entity within the scope of this ASU is required to recognize or otherwise consider the fair value of intangible assets as a result of any one of the following transactions (in-scope transactions):

   a. Applying the acquisition method under Topic 805 on business combinations

   b. Assessing the nature of the difference between the carrying amount of an investment and the amount of underlying equity in net assets of an investee when applying the equity method under Topic 323 on investments—equity method and joint ventures, or

   c. Adopting fresh-start reporting under Topic 852 on reorganizations.

3. An entity within the scope of this ASU that elects to apply the ASU is subject to all of the recognition requirements within the accounting alternative.

4. The accounting alternative, when elected, should be applied to all in-scope transactions entered into after the effective date.

5. An entity that elects the accounting alternative to a business combination, should *no longer recognize separately from goodwill* the following:

   - customer-related intangible assets unless they are capable of being sold or licensed independently from the other assets of the business, and

   - noncompetition agreements.

6. An entity that elects the accounting alternative in this ASU must adopt the private company alternative to amortize goodwill (over a maximum of 10 years straight line) as described in FASB Accounting Standards Update No. 2014-02, Intangibles—Goodwill and Other (Topic 350): Accounting for Goodwill. However, an entity that elects the accounting alternative in Update 2014-02 is not required to adopt the amendments in this Update.

ASU No. 2014-17: Business Combinations (Topic 805): Pushdown Accounting (a consensus of the FASB Emerging Issues Task Force)

Issued: November 2014

Effective date: The ASU is effective on November 18, 2014. After the effective date, an acquired entity can make an election to apply the guidance to future change-in-control events or to its most recent

change-in-control event. However, if the financial statements for the period in which the most recent change-in-control event occurred already have been issued or made available to be issued, the application of this guidance would be a change in accounting principle.

Objective: The objective of the ASU is to provide guidance on whether and at what threshold an acquired entity that is a business or nonprofit activity can apply pushdown accounting in its separate financial statements.

Background: Current GAAP offer limited guidance for determining whether and at what threshold an acquiree (acquired entity) can reflect the acquirer's accounting and reporting basis (pushdown accounting) in its separate financial statements.

SEC Staff Accounting Bulletin Topic No. 5.J, *New Basis of Accounting Required in Certain Circumstances*, Emerging Issues Task Force (EITF) Topic No. D-97, "*Push Down Accounting*," and other comments made by the SEC Observer at EITF meetings provide guidance on pushdown accounting for SEC registrants. However, because the SEC staff's guidance applies only to SEC registrants, no guidance exists for the application of pushdown accounting for entities that are not SEC registrants.

Rules:

1. The ASU applies to the separate financial statements of an acquired entity and its subsidiaries that are a business or nonprofit activity (either public or nonpublic) upon the occurrence of an event in which an acquirer (an individual or an entity) obtains control of the acquired entity.

2. The ASU provides an acquired entity with an option to apply pushdown accounting in its separate financial statements upon occurrence of an event in which an acquirer *obtains control of the acquired entity*.

    a. An acquired entity may elect the option to apply pushdown accounting in the reporting period in which the change-in-control event occurs.

3. An acquired entity should determine whether to elect to apply pushdown accounting for each individual change-in-control event in which an acquirer obtains control of the acquired entity.

4. If pushdown accounting is not applied in the reporting period in which the change-in-control event occurs, an acquired entity will have the option to elect to apply pushdown accounting in a subsequent reporting period to the acquired entity's most recent change-in-control event.

    a. An election to apply pushdown accounting in a reporting period after the reporting period in pushdown accounting in a reporting period after the reporting period in which the change-in-control event occurred should be considered a change in accounting principle in accordance with Topic 250, *Accounting Changes and Error Corrections*.

5. If pushdown accounting is applied to an individual change-in-control event, that election is irrevocable. If an acquired entity elects the option to apply pushdown accounting in its separate financial statements, it should disclose information in the current reporting period that enables users of financial statements to evaluate the effect of pushdown accounting

ASU No. 2014-07: Consolidation (Topic 810) Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements (a consensus of the PCC)

Issued: March 2014:

Effective date: ASU 2014-07 is effective for the first annual period beginning after December 15, 2014, and interim periods within annual periods *beginning after December 15, 2015*. Early application is permitted for any annual or interim period before which an entity's financial statements are available to be issued.

Objective: The objective of ASU 2014 is to permit a private company lessee (the reporting entity) to elect an accounting alternative not to apply the variable interest entity (VIE) guidance to a lessor entity if certain conditions are met.

Background: Under current U.S. GAAP, a reporting entity is required to consolidate an entity in which it has a controlling financial interest. GAAP has *two models* for assessing whether there is a controlling financial interest: the *voting-interest model* and the *variable interest entity (VIE) model*.

- Under the *voting-interest model*, a controlling financial interest exists if there is ownership of more than 50% of an entity's voting interests.

- Under the *VIE model*, a reporting entity has a controlling financial interest in a variable interest entity (VIE) when it has both (1) the power to direct the VIE's activities that most significantly affect the economic performance of the VIE and (2) the obligation to absorb the VIE's losses or the right to receive benefits of the VIE that could potentially be significant to the VIE.

The VIE model was introduced to GAAP by the issuance of FASB Interpretation No. 46R, *Consolidation of Variable Interest Entities* (FIN 46R), now part of ASC 810, *Consolidations*. Under the VIE model, a reporting entity must determine whether it has a variable interest in a VIE (e.g., form of support), and whether the entity being evaluated is a VIE. Thus, under the VIE model, a reporting entity may be required to consolidate a VIE even though it has no direct ownership in the VIE.

With respect to nonpublic (private) companies, a common situation in which the VIE model applies is where there is a related-party lease involving an operating company lessee and a real estate lessor. In such a situation, the VIE model rules require the operating company lessee to consolidate the real estate lessor if certain criteria are met. First, the real estate lessor must be a variable interest entity (VIE). Second, the operating company lessee must have a variable interest in the VIE, which is a form of support. Third, the operating company lessee must be considered the primary beneficiary (defacto parent) of the VIE.

Rules :

ASU 2014-07 offers rules to apply if a private company lessee wants to elect the ASU's *accounting alternative* and not apply the VIE consolidation rules to a lessor related by common ownership.

1. A private company (nonpublic entity) lessee may elect an accounting alternative in applying the variable interest entity rules to a lessor under common ownership.

2. Under the accounting alternative, a *private company* (nonpublic entity) lessee is not required to evaluate a lessor entity under the guidance in the variable interest entity (VIE) rules if all of the following *four criteria* are met:

   Criterion 1: The private company lessee (the reporting entity) and the lessor entity are under common control.

   Criterion 2: The private company lessee has a *lease arrangement* with the lessor entity.

   Criterion 3: *Substantially all activities* between the private company lessee and the lessor entity are related to leasing activities (*including supporting leasing activities*) between those two entities.

   Criterion 4: Additional requirement where the private company lessee explicitly guarantees or provides collateral for the lessor:

   a. If the private company lessee *explicitly guarantees* or *provides collateral* for any obligation of the lessor entity related to the asset leased by the private company, then the principal amount of the obligation at inception of such guarantee or collateral arrangement *does not exceed the value of the asset* leased by the lessee from the lessor entity.

3. Application of this accounting alternative is an *accounting policy election* that shall be applied by a private company lessee to *all lessor entities*, provided that all of the four criteria for applying this accounting alternative are met.

4. For lessor entities that as a result of this accounting alternative are excluded from applying the VIE rules (e.g., are exempt from being consolidated), a private company lessee shall continue to apply other GAAP guidance as applicable.

5. Disclosures: A private company lessee that elects the accounting alternative shall make two specific disclosures identified in this ASU, unless the lessor entity is consolidated through other GAAP rules other than VIE guidance (e.g., there is more than 50% ownership in the voting shares of the lessor).

6. If, after making the election, any of the first three conditions (Criterion (1), (2) or (3)) for applying the accounting alternative cease to be met, a private company lessee shall apply the guidance for consolidation of a VIE at the date of change on a prospective basis.

   Note: A private company lessee must satisfy the first three criteria continuously after the election is made.

ASU No. 2014-02: Intangibles—Goodwill and Other (Topic 350): Accounting for Goodwill - a consensus of the Private Company Council

Issued: January 2014

Effective date: If the ASU is elected, it should be applied prospectively to goodwill existing as of the beginning of the period of adoption and new goodwill recognized in annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015. Early application is permitted, including application to any period for which the entity's annual or interim financial statements have not yet been made available for issuance.

Objective: The objective of this ASU is to provide nonpublic entities an option to amortize goodwill, contrary to existing GAAP which does not permit amortization of goodwill.

Background: This ASU represents one of the first two standards issued by the Private Company Council (PCC) under the FASB, which provides for an exception to traditional U.S. GAAP for nonpublic (private) companies.

The Private Company Council (PCC) added this issue to its agenda in connection with a separate, but related, issue addressing identifiable intangible assets acquired in a business combination. Because goodwill is a residual asset calculated after recognizing other (tangible and intangible) assets and liabilities acquired in a business combination, any modifications to the initial recognition and measurement guidance for identifiable intangible assets would correspondingly change the goodwill amount recognized in the business combination. Accordingly, the PCC decided that it should take such modifications into consideration in determining how private companies should account for goodwill after a business combination.
Feedback from users of private company financial statements indicated that:

a. The goodwill impairment test performed today provides limited decision-useful information because most users of private company financial statements generally disregard goodwill and goodwill impairment losses in their analysis of a private company's financial condition and operating performance.

b. There are concerns about the cost and complexity involved in performing the current goodwill impairment test.

Private company stakeholders acknowledged that the FASB's recent introduction of the optional qualitative assessment has provided some cost reduction in testing goodwill for impairment, but many of those stakeholders stated that the level of cost reduction has not been significant.

The PCC decided that the concerns expressed about the cost and complexity encountered with applying the current goodwill accounting guidance and the limited relevance to users indicated that a change to the accounting for goodwill was warranted, regardless of the outcome of the related issue on identifiable intangible assets.

Rules:

1. A private company may make an accounting policy election to apply the accounting alternative (amortize goodwill) for the following transactions or activities:

   a. Goodwill that an entity recognizes in a business combination after it has been initially recognized and measured, and

   b. Amounts recognized as goodwill in applying the equity method of accounting, and to the excess reorganization value recognized by entities that adopt fresh-start reporting.

2. An entity that elects the accounting alternative shall apply all of the related subsequent measurement, derecognition, other presentation matters, and disclosure requirements upon election.

3. The accounting alternative, once elected, shall be applied to existing goodwill and to all additions to goodwill recognized in future transactions within the scope of this accounting alternative.

4. The accounting alternative: amortization of goodwill:

   a. Goodwill relating to each business combination or reorganization event resulting in fresh-start reporting (amortizable unit of goodwill) *shall be amortized on a straight-line basis over 10 years*, or less than 10 years, if the entity demonstrates that another useful life is more appropriate.

   b. An entity may revise the remaining useful life of goodwill upon the occurrence of events and changes in circumstances that warrant a revision to the remaining period of amortization. However, the cumulative amortization period for any amortizable unit of goodwill *cannot exceed 10 years*. If the estimate of the remaining useful life of goodwill is revised, the remaining carrying amount of goodwill shall be amortized prospectively on a straight-line basis over that revised remaining useful life.

5. Equity method investments:

   a. The portion of the difference between the cost of an investment and the amount of underlying equity in net assets of an equity method investee that is recognized as goodwill (equity method goodwill) shall be amortized on a straight-line basis over 10 years, or less than 10 years if the entity demonstrates that another useful life is more appropriate.

   b. Equity method goodwill shall not be reviewed for impairment in accordance with this Subtopic. Equity method investments shall continue to be reviewed for in accordance with paragraph 323-10-35-32.

6. Goodwill impairment test:

   a. Upon adoption of this accounting alternative, an entity shall make an accounting policy election to test goodwill for impairment at the entity level or the reporting unit level.

   b. Goodwill of an entity (or a reporting unit) shall be tested for impairment if an event occurs or circumstances change that indicate that the fair value of the entity (or the reporting unit) may be below its carrying amount (a triggering event).

      1) Upon the occurrence of a triggering event, an entity may assess qualitative factors to determine whether it is more likely than not (that is, a likelihood of more than 50 percent) that the fair value of the entity (or the reporting unit) is less than its carrying amount, including goodwill.

      2) An entity has an unconditional option to bypass the qualitative assessment and proceed directly to a quantitative calculation by comparing the entity's (or the reporting unit's) fair value with its carrying amount. An entity may resume performing the qualitative assessment upon the occurrence of any subsequent triggering event.

         Note: The annual goodwill impairment test is eliminated if the entity elects to amortize goodwill over 10 years. Instead, goodwill is tested for impairment only if there is a triggering event.

c. A goodwill impairment loss, if any, shall be allocated to individual amortizable units of goodwill of the entity (or the reporting unit) on a pro rata basis using their relative carrying amounts, or using another reasonable and rational basis.

d. After a goodwill impairment loss is recognized, the adjusted carrying amount of goodwill shall be its new accounting basis, which shall be amortized over the remaining useful life of goodwill. Subsequent reversal of a previously recognized goodwill impairment loss is prohibited.

7. Disposal of a portion of an entity (or a reporting unit):

a. When a portion of an entity (or a reporting unit) that constitutes a business is to be disposed of, goodwill associated with that business shall be included in the carrying amount of the business in determining the gain or loss on disposal. An entity shall use a reasonable and rational approach to determine the amount of goodwill associated with the business to be disposed of.

8. The ASU carries over several provisions from existing GAAP:

a. The aggregate amount of goodwill net of accumulated amortization and impairment shall be presented as a separate line item in the statement of financial position.

b. The amortization and aggregate amount of impairment of goodwill shall be presented in income statement line items within continuing operations (or similar caption) unless the amortization or a goodwill impairment loss is associated with a discontinued operation.

c. The amortization and impairment of goodwill associated with a discontinued operation shall be included (on a net-of-tax basis) within the results of discontinued operations.

9. Transition and effective date:

a. The ASU is effective prospectively for new goodwill recognized in annual periods *beginning after December 15, 2014*, and interim periods within annual periods beginning after December 15, 2015.

b. Goodwill existing as of the beginning of the period of adoption shall be amortized prospectively on a straight-line basis over 10 years, or less than 10 years, if an entity demonstrates that another useful life is more appropriate.

c. Early application is permitted for any annual or interim period for which an entity's financial statements have not yet been made available for issuance.

d. Upon adoption of the accounting alternative, an entity shall make an accounting policy election to test goodwill for impairment at either the entity level or the reporting unit level.

ASU No. 2013-11: Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists

Issued: July 2013

Effective date: For fiscal years, and interim periods within those years, *beginning after December 15, 2013*.

Objective: The objective of this ASU is to provide explicit guidance on the financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists.

Background: Current U.S. GAAP does not include explicit guidance on the financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. The amendments in this ASU are expected to provide guidance on the presentation of unrecognized tax benefits and the manner in which an entity would settle at the reporting date any additional income taxes that would result from the disallowance of a tax position when net operating loss carryforwards, similar tax losses, or tax credit carryforwards exist.

Rules:

1. An unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, except as follows:

    a. The unrecognized tax benefit should be presented in the financial statements *as a liability* and should not be combined with deferred tax assets under the following rules:

        1) To the extent a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date (under the tax law of the applicable jurisdiction) to settle any additional income taxes that would result from the disallowance of a tax position, or

        2) The tax law of the applicable jurisdiction does not require the entity to use (and the entity does not intend to use), the deferred tax asset for such purpose,

    Note: The assessment of whether a deferred tax asset is available is based on the unrecognized tax benefit and deferred tax asset that exist at the reporting date and should be made presuming disallowance of the tax position at the reporting date. For example, an entity should not evaluate whether the deferred tax asset expires before the statute of limitations on the tax position, or whether the deferred tax asset may be used prior to the unrecognized tax benefit being settled.

2. The amendments in this ASU do not require new recurring disclosures.

ASU 2013-07: Presentation of Financial Statements (Topic 205) Liquidation Basis of Accounting

Issued: April 2013

Effective date: Accounting Standards Update (ASU) 2013-07 is effective for entities that determine liquidation is imminent during annual reporting periods *beginning after December 15, 2013*, and interim reporting periods therein.

Entities should apply the requirements prospectively from the day that liquidation becomes imminent. Early adoption is permitted.

Objective: The objective of ASU 2013-07 is to clarify when an entity should apply the liquidation basis of accounting. In addition, the ASU's guidance provides principles for the recognition and measurement of assets and liabilities and requirements for financial statements prepared using the liquidation basis of accounting.

Background: Currently, GAAP assumes that an entity will continue as a going concern which is the reason why financial statements are recorded at a mixture of cost, lower of cost or market, fair value, and other measurements.

If an entity is not going to continue as a going concern, the entity's balance sheet should be recorded at liquidation value. In fact, the reason why an auditor modifies his or her audit report when there is "substantial doubt" of an entity's ability to continue as a going concern, is because that entity's balance sheet is incorrectly presented. That is, if there is substantial doubt of going concern, the balance sheet probably should be adjusted to liquidation value.

To date, there has been little authoritative guidance as to when liquidation accounting should be used and how to apply it as well as required disclosures.

On the international front, international standards currently do not provide explicit guidance on when and how to apply the liquidation basis of accounting.

Scope of ASU 2013-07: ASU 2013-07 applies to all entities *except* for investment companies regulated under the Investment Company Act of 1940.

Rules:

1. An entity should prepare financial statements under the assumption that the entity will continue to operate as a going concern.

   Example: As a going concern, GAAP records assets and liabilities at cost, lower of cost or market, fair value, replacement cost, etc.

2. Liquidation basis of accounting

   An entity shall prepare financial statements using the *liquidation basis of accounting* when *liquidation is imminent.*

a. If liquidation is imminent, there is no longer an assumption that the entity will continue to operate as a going concern.

b. *Exception for limited-life entities*: The liquidation basis of accounting should not be used if the liquidation follows a plan for liquidation that was specified in the entity's governing documents at the entity's inception (limited-life entity).

3. Definition of imminent

Liquidation is *imminent* when *either* of the following occurs:

a. A plan for liquidation has been approved by the person or persons with the authority to make such a plan effective, and the likelihood is *remote* that any of the following will occur:

1) Execution of the plan will be blocked by other parties (for example, those with shareholder rights), or

2) The entity will return from liquidation.

b. A plan for liquidation is imposed by other forces (for example, involuntary bankruptcy), and the likelihood is remote that the entity will return from liquidation.

4. Measurement of assets and liabilities- liquidation basis

a. Assets shall be measured to reflect the estimated amount of cash or other consideration that it expects to collect in settling or disposing of those assets in carrying out its plan for liquidation.

Note: The ASU notes that in some cases, fair value may approximate the amount that an entity expects to collect. However, an entity *shall not presume* this to be true for all assets.

b. Liabilities shall be measured based on other GAAP that otherwise would apply to those liabilities.

1) An entity shall accrue estimated costs to dispose of assets or other items that it expects to sell in liquidation and present those costs in the aggregate separately from those assets or items.

2) An entity shall accrue costs and income that it expects to incur or earn (such as payroll costs or income from preexisting orders that the entity expects to fulfill during liquidation) through the end of its liquidation if and when it has a reasonable basis for estimation.

c. Unrecognized assets and liabilities: When using the liquidation basis of accounting, an entity shall recognize other items that it previously had not recognized, such as trademarks or patents, but that it expects to sell in liquidation or use to settle liabilities.

Example: Company X adopts the liquidation basis of accounting effective June 1, 20X1. The company has several patents and trademarks that are not recorded.

Conclusion: In adopting liquidation basis of accounting, X should bring those assets onto the statement of net assets in liquidation, recording the patents and trademarks at liquidation value.

d. Subsequent measurement: At each reporting date, an entity shall re-measure its assets and other items it expects to sell that it had not previously recognized (for example, trademarks), liabilities, and the accruals of disposal or other costs, or income to reflect the actual or estimated change in the carrying value since the previous reporting date.

5. Presentation rules

a. The ASU requires that at a minimum, an entity that applies the liquidation basis of accounting shall prepare *two statements* as follows:

- A statement of net assets in liquidation, and
- A statement of changes in net assets in liquidation.

b. The liquidation basis of accounting shall be applied prospectively from the day that liquidation becomes imminent. The initial statement of changes in net assets in liquidation shall present only changes in net assets that occurred during the period since liquidation became imminent.

6. Disclosures

a. An entity that uses the liquidation basis of accounting is required to make all disclosures required by GAAP that are relevant to understanding of the following information:

- The entity's statement of net assets in liquidation and statement of changes in net assets in liquidation.

- The amount of cash or other consideration that an entity expects to collect and the amount that the entity is obligated, or expects to be obligated to pay, during the course of liquidation.

b. At a minimum, an entity shall disclose all of the following when it prepares financial statements using the liquidation basis of accounting:

1) That the financial statements are prepared using the liquidation basis of accounting, including the facts and circumstances surrounding the adoption of the liquidation basis of accounting and the entity's determination that liquidation is imminent.

2) A description of the entity's plan for liquidation, including a description of each of the following:

- The manner by which it expects to dispose of its assets and other items it expects to sell that it had not previously recognized as assets (for example, trademarks)

- The manner by which it expects to settle its liabilities, and

- The expected date by which the entity expects to complete its liquidation.

3) The methods and significant assumptions used to measure assets and liabilities, including any subsequent changes to those methods and assumptions.

4) The type and amount of costs and income accrued in the statement of net assets in liquidation and the period over which those costs are expected to be paid or income earned.

ASU 2013-04: Liabilities (Topic 405): Obligations Resulting from Joint and Several Liability Arrangements for Which the Total Amount of the Obligation is Fixed at the Reporting Date

Issued: February 2013

Effective date: The amendments in ASU 2013-04 are effective for fiscal years, and interim periods within those years, *beginning after December 15, 2013*.

For nonpublic entities, the amendments are effective for fiscal years *ending after December 15, 2014*, and interim periods and annual periods thereafter.

Objective: The objective of the amendments in ASU 2013-04 is to provide guidance for the recognition, measurement, and disclosure of obligations resulting from joint and several liability arrangements for which the total amount of the obligation within the scope of this guidance is fixed at the reporting date, except for obligations addressed within existing guidance in U.S. GAAP.

Background: In some instances, several entities may engage in a transaction in which each entity is jointly and severally liable for the joint obligations of the entities; that is, a liability is established that is shared by more than one party. Examples of such obligations include:

- Debt arrangements
- Contractual obligations, and
- Settled litigation and judicial rulings.

Currently, U.S. GAAP offers no specific guidance on accounting for such obligations, including the recognition, measurement and disclosure of such obligations. Consequently, there are variations in practice.

For instance:

1. Some entities record the entire amount of the obligation under the joint and several liability arrangement on the basis of the concept of a liability, and based on the premise that the amount recorded should equal the amount that must be satisfied to extinguish a liability under the guidance in ASC 405-20, *Liabilities-Extinguishments of Liabilities.*

2. Other entities record a portion of the total obligations allocated among all obligors. The allocation method may be based on the amount contractually allocated among the entities, the amount of proceeds received, or the portion of the amount the entity agreed to pay among its co-obligors. This allocation method is based on guidance found in the contingent liabilities rules in ASC 450-20, *Contingencies- Loss Contingencies*, and ASC 410-30, *Asset Retirement and Environmental*

Obligations- Environmental Obligations. ASC 410-30 permits an entity to record its estimated portion of the total obligation subject to joint and several liability.[51]

Example: Illustrating Problems With Current Practice

One of the problems with existing practice that lead to the issuance of ASU 2013-04 was that several co-borrowers involved with each other under a joint and several liability arrangement would potentially record duplicate liabilities to account for the same liability obligation.

Consider the following example:

Example: Companies X, Y and Z are co-borrowers of a loan in the amount of $3 million. Each of the companies receives one third of the proceeds ($1 million each) and each is jointly and severally liable for the entire $3 million.

Because each company is potentially liable for $3 million, each company records the entire $3 million liability even though each only receives $1 million.

The result is that the entire liability recorded among the three entities is:

Entity	Liability Recorded
Company X	$3,000,000
Company Y	3,000,000
Company Z	3,000,000
	$9,000,000

Because of the fact that each company is jointly and severally liable for the entire $3,000,000, the companies collectively record total liabilities of $9,000,000. There is clearly redundancy.

Scope

1. The amendments in ASU 2013-04 apply to all entities, *both public and nonpublic*, that have obligations resulting from joint and several liability arrangements for which the total amount of the obligation is *fixed* at the reporting date and for which no specific guidance exists.

   a. The ASU applies to obligations that have the following *two criteria*:

      1) There must be a *joint and several liability arrangement*, and
      2) The total amount under the arrangement must be *fixed* at the reporting date.

   b. ASU 2013-04 *does not apply* to obligations accounted for under the following ASC Topics:

      1) Asset Retirement and Environmental Obligations, ASC Topic 410

[51] ASC 410-30-30, *Asset Retirement and Environmental Obligations, Environmental Obligations-Initial Measurement*, states that the environmental remediation liability recorded by an entity should be based on that entity's estimate of its allocable share of the joint and several remediation liability.

2) Contingencies, ASC Topic 450
3) Guarantees, ASC Topic 460
4) Compensation—Retirement Benefits, ASC Topic 715
5) Income Taxes, ASC Topic 740

c. In order for the total amount of an obligation to be considered *fixed at the reporting date*, there can be *no measurement uncertainty* at the reporting date relating to the total amount of the obligation.

d. The ASU applies to all joint and several liability arrangements for which the total amount of the obligation is fixed at the reporting date, *regardless of the relationship among parties involved in the arrangement*.

   1) A joint and several liability arrangement is not excluded from the scope of the ASU because the parties involved are unrelated or related.

e. The ASU *does not apply* to guarantors of an obligation.

   1) A joint and several liability arrangement involving an entity as a guarantor (instead of borrower) of an obligation must follow the guidance of ASC 460, *Guarantees*, and not ASU 2013-04.

f. Liabilities subject to a measurement uncertainty (e.g., not fixed) are excluded from the scope of the ASU and should continue to be accounted for under the guidance in ASC 450, *Contingencies*, or other U.S. GAAP.

Rules:

1. An entity shall recognize obligations resulting from joint and several liability arrangements where the total amount under the arrangement *is fixed* at the reporting date.

2. Obligations resulting from joint and several liability arrangements where the *total amount under the arrangement is fixed* at the report date, shall be measured as the sum of the following:

   a. The amount the reporting entity agreed to pay on the basis of its arrangement among its co-obligors, and

   b. Any additional amount the reporting entity *expects to pay* on behalf of its co-obligors, using the guidance similar to the rules found in ASC 450, *Contingencies*.

What if the entity is a guarantor of a debt, instead of a co-borrower?

In some situations, an entity may be a guarantor of a loan, under a joint and several obligation.

ASU 2013-04 applies to a situation in which an entity is a co-borrower, and *not a guarantor*. Therefore, if an entity is a guarantor, the entity must follow the rules found in ASC 460, *Guarantees.*

ASC 460 states that:

a. At the inception of a guarantee, the guarantor shall recognize in its statement of financial position *a liability for that guarantee*. The initial measurement of the liability is the *fair value* of the guarantee.

b. The fair value of the liability shall be based on a *standalone arm's-length transaction.* When a guarantee is issued in a standalone arm's-length transaction with an unrelated party, the liability recognized at the inception of the guarantee should be the *premium received or receivable* by the guarantor.

c. ASC 460 does not apply to related party guarantees. Therefore, if an entity guarantees the debt of a related party, the guarantor is not required to record a liability (at fair value) in accordance with ASC 460.

Example 1: Company X guarantees the debt of its related party, Company Y.

Conclusion: Because X is a guarantor of a related-party's debt, the rules found in ASC 460, *Guarantees*, apply. Under those 460 rules, X is exempt from having to record a liability for the guarantee obligation, because X is giving a related-party guarantee.

If, instead, X and Y were not related parties, X would be required to record a liability at the inception of the guarantee, based on the fair value of the guarantee on that date.

Example 2: Company X is a co-borrower of the debt of its related party, Company Y.

Conclusion: Because X is a co-borrower (and not a guarantor) of a related-party, joint and several obligation that is fixed in amount, X must comply with the provisions of ASU 2013-04 that require X to record a liability. That liability is recorded on X's balance sheet at:

- The amount that X agreed to pay on the basis of its arrangement with Y, and
- Any additional amount that X *expects to pay* on behalf of its co-obligor, Y.

3. The corresponding entry or entries to recording the obligation depends on the facts and circumstances of the obligation:

Examples of some corresponding (debit) entries include:

a. Cash for proceeds from a debt arrangement
b. An expense for a legal settlement
c. A receivable (that is assessed for impairment) for a contractual right
d. An equity transaction with an entity under common control where there is equity ownership.

Note: In instances in which a legal or contractual arrangement exists to recover amounts funded under a joint and several obligation from the co-obligors, the FASB EITF noted that a receivable could be recognized at the time the corresponding liability is established. After recording, that receivable would need to be assessed for impairment. When no legal or contractual arrangement exists to recover the funded amounts from the co-obligors, the FASB EITF noted that an entity should consider all relevant facts and circumstances to determine whether the gain contingencies guidance

found in ASC 450-30, *Gain Contingencies*, or other guidance would apply in recognizing a receivable for potential recoveries.

4. Disclosures: An entity shall disclose the following information about each obligation, or each group of similar obligations, resulting from joint and several liability arrangements:

   a. The nature of the arrangement, including:

      - How the liability arose
      - The relationship with other co-obligors
      - The terms and conditions of the arrangement.

   b. The total outstanding amount under the arrangement, which shall not be reduced by the effect of any amounts that may be recoverable from other entities

   c. The carrying amount, if any, of an entity's liability and the carrying amount of a receivable recognized, if any

   d. The nature of any recourse provisions that would enable recovery from other entities of the amounts paid, including any limitations on the amounts that might be recovered, and

   e. In the period the liability is initially recognized and measured, or in a period when the measurement changes significantly:

      - The corresponding entry
      - Where the entry was recorded in the financial statements.

   Note: The disclosures required by the ASU do not affect the related-party disclosure requirements in ASC 850, *Related Party Disclosures*. The disclosure requirements in the ASU are incremental to those requirements.

5. Transition and effective date information:

   a. The ASU is effective as follows:

      1) For fiscal years, and interim periods, within those years, *beginning after December 15, 2013*.

      2) For *nonpublic entities*, for fiscal years *ending after December 15, 2014*, and interim and annual periods thereafter.

   b. The ASU shall be applied retrospectively to all prior periods presented for those obligations resulting from joint and several liability arrangements within the scope of the ASU that exist at the beginning of an entity's fiscal year of adoption.

   c. An entity may elect to use hindsight for the comparative periods presented in the initial year of adoption (if it changed its accounting as a result of adopting the ASU) and shall disclose that fact. The use of hindsight would allow an entity to recognize, measure, and disclose obligations resulting from joint and several liability arrangements within the scope of this Subtopic in

comparative periods using information available at adoption, rather than requiring an entity to make judgments about what information it had in each of the prior periods to measure the obligation.

d. Earlier application is permitted.

e. An entity shall disclose information required in ASC 250, *Accounting Changes and Error Corrections*, within paragraphs 250-10-50-1 through 3, in the period the entity adopts the new content.

ASU No. 2013-03: Financial Instruments (Topic 825) Clarifying the Scope and Applicability of a Particular Disclosure to Nonpublic Entities

Issued: February 2013

Effective date: Upon issuance

Objective: The main objective of this ASU is to clarify the scope and applicability of a particular disclosure to nonpublic entities that resulted from the issuance of ASU No. 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*.

Contrary to the stated intent of ASU 2011-04 to exempt all nonpublic entities for a particular disclosure, that ASU's amendments to ASC Topic 825 suggested that nonpublic entities that have total assets of $100 million or more, or, that have one or more derivative instruments would not qualify for the intended exemption.

Background: The FASB issued ASU 2011-4 to clarify certain provisions of fair value and expand fair value disclosures, particularly those disclosures pertaining to Level 2 and 3 financial instruments.

ASU 2011-04 carried over certain scope requirements related to nonpublic companies and whether fair value disclosures apply.

As written, ASC 825, *Financial Instruments*, as amended by ASU 2011-04, requires fair value disclosures for financial instruments, regardless of whether such financial instruments are recorded at fair value at the balance sheet date.

However, ASU 2011-04 states that such fair value disclosures are *optional* for certain nonpublic entities unless such financial instruments are recorded at fair value at the balance sheet date.

Currently, the following nonpublic entities are exempt from fair value disclosures unless a financial instrument is recorded at fair value at the balance sheet date:

- The entity is a *nonpublic entity*
- The entity's total assets are less than $100 million on the date of the financial statements, and

- The entity has no instrument that, in whole or in part, is accounted for as a derivative instrument other than commitments related to the origination of mortgage loans to be held for sale during the reporting period.

Thus, the way it is currently written, nonpublic entities with less than $100 million of total assets and have no derivatives, are exempt from the fair value disclosures for financial instruments unless such financial instruments are recorded at fair value at the balance sheet date.

But, that also means that large nonpublic entities (with $100 million or more of total assets) or nonpublic entities with derivatives are required to include such fair value disclosures for all financial instruments regardless of whether they are recorded at fair value at the balance sheet date.
In reading the FASB's intent in issuing ASU 2011-04, the FASB sought for all nonpublic entities to be exempt from one particular fair value disclosure regardless of the size or whether it had derivatives.

Paragraph 825-10-50-10(d)'s requires disclosure of:

"The level of the fair value hierarchy within which the fair value measurements are categorized in their entirety (Level 1, 2, or 3)."

Once ASU 2011-04 was issued, users questioned whether ASU 2011-04 was written correctly.

Rules of ASU 2013-03:

ASC 825-10-50-3 is amended as follows:

1. *Except as noted in the following paragraph*, for annual reporting periods, the disclosure guidance related to fair value of financial instruments (found in paragraphs 825-10-50-10 through 50-19) applies to all entities, but is *optional* for an entity that meets all of the following criteria:

   a. The entity is a nonpublic entity.

   b. The entity's total assets are less than $100 million on the date of the financial statements.

   c. The entity has no instrument that, in whole or in part, is accounted for as a derivative instrument other than commitments related to the origination of mortgage loans to be held for sale during the reporting period.

2. A nonpublic entity is not required to provide the disclosure in paragraph 825-10-50-10(d) for items disclosed at fair value *but not measured at fair value* in the statement of financial position.

   Paragraph 825-10-50-10(d)'s requires disclosure of:

   The level of the fair value hierarchy within which the fair value measurements are categorized in their entirety (Level 1, 2, or 3).

Thus, all nonpublic companies, regardless of size and whether they have derivatives, are not required to present the above disclosure for financial instruments unless such instruments are recorded at fair value.

Observation: The rules for fair value disclosures are confusing because there have been so many documents issued since the original issuance of FASB No. 157, *Fair Value Measurements* (now part of ASC 820).

Here is a summary of how the disclosures for fair value apply.

1. General rule: Companies must include fair value disclosures:

    a. For any asset or liability that is recorded on the balance sheet at fair value.

    b. For financial instruments, even if they are not recorded on the balance sheet at fair value

2. Nonpublic company exception: Nonpublic companies with less than $100 million of total assets and no derivatives:

    - Are exempt from fair value disclosures for financial instruments that are not recorded on the balance sheet at fair value.

3. All nonpublic companies are exempt from the fair value disclosure found in paragraph 825-10-50-10(d) unless a financial instrument is recorded at fair value on the balance sheet:

    Paragraph 825-10-50-10(d)'s disclosure:

    "The level of the fair value hierarchy within which the fair value measurements are categorized in their entirety (Level 1, 2, or 3)."

Example 1: Company X is a public company that has numerous financial instruments, some of which are recorded at fair value and some are not recorded at fair value at December 31, 20X1.

Conclusion: Because X is a public company, X is required to include the various fair value disclosures related to all of its financial instruments regardless of whether those instruments are recorded at fair value or not at the December 31, 20X1 balance sheet date.

Example 2: Company Y is a nonpublic company with $200 million of total assets and no derivatives. Y's equity securities are recorded at fair value and its bonds are recorded at cost at December 31, 20X1.

Conclusion: Because Y is a nonpublic company with $100 million or more of total assets, Y is required to include the various fair value disclosures related to all of its financial instruments regardless of whether those instruments are recorded at fair value or not at the December 31, 20X1 balance sheet date. Thus, fair value disclosures are required as of December 31, 20X1 with respect to both the financial instruments recorded at fair value (equity securities) and the bonds (recorded at cost).

The exception is that because Y is a nonpublic entity, it is exempt from one fair value disclosure found in paragraph 825-10-50-10(d) for any financial instruments not recorded at fair value (bonds) at December 31, 20X1 as follows:

"The level of the fair value hierarchy within which the fair value measurements are categorized in their entirety (Level 1, 2, or 3)."

Thus, Y will include all fair value disclosures for both the equity securities and bonds, but will not have to disclose the "level of the fair value hierarchy" with respect to the bonds that are not recorded at fair value.

Example 3: Same facts as Example 2 except that Company Y has total assets of $80 million at December 31, 20X1 and has some derivatives at that date.

Conclusion: Although Y does not have total assets of $100 million or more, it does have derivatives.

Y is required to include the various fair value disclosures related to all of its financial instruments regardless of whether those instruments are recorded at fair value or not at the December 31, 20X1 balance sheet date. Thus, fair value disclosures are required as of December 31, 20X1 with respect to both the financial instruments recorded at fair value (equity securities), derivatives (recorded at fair value), and the bonds (recorded at cost).

The exception is that because Y is a nonpublic entity, it is exempt from one fair value disclosure found in paragraph 825-10-50-10(d) for any financial instrument not recorded at fair value (bonds) at December 31, 20X1 as follows:

> *"The level of the fair value hierarchy within which the fair value measurements are categorized in their entirety (Level 1, 2, or 3)."*

Thus, Y will include all fair value disclosures for equity securities, derivatives, and bonds, but will not have to disclose the "level of the fair value hierarchy" with respect to the bonds that are not recorded at fair value.

Example 4: Company Z is a nonpublic entity with total assets of $20 million and no derivatives.

Z has some financial instruments consisting of equity securities recorded at fair value, and some bonds recorded at cost.

Conclusion: Because Z is a nonpublic entity with less than $100 million of total assets and no derivatives, Z is only required to make fair value disclosures for financial instruments recorded at fair value at the December 31, 20X1 balance sheet date. That means, fair value disclosures are required for the equity securities, but not the bonds.

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self - study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

1. Ralph is a CPA and controller for Company K. K has a cloud arrangement with an outside vendor under which certain software functions are run and held on the vendor's cloud. Ralph is evaluating how K should account for the costs of the cloud arrangement which are paid monthly. The cloud arrangement does not include a software license. Howe should the cost be accounted for:
   a. As internal-use software
   b. As a service contract
   c. As a prepaid asset
   d. Split with a portion expensed and a portion capitalized as a fixed asset

2. Company Z has debt issuance costs related to a $5 million loan. How should Z present the debt issuance costs on its balance sheet in accordance with ASU 2015-03:
   a. Nowhere as the costs should be expensed as incurred
   b. As an asset
   c. Netted against the debt
   d. As a contra- equity account

3. Company X is purchasing the net assets of Company Y. X has elected the accounting alternative related to identifiable intangibles in ASU 2014-18. Which of the following should no longer be recognized separately from goodwill:
   a. Inventory
   b. Fixed assets
   c. Noncompete agreement
   d. Liabilities

4. In order for an entity to elect the accounting alternative under ASU 2014-07, there must be a(an):
   a. Lease arrangement
   b. Written contract
   c. Service contract
   d. Derivative contract

5. Company X is an SEC company and has goodwill. Which of the following is correct:
   a. X may amortize goodwill over a 10-year period for GAAP
   b. X may amortize goodwill over a 15-year period for GAAP
   c. X may not amortize goodwill for GAAP
   d. X has a choice of amortizing goodwill or not amortizing goodwill for GAAP

6. In accordance with ASU 2013-07, an entity should use the liquidation basis of accounting when liquidation is _____.
   a. Reasonably possible
   b. Probable
   c. More likely than not
   d. Imminent

7. In order for ASU 2013-04 to apply to an entity's joint and several obligation, the total amount under the arrangement must be _____.
   a. Predictable
   b. Calculable
   c. Fixed
   d. Variable

SUGGESTED SOLUTIONS

1. Ralph is a CPA and controller for Company K. K has a cloud arrangement with an outside vendor under which certain software functions are run and held on the vendor's cloud. Ralph is evaluating how K should account for the costs of the cloud arrangement which are paid monthly. The cloud arrangement does not include a software license. How should the cost be accounted for:
   a. Incorrect. The transaction should be accounted for as internal-use software only if it includes a software license, which it does not. Thus, the answer is incorrect.
   b. **Correct. If a cloud computing arrangement does not include a software license, the customer should account for the arrangement as a service contract.**
   c. Incorrect. At best, the asset is an intangible asset, and not a prepaid one, as there is no evidence to suggest there is a prepaid expense that should be recorded.
   d. Incorrect. GAAP does not provide for expensing a portion while capitalizing the remainder.

2. Company Z has debt issuance costs related to a $5 million loan. How should Z present the debt issuance costs on its balance sheet in accordance with ASU 2015-03:
   a. Incorrect. Debt issuance costs are capitalized and amortized, and not expensed as incurred
   b. Incorrect. The previous rules required the debt issuance costs to be recorded as an asset and amortized. Under ASU 2015-03, recording those costs as an asset is no longer an option.
   c. **Correct. The ASU requires that the debt issuance costs be presented as a net amount against the underlying debt.**
   d. Incorrect. The ASU does not permit the costs to be presented as a contra- equity account as they have nothing to do with equity.

3. Company X is purchasing the net assets of Company Y. X has elected the accounting alternative related to identifiable intangibles in ASU 2014-18. Which of the following should no longer be recognized separately from goodwill:
   a. Incorrect. The ASU applies to identifiable intangibles, not inventory.
   b. Incorrect. Fixed assets are not a category of assets covered by the ASU. Fixed assets continue to be recognized as a separate asset and certainly have no correlation with goodwill.
   c. **Correct. The ASU provides that a noncompete agreement should be part of goodwill and not be recognize separate from goodwill.**
   d. Incorrect. The ASU applies to assets and not liabilities, making the answer incorrect.

4. In order for an entity to elect the accounting alternative under ASU 2014-07, there must be a(an):
   a. **Correct. The ASU election addresses a situation in which there is a lessee-lessor that are engaged in a lease arrangement. One of the four criteria that must be met is that there must be a lease arrangement, making the answer correct.**
   b. Incorrect. There is no requirement for there to be a written contract. There could be a verbal lease arrangement.
   c. Incorrect. The ASU does not state that a service contract must be in place and, instead, it must be a lease arrangement. A lease arrangement, that involves an asset, is not the same as a service contract, which does not.
   d. Incorrect. A lease arrangement is not a derivative contract, making the answer incorrect.

5. Company X is an SEC company and has goodwill. Which of the following is correct:
   a. Incorrect. Under ASU 2014-02, a special election to amortize goodwill is available. However, it is only available for nonpublic (private) companies, and not SEC companies.
   b. Incorrect. If X were a nonpublic company, for GAAP, it could amortize goodwill over 10 years, not 15 years, making the answer incorrect.
   c. **Correct. Existing GAAP does not permit goodwill to be amortized for an SEC company, making the answer correct.**
   d. Incorrect. Only nonpublic entities have a choice of amortizing goodwill or not amortizing it, under ASU 2014-02. Because X is an SEC company, such a choice is not available.

6. In accordance with ASU 2013-07, an entity should use the liquidation basis of accounting when liquidation is _____.
   a. Incorrect. Reasonably possible is a threshold used in contingencies, and not part of liquidation basis of accounting.
   b. Incorrect. The probable threshold is not used in liquidation basis of accounting. Instead, it is used in the contingency rules.
   c. Incorrect. The ASU does not use the more likely than not threshold making the answer incorrect.
   d. **Correct. The ASU requires use of the liquidation basis of accounting when liquidation is imminent, making the answer correct.**

7. In order for ASU 2013-04 to apply to an entity's joint and several obligation, the total amount under the arrangement must be _____.
   a. Incorrect. Predictability is not a requirement under ASU 2013-04. The fact that the amount is predictable does not mean there is sufficient information to measure the amount of the obligation on the obligor's balance sheet.
   b. Incorrect. The ASU does not use the term calculable even though the obligor must calculate the amount of the obligation. Thus the answer is incorrect.
   c. **Correct. The total amount must be fixed at the reporting date so that there is no measurement uncertainty related to the amount of the obligation. The reason is because an entity cannot measure the obligation without knowing the amount of that obligation.**
   d. Incorrect. The total amount should not be variable because the amount of the obligation must be determined. If the amount is variable, that obligation amount cannot be measured on the obligor's balance sheet.

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Glossary

Excess cash margin: Formula as follows: **(**Operating cash flow – operating earnings)/ revenue.

Fair value accounting: Merely an appraisal of an entity's net assets from period to period; introduces a degree of volatility to the accounting model.

Free cash flow: The amount of cash flow that is free for common shareholders after accounting for fixed commitments such as capital expenditures and preferred stock dividends.

Financial asset: Cash, evidence of an ownership interest in an entity, or a contract.

Financial liability: A contract that imposes on one entity a contractual obligation to deliver cash or another financial instrument to a second entity, or, to exchange other financial instruments on potentially unfavorable terms with the second entity.

Level 1 input: Observable market inputs that reflect quoted prices for identical assets or liabilities in active markets that the reporting entity has the ability to access at the measurement date.

Level 2 input: Observable market inputs other than quoted prices for identical assets or liabilities such as quoted prices for similar assets and liabilities in active markets, quotes prices for identical or similar assets and liabilities in markets that are not active, and market inputs other than quoted prices that are directly observable for the asset or liability, such as interest rates, yield curves, volatilities, and default rates.

Level 3 input: Unobservable market inputs, such as those derived through extrapolation or interpolation that are not able to be corroborated by observable market data.

Public Company Accounting Oversight Boards (PCAOB): The standard-setter for SEC auditors.

ACCOUNTING AND FINANCIAL REPORTING UPDATES
16 CPEs

Final Exam

1. One of the twelve (12) recommended principles for a comprehensive business reporting model is that the company must be viewed from the perspective of _____.
   a. All investors in the company's equity
   b. All third parties with a range of perspectives considered
   c. The current investor in the company's common equity
   d. The financial analyst

2. One of the twelve (12) recommended principles is that the cash flow statement provides essential information and should _____.
   a. Be prepared using the indirect method
   b. Be prepared using the direct method
   c. Add a fourth category in addition to operating, investing and financing activities
   d. Reconcile to working capital instead of cash

3. *IBM's investors complain about the fact that IBM's disclosures keep growing from year to year. Which of the following might be a prime reason why IBM overdiscloses in their notes to financial statements.*
   a. To protect against litigation
   b. To save time in removing disclosures from period to period
   c. To avoid challenges from over-reactive third parties who seek specific information
   d. Because those in charge with governance may be ignorant of accounting and disclosure issues

4. Implications of a drastic change in the format of financial statements would include all of the following *except:*
   a. Tax return M-1 reconciliation would differ
   b. Contract formulas for bonuses would have to be rewritten
   c. The cost would be significant
   d. The use of the term cash equivalents would remain in tact

5. Free cash flow is the amount of cash flow that is free after accounting for:
   a. Fixed commitments such as capital expenditures and preferred stock dividends
   b. Unrealized gains and losses on securities
   c. Variable items such as commissions and other variable costs
   d. Other income or expense

6. Which of the following would be the logical flow of particular elements in financial statements:
   a. Working capital flows to Cash
   b. Core earnings flow to working capital
   c. Cash flows to Free cash flow
   d. Inventories flow to receivables

7. Four (4) key ratios provide a thorough analysis of working capital. These ratios include all of the following *except*:
   a. Days payables outstanding
   b. Days sales in accounts receivable
   c. Days in cash flow
   d. Days supply in inventory

8. Assume the following:
   - Days sales outstanding (DSO) is 45 days
   - Best possible DSO is 30
   - Credit terms are 20 days

   Which is the average days delinquent (ADD):
   a. 10 days
   b. 15 days
   c. Zero
   d. 25 days

9. Symptoms of inefficiently managed working capital include all of the following *except*:
   a. Bad debts are increasing
   b. Customer service levels are higher than normal
   c. Interest payments to suppliers are increasing
   d. Receivables are growing disproportionately to sales

10. In the computation of the S&P's Core Earnings, items excluded consist of all of the following *except*:
    a. Gains/losses from asset sales
    b. Goodwill impairment charges
    c. Merger/acquisition related expenses
    d. Pension costs

11. Company X has a restatement. Based on one study, which one of the following is likely to be one of the top individual reasons for X's restatement:
    a. Accrual adjustments
    b. Inventory writedowns
    c. Consolidation issues
    d. Income tax issues

12. What did Glass Lewis report with regard to financial restatements:
    a. Restatements by companies audited by the Big Four were about half those by other firms
    b. Lease accounting errors are declining as a cause of restatements
    c. The number of restatements by overseas companies that do business in the U.S. decreased significantly
    d. The number of restatements in 2014 was more than double the amount in 2008

13. Company X is subject to Section 954 of Dodd-Frank's clawback provision. Which of the following is the reason why Section 954 applies to X's restatement.
    a. A material noncompliance
    b. An error
    c. A fraud
    d. An irregularity

14. Which of the following is true in comparing the key differences between the Sarbanes Section 304 and Dodd-Frank Section 954 clawback provisions:
    a. Section 304 of Sarbanes only applies to a CEO and CFO, while Section 954 of Dodd-Frank applies to "any current or former executive"
    b. Section 954 requires that the misstatement be due to misconduct while Section 304 does not require misconduct.
    c. Section 304 goes back two years while Dodd-Frank extends back only six months from the year of restatement
    d. The two provisions are identical as Section 954 was written to mirror Section 304

15. One of the characteristics of a multi-employer pension plan is that:
    a. Many employers are part of one, identical collective bargaining agreement
    b. Assets contributed by one particular employer must be used for that employer's employees only
    c. Employers are jointly and severely liability for the plan obligations
    d. There is no withdrawal or exit fee

16. What is the author's opinion of the funded status of the pension plans recomputed by Credit Suisse:
    a. The funded status shortfall of $(101) billion is distorted and should be about $(428) billion
    b. The funded status shortfall of $(101) billion finally represents a true picture of the status of pension plans
    c. The funded status shortfall of $(101) billion really should be a surplus of about $500 billion
    d. The funded status is understated because of the poor stock market performance

17. By filing Chapter 11, Hostess was able to achieve which of the following results:
    a. It payed a reduced pension withdrawal liability
    b. It shifted the burden of its single employer plans to the unions
    c. It terminated all of its single and multi-employer plans
    d. It shifted the burden of its multi-employer plans to the IRS

18. _____ is defined as the average rate of earnings expected on the funds invested or to be invested.
    a. Actual return
    b. Expected rate of return
    c. Discounted rate of return
    d. Projected rate of return

19. The expected rates of return uses by U. S. pension plans are _____ those rates used by other major countries in measuring their pension liabilities:
    a. Significantly higher than
    b. The same as
    c. Slightly lower than
    d. Significantly lower than

20. One of changes to pension plans that GASB Statement 68 makes is:
    a. Its requires governments to report the funded status of their plans on their statement of financial position
    b. It requires governments to use a higher expected rate of return
    c. It requires governments to use a higher discount rate
    d. It requires governments to use a higher compensation growth rate

21. The _____ may be in trouble and may have to be bailed out by Congress because of its $88 billion in assets and exposure of $377 billion for potential claims:
    a. Congressional Budget Office
    b. Pension Fund Society of America
    c. Pension Benefit Guaranty Corporation
    d. Social Security Administration

22. A benefit of implementing an objectives-oriented, principles-based system is that it would:
    a. Decrease the amount of time spent communicating with governing bodies
    b. Decrease the cost of accounting
    c. Decrease litigation risk
    d. Provide a vehicle to make U.S. standards closer to international standards

23. One disadvantage of a principles-based system of accounting is that it:
    a. Is more difficult for accountants and auditors to stay current
    b. Is much more complex and detailed
    c. Requires a high degree of ethics and exercise of professional judgment
    d. Is less expense to implement

24. Which of the following is a reason why U.S. convergence with international standards has not occurred:
    a. It would require issuing financial statements in more than one language
    b. The cost to change would be significant
    c. It would require all companies to adopt LIFO
    d. International standards would be superior to U.S. standards thereby requiring more disclosures

25. Which of the following is true as it relates to how certain elements are accounted for under U.S. GAAP as compared with IFRS:
    a. U.S. GAAP has more extensive disclosures using a principles-based system than IFRS.
    b. IFRS uses a one-step approach versus a two-step approach for impairment of long-lived assets
    c. Both the IFRS and U.S. GAAP deal with uncertain tax positions
    d. U.S. GAAP guidance on revenue recognition is limited while IFRS has significant guidance

26. Which of the following is true:
    a. IFRS permits use of LIFO inventory in most cases
    b. IFRS does not permit use of LIFO inventory
    c. IFRS permits use of LIFO inventory in all cases
    d. IFRS follows U. S. GAAP in determining whether LIFO is permitted and when

27. If LIFO is used for tax purposes, the LIFO Conformity Requirement _____.
    a. Permits that the primary income statement be presented on FIFO or average cost
    b. Requires that the primary income statement and balance sheet must be presented on LIFO
    c. Permits the balance sheet to be presented on a non-LIFO basis
    d. Does not require either the income statement or balance sheet to be presented on a LIFO basis

28. Which of the following is a current challenge to a fair value model noted by its critics:
    a. The historical cost model is more relevant
    b. Fair value accounting introduces a degree of volatility to the model
    c. Fair value accounting is too objectives-based
    d. Fair value accounting will reveal an entity's true value from period to period

29. Under the fair value hierarchy, which of the following is a description of a Level 1 input:
    a. Quoted prices for identical assets or liabilities in active markets
    b. Other than quoted prices for identical assets or liabilities
    c. Quoted prices for similar assets and liabilities in active markets
    d. Quoted prices for identical or similar assets and liabilities in markets that are not active

30. Under the newly issued ASU 2016-01, which of the following is eliminated:
    a. Available-for-sale category for equity investments
    b. Held to maturity category for equity investments
    c. Trading category for equity investments
    d. Lower of cost or market category for all investments

31. One key change under the proposed lease standard is:
    a. A small portion of operating leases, but not capital leases, would be brought onto the balance sheet
    b. Capital leases, but not operating leases, would be brought onto the balance sheet
    c. No leases would be capitalized
    d. Most existing operating leases would be brought onto the balance sheet

32. Under the proposed lease standard, the lessee recognizes the liability at the present value of the lease payments discounted at which of the following permitted rates:
    a. The lessor's borrowing rate
    b. The interest rate for similar obligations in the market
    c. The lessee's incremental borrowing rate
    d. 110% of the applicable federal rate

33. Under the proposed lease standard, which of the following is true as it relates to the lessee:
    a. An asset is recognized representing the sum of the lease payments over the lease term
    b. An asset is recognized representing its right to use the leased asset for the lease term
    c. An asset is not recognized
    d. An asset is recognized only if four criteria are met

34. How would a lessee account for initial direct costs incurred in connection with a lease, under the proposed lease standard:
    a. Initial direct costs are included in the lease asset that is recorded at the commencement date
    b. Initial direct costs are not part of the lease asset
    c. Initial direct costs are expensed as period costs
    d. The proposed lease standard is silent as to how to account for initial direct costs

35. Which of the following is <u>not</u> considered part of lease payments under the proposed lease standard:
    a. Fixed payments
    b. Amortization on the underlying leased asset
    c. Exercise price of a purchase option
    d. Payments for penalties for terminating the lease

36. What happens to existing leases on the date of adoption of the proposed lease standard:
    a. Existing operating leases are grandfathered but capital leases are not
    b. Existing capital leases are grandfathered but operating leases are not
    c. The proposed standard does not grandfather any existing leases
    d. Existing leases are phased into the new standard over a four-year period

37. Under the proposed lease standard, which of the following is true:
    a. Lease terms are likely to shorten to decrease the amount of the lease obligation
    b. Lease terms are likely to get longer to reduce the amount of the lease obligation
    c. Lease terms are likely to shorten to increase the amount of the lease asset recorded
    d. Lease terms are likely to get longer to reduce the amount of the lease asset recorded

38. The proposed lease standard would likely result in which of the following occurring for existing operating leases:
    a. Total lease expense for tax purposes would be greater than total GAAP expense
    b. Total GAAP expense would be greater than lease expense for tax purposes
    c. GAAP and tax expense would be identical
    d. There would be no change in the total expense for GAAP or tax purposes from current practice

39. Under the proposed lease standard _____.
    a. Deferred tax assets would likely be created
    b. Deferred tax assets would likely be reduced
    c. Deferred tax liabilities would likely be created
    d. Deferred tax liabilities would likely be reduced

40. One potential impact from the proposed lease standard for Type A leases would be that EBITDA would have a/an _____.
    a. Favorable impact because interest would decrease while rental expense would increase
    b. Unfavorable impact because depreciation would increase while rental expense would decrease
    c. Favorable impact because interest and amortization expense would increase while rental expense would decrease
    d. Unfavorable impact because interest, depreciation and rental expense would all increase

41. One potential impact from the proposed lease standard would be that the debt-equity ratio would be _____.
    a. Higher
    b. Lower
    c. The same
    d. Either higher or lower depending on several factors

42. With respect to the FASB ASC, under which area would one find the Topic 808, *Collaborative Arrangements*:
    a. Presentation
    b. Industry
    c. General Principles
    d. Broad Transactions

43. Which of the following is not one of the areas within the general structure of the ASC:
    a. General principles
    b. Presentation
    c. Disclosure
    d. Industry

44. Which of the following is the system used for the FASB ASC in presenting a Topic, Subtopic and Section:
    a. XXX-YY-ZZ
    b. XX-YYY-Z
    c. X-Y-Z
    d. XXX-YYY-ZZZ

45. After the effective date of the FASB ASC, all updates are achieved _____.
    a. By directly amending the ASC on an annual basis
    b. By issuing Accounting Standards Updates (ASUs)
    c. Through issuing EITF Consensus opinions
    d. By issuing FASB Staff Positions (FSPs)

46. With respect to the Big-GAAP, Little-GAAP issue, accountants and their clients have defaulted to several techniques to avoid the burdensome task of having to comply with recently issued difficult and irrelevant accounting standards. Such techniques include all of the following *except*:
    a. Ignore the new GAAP standards
    b. Include a GAAP exception in the accountant's/auditor's report
    c. Issue OCBOA (income tax basis financial statements)
    d. Issue standard GAAP statements

47. If a company uses the AICPA's FRF for SMEs, that company may have a challenge in its use which may be that this framework _____.
    a. Is too complex to follow
    b. Is nonauthoritative
    c. Lack core disclosures required by third parties
    d. Is too costly to implement

48. Which of the following is a key difference between IFRS for SMEs and IFRS:
    a. IFRS for SMEs is more complex than full IFRS
    b. IFRS for SMEs has simpler reporting needs
    c. IFRS for SMEs applies to large companies while IFRS applies to small to medium-sized companies
    d. IFRS for SMEs has more disclosures than IFRS

49. Which of the following is an example of an attribute found in the IFRS for SMEs:
    a. Topics that are not relevant to larger, public companies, have been omitted
    b. Revisions to the IFRS for SMEs are limited to once every decade
    c. There are thousands of pages in the IFRS for SMEs
    d. IFRS for SMEs is organized by topic within 35 sections

50. Which of the following is true as it relates to U.S. companies and their use of IFRS for SMEs:
    a. U.S. private companies are not yet permitted to adopt IFRS for SMEs
    b. U.S. private companies are required to adopt IFRS for SMEs
    c. U.S. public companies may adopt IFRS for SMEs
    d. U.S. private companies are permitted to adopt IFRS for SMEs

51. In accordance with the FASB's ASU 2014-15 related to going concern, management's evaluation of going concern runs for what period of time:
    a. One year
    b. Six months
    c. A reasonable period of time that is no quantified
    d. Eighteen months

52. Under GAAP, a disclosure is required if, among other requirements, a concentration makes the entity vulnerable to the risk of _____.
    a. A short-term negative impact
    b. A near-term severe impact
    c. A long-term disruptive impact
    d. A prospective loss

53. Company X has various concentrations in its business. X wants to know which concentrations might require disclosure. Under ASC 275, which of the following is *not* likely to be a type of concentration to which a disclosure might be required:
    a. Concentration of trucks
    b. Concentration in the volume with a particular customer
    c. Concentration in the available sources of materials
    d. Concentration in available labor

54. Under Section 953 of the Dodd-Frank Act, which of the following must be disclosed by public companies:
    a. The annual total compensation of the CEO or equivalent position
    b. Whether a company's compensation committee retained or obtained the advice of a compensation consultant
    c. Asset-level or loan-level data, including data having unique identifiers relating to loan brokers or originators
    d. Whether any employee or member of the board of directors is permitted to purchase financial instruments that are designed to hedge or offset any decrease in the market value of equity securities

55. Which of the following is an area in which the SEC is focused to address missing disclosures:
    a. Depreciation and amortization lives
    b. Revenue recognition
    c. Cost capitalization for plant and equipment
    d. Accruals and prepaid items

56. Company X is determining whether it requires a valuation account for its unused NOL. X should be concerned that a valuation account is needed if it is _____ that X will not have enough future taxable income during the NOL carryforward period to utilize the unused NOL.
    a. Probable
    b. More likely than not
    c. Reasonably possible
    d. Highly probable

57. At December 31, 20X4, Company Y has a deferred tax asset due to an unused NOL carryforward. Y has had cumulative losses in years 20X2, 20X3 and 20X4. There are no deferred income tax liabilities at December 31, 20X4. In assessing whether the company will have sufficient future taxable income to absorb the deferred tax asset, how should the three years of cumulative losses be considered:
    a. The losses should be considered strong negative evidence in making the assessment
    b. The losses should be disregarded in making the assessment
    c. The losses are only a small factor to be considered in making the assessment
    d. There must be at least five years of cumulative losses to be considered in making the assessment

58. In estimating future taxable income that will absorb deferred tax assets, such estimated future taxable income _____.
    a. Should exclude any taxable income from reversal of existing deferred income tax liabilities
    b. Should include all estimated future taxable income that will be generated during the carryforward period
    c. Should be limited to income estimated over the first five years in the carryforward period
    d. Should include taxable income from reversal of existing deferred income tax assets

59. Company X is a nonpublic entity that has no uncertain tax positions liability. Which of the following is correct:
    a. X must disclose the number of tax years open for tax examination
    b. X must include an abbreviated disclosure of the number of tax years open for examination
    c. The exclusion of the disclosure only applies if X is SEC registered and not a nonpublic entity
    d. X is not required to disclose the number of tax years open for examination

60. In considering whether to accept a client who grows and sells marijuana, which of the following is true:
    a. Most marijuana businesses have to work on a literal cash basis
    b. Credit card companies now accept payments for the purchases of marijuana
    c. Security is no longer an issue because banks will accept deposits from marijuana businesses
    d. Marijuana businesses are permitted to make payroll tax deposits by check instead of cash

61. Common criticisms of the statement of cash flows include all of the following *except*:
    a. Investors are unable to understand the completeness of transactions including non-cash transactions that are not included on the statement
    b. Investors do not understand the indirect method of presenting cash flows from operating activities
    c. Users are confused about classifications of items on the statement of cash flows among operating, investing and financing activities
    d. Users understand the indirect method but are most confused about the direct method

62. In general, which of the following methods do most companies use to display operating cash flows in the statement of cash flows:
    a. Indirect method
    b. Direct method
    c. Both the indirect and direct method using comparative side-by-side statement presentations
    d. There is no evidence to support that there is no preference for either method

63. How does the author recommend presenting the increase in cash value of life insurance on the statement of cash flows:
    a. In the operating activities section
    b. In the investing activities section
    c. As a split item within the investing and financing activities sections
    d. In the financing activities section

64. ASC 230 (formerly FASB No. 95) requires that all of the following be disclosed within the notes to financial statements or elsewhere, *except*:
    a. Cash equivalents policy
    b. Interest and income taxes paid
    c. Non-cash investing and financing activities
    d. Reconciliation of interest paid to interest expense

65. A company purchases real estate in the amount of $400,000 by borrowing $400,000 from the seller at closing. How should this transaction be accounted for on the statement of cash flows:
    a. Disclose as a non-cash investing and financing transaction
    b. Show as two items: as an outflow in investing activities and as an inflow in the financial activities section
    c. Show as a split with a recording in the financing activities section and a related disclosure as a non-cash transaction
    d. Show as an inflow in operating activities and outflow in financing activities

66. ASC 230 (formerly FASB No. 95) requires that transactions be presented gross instead of net. There is an exception whereby certain transactions may be presented net if three criteria are met that include all of the following *except*:
    a. Amounts turnover quickly
    b. Amounts are large
    c. Items liquidate within two years
    d. Maturities are short

67. Insurance settlement proceeds, other than those related to the destruction of or damage to a building or equipment, are included in _____ in the statement of cash flows:
    a. Operating activities
    b. Investing activities
    c. Financial activities
    d. Split between operating and investing activities depending on the underlying basis of the damaged property

68. Common approaches that companies use to legitimately manipulate cash from operating activities include all of the following <u>except</u>:
    a. Vendor financing and extended payment terms
    b. Use of cash overdrafts
    c. Shift the securities classification
    d. Sales of equipment

69. How should the change in vendor financing due to repaying the debt be treated in the statement of cash flows:
    a. As a reduction in financing activities
    b. As a reduction in operating activities
    c. Disclosed only
    d. As a reduction in investing activities

70. Facts: Company Y purchases the net assets of another company consisting of accounts receivable, inventories, fixed assets, goodwill, and assumption of accounts payable. The net price is $1,000,000 and paid for in cash. How should this transaction be presented on the statement of cash flows:
    a. Each individual asset and liability will be presented as a separate line item in the operating, investing or financing activities section of the statement of cash flows
    b. The net price of $1,000,000 is presented as a single line item in the investing activities section of the statement of cash flows
    c. The total assets are aggregated and presented as a single line item in the investing activities while the total liabilities are aggregated and presented as a single line item in the financial activities section
    d. The entire transaction is disclosed only and not presented on the statement of cash flows

71. Facts: Company X has a collection of a customer note receivable from a customer in the amount of $100,000. How should this change be presented in the statement of cash flows under ASC 230:
    a. As an inflow in operating activities
    b. As an inflow in investing activities
    c. As an inflow in financing activities
    d. Disclosed only

72. Which of the following flows is sustainable:
    a. Working capital flow
    b. Changes in working capital components
    c. Cash from operations
    d. By definition, no flow is sustainable

73. Company X has signed a contract and obtains access to software in a hosting arrangement. In accordance with ASU 2015-05, which of the following is one of the criteria that must be met in order for X to treat it as internal-use software:
    a. X is not permitted to run the software on its own hardware
    b. X has the contractual right to take possession of the software without significant penalty
    c. X is permitted to take possession of the software by paying a significant penalty
    d. X is not permitted to have another party unrelated to the vendor to host the software

74. Company X is a private company who is acquiring the net assets of Company Y. If X elects to use the accounting alternative under ASU 2014-18, which of the following is true:
    a. X should allocate a portion of acquisition cost to all customer-related intangible assets
    b. X should recognize all intangible assets separately from goodwill
    c. X should no longer recognize customer-related intangible assets from goodwill, unless those assets are capable of being sold or licensed independently
    d. X should not recognize a separate value for goodwill

75. Company X (acquiree) is being acquired by Company Y (the acquirer). X and Y are both non-public entities. X wants to use pushdown accounting. When can X use pushdown accounting.
    a. When Y (the acquirer) obtains control of X (the acquiree)
    b. When Y (the acquirer) obtains 100% ownership in X
    c. At any time regardless of whether an acquisition is consummated
    d. Never. Pushdown accounting cannot be used by a non-SEC company.

76. In order for a private company to elect the accounting alternative under ASU 2014-07 with respect to the consolidation of VIE rules, the private company lessee and the lessor entity ___:
    a. Must be in the same industry
    b. Must have a formal lease between them
    c. Must have a parent-subsidiary relationship
    d. Must be under common control

77. Company Y is a nonpublic (private) company with goodwill. Over what life may Y amortize its goodwill under ASU 2014-02:
    a. 10 years straight line
    b. Goodwill may not be amortized
    c. 15 years straight line
    d. 40 years straight line or accelerated

78. ASU 2013-07 requires that which of the following statements be prepared for an entity using the liquidation basis of accounting:
    a. Statement of net assets in liquidation
    b. Statement of income
    c. Balance sheet
    d. Statement of changes in cash flow

79. Under ASU 2013-04, obligations resulting from joint and several liability arrangements includes an additional amount the reporting entity _____ on behalf of its co-obligors.
   a. May have to pay
   b. Expects to pay
   c. Could have to pay
   d. Will likely have to pay

80. Company X is a non-public entity with no financial instruments recorded at fair value. X's total assets are less than $100 million and X has no derivatives. Which of the following is true:
   a. X must disclose fair value information for all financial instruments even if not recorded at fair value
   b. X is not required to include any fair value disclosures
   c. X is exempt from fair value disclosures only as they relate to receivables and payables
   d. X must follow the same fair value disclosure rules that public companies must follow, without exception