Changes You Need to Know – The 2016 FASB Review

9 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.

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2016 FASB REVIEW

The purpose of this course is to inform the reader of the various changes affecting accounting and financial reporting, as well as a review and recall of existing accounting standards. Topics include a summary of newly issued FASB statements, current and pending developments, practice issues, and more.

After reading the Chapter 1, course material, you will be able to:

- Identify the measurement basis used to measure FIFO and LIFO inventories under ASU 2015-11
- Recognize how to account for a recovery of an inventory writedowns in subsequent periods
- Recall the method to be used to implement ASU 2015-11 for inventory

After reading the Chapter 2, you will be able to:

- Recall how to present a deferred tax asset on a balance sheet under ASU 2015-17
- Recognize how to present deferred tax assets and liabilities on an unclassified balance sheet per ASU 2015-17
- Identify the actions an entity should take to adopt ASU 2015-17 with respect to its deferred tax assets and liabilities

After reading the Chapter 3, you will be able to:

- Recognize a key aspect of a variable interest entity (VIE)
- Recall situations in which use of combined statements is useful and not useful
- Identify when a limited partner has a controlling financial interest in a limited partnership under the voting interest model per ASU 2015-02
- Recognize a key change to the consolidation model made by ASU 2015-02 with respect to a general partner of a limited partnership.
- Identify some of the rights a noncontrolling limited partner might have in a limited partnership

After reading the Chapter 4, you will be able to:

- Recognize at least one reason why companies are motivated to shift losses from continuing operations to discontinued operations
- Identify at least one reason why the existing definition of discontinued operations is criticized

- Recognize some of the criteria that must be met for a disposal to qualify as discontinued operations under ASU 2014-08
- Identify how discontinued operations should be presented on the income statement and balance sheet under the ASU 2014-08 rules
- Recognize a change made to the extraordinary item rules by ASU 2015-01

After reading the Chapter 5, you will be able to:

- Recognize some of the types of entities that are permitted to elect the accounting alternative for identifiable intangible assets under ASU 2014-18
- Identify how to apply the accounting alternative for goodwill amortization when electing the accounting alternative for identifiable intangibles in ASU 2014-18
- Recognize at least one criterion for an identifiable intangible asset
- Recall an example of a customer-related intangible asset

After reading the Chapter 6, you will be able to:

- Recognize the date on which an entity may elect to use pushdown accounting
- Identify an element that an acquire should recognize in its separate financial statement
- Identify an advantage to using pushdown accounting

Field of study:	Accounting
Level of knowledge:	Overview
Prerequisite:	Basic understanding of U.S. GAAP
Advanced Preparation:	None
Recommended CPE hours:	9
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

Table of Contents

Chapter 1: ASU 2015-11: Inventory (Topic 330)

Simplifying the Measurement of Inventory

Issued: July 2015

Effective date: ASU 2015-11 is effective as follows:

For public entities: the amendments in the ASU are effective for fiscal years *beginning after December 15, 2016*, and interim periods within those annual periods.

All other entities: (nonpublic entities): the amendments in the ASU are effective for fiscal years *beginning after December 15, 2016*, and interim periods within fiscal years beginning after December 15, 2017.

The ASU should be applied prospectively with earlier application permitted as of the beginning of an interim or annual reporting period.

I. Objective

The objective of ASU 2015-11 is to simplify the measurement of inventory as part of the FASB's *Simplification Initiative.*

The objective of the Simplification Initiative is to identify, evaluate, and improve areas of U.S. 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 FASB received comments from users that the current guidance on the measurement of inventory is unnecessarily complex because there are *three potential outcomes* to determine market.

ASC 330, *Inventory*, currently requires an entity to measure inventory at the lower of cost or market. Market could be any one of three outcomes: replacement cost, net realizable value, or net realizable value less normal profit margin.

II. Background

The FASB issued ASU 2015-11 as part of its *Simplification Initiative*.

Current, ASC 330, *Inventory*, requires an entity to measure inventory at the lower of cost or market.

Market is defined as *replacement cost*, subject to a range.

The upper amount of the range (ceiling) is net realizable value (selling price less costs to dispose (sell) , transportation, and complete).

The floor is net realizable value less the normal profit margin.

Replacement cost is market subject to a ceiling and floor computed as follows:

Selling price	$XX
Costs of completion, disposal and transportation	(XX)
NET REALIZABLE VALUE- MARKET CEILING	XX
Normal profit margin	(XX)
MARKET FLOOR	$XX

In computing market, replacement cost is compared to the range. If replacement cost is within the ceiling and floor range, replacement cost is considered market and compared with cost to determine lower of cost or market. If replacement cost is greater than the ceiling, the ceiling is the market. If replacement cost is lower than the floor, the floor is the market.

Assume the following fact pattern:

	Item 1	**Item 2**
Cost (A):	**$40**	**$60**
Replacement cost	50	70
Ceiling (given) (1)	55	55
Floor (given) (2)	45	45
Market: (B):		
Replacement cost	**$50**	
Ceiling		**$55**
Lower of cost or market (lower of (A) or (B))	**$40**	**$55**

(1) Ceiling: Selling price less costs to dispose (sell) , transport and complete.
(2) Floor: Ceiling less normal profit

The previous example illustrates the complexity of the current model.

Market can be any *one of three outcomes*:

- Replacement cost
- Net realizable value (ceiling)
- Net realizable value less normal profit (floor)

The FASB heard from third-party users that the current guidance on the measurement of inventory is unnecessarily complex because there are *three potential outcomes*.

Therefore, the FASB decided to eliminate the possibility of three outcomes by replacing the concept of "market" with "net realizable value."

The FASB decided to simplify the model to reduce costs and increase comparability for inventory measured at FIFO or average cost. The FASB chose to *exclude from the new rules* inventory measured using LIFO or the retail inventory method.

Thus, for FIFO and average cost inventory, cost is compared with net realizable value instead of market (lower of cost and net realizable value approach). For LIFO and average cost, the existing lower of cost or market approach is retained.

A summary of the key provisions of the ASU follows:

1. The ASU applies to all inventory valuation methods *other than* LIFO and retail inventory method.

2. The ASU makes *no changes* to inventory measured using LIFO or the retail inventory method.

3. An entity should measure inventory measured on FIFO or average cost at the *lower of cost and net realizable value*.[1]

[1] ASU 2015-11 uses the term "lower of cost and net realizable value, instead of lower of cost or net realizable value. The author believes the term "or" should be used but has retained "and" in this chapter consistent with the language in ASU 2015-11. Interestingly, GAAP has used the term "lower of cost or market" and not "lower of cost and market."

Note: For FIFO and average cost inventory, use of replacement cost, with a ceiling and floor, is eliminated, and replaced with one outcome which is net realizable value.

4. Lower of cost or market is no longer used for FIFO or average cost.

5. Net realizable value (NRV) is defined as estimated selling prices less costs of completion, disposal and transportation.

The amendments in the ASU make U.S. inventory valuations more closely aligned with the measurement of inventory in International Financial Reporting Standards (IFRS).

Other than the change in the measurement guidance from the lower of cost or market to the lower of cost and net realizable value for inventory within the scope of the ASU, there are no other substantive changes made by the ASU to the measurement of inventory.

III. Scope

1. The changes made by ASU 2015-11 apply to inventory valued at all methods *other than* last-in, first-out (LIFO) and retail inventory method.

   a. The result is that the ASU applies primarily to inventory valued at FIFO or average cost.

   b. The changes do not apply to inventory valued using last-in, first-out (LIFO) and retail inventory method.

IV. Definitions

The following definitions are found in the Master Glossary in ASC 330, *Inventory*.

Direct Effects of a Change in Accounting Principle: Those recognized changes in assets or liabilities necessary to effect a change in accounting principle. An example of a direct effect is an adjustment to an inventory balance to effect a change in inventory valuation method. Related changes, such as an effect on deferred income tax assets or liabilities or an impairment adjustment resulting from applying the subsequent measurement guidance in Subtopic 330-10 to the adjusted inventory balance, are also examples of direct effects of a change in accounting principle.

Net Realizable Value: Estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation.

V. Rules

1. The method used for the subsequent measurement of inventory depends on the cost method and is different for the following:

   a. Inventory measured using any method *other than* last-in, first-out (LIFO) or the retail inventory method (example: FIFO or average cost)

   b. Inventory measured using LIFO or the retail inventory method

2. The method used for the subsequent measurement of inventory depends on the cost method and is different for the following:

Inventory measured using any method other than LIFO or the retail inventory method (example: FIFO or average cost):

a. Inventory measured using any method other than LIFO or the retail inventory method shall be measured at the *lower of cost and net realizable value*.

Net realizable value:	
Estimated selling prices in the ordinary course of business	$XX
Less reasonably predicable costs of completion, disposal (sale), and transportation	XX
= NET REALIZABLE VALUE	$XX

b. When evidence exists that the net realizable value of inventory is lower than its cost, the difference shall be recognized as a *loss in earnings* in the period in which it occurs.

- Any such loss may be required, for example, due to damage, physical deterioration, obsolescence, changes in price levels, or other causes.

Inventory measured using LIFO or the retail inventory method:

a. Inventory measured using LIFO or the retail inventory method shall continue to be measured at the *lower of cost or market.*

- Market continues to be determined based on replacement cost, limited to a ceiling and a floor.

Ceiling: Net realizable value
Floor: Net realizable value reduced by normal profit margin

- A departure from the cost basis of pricing inventory measured using LIFO or the retail inventory method is required when the utility of the goods is no longer as great as their cost.

- Where there is evidence that the utility of goods, in their disposal in the ordinary course of business, will be less than cost, (whether due to damage, physical deterioration, obsolescence, changes in price levels, or other causes), the difference shall be recognized as a *loss in earnings* of the current period. This is generally accomplished by stating such goods at a lower level commonly designated as *market***.**

3. The ASU does not make any changes to the way in which cost is determined, such as FIFO, LIFO and average cost.

4. Subsequent measurement guidance applicable to all inventory:

   a. If inventory has been the hedged item in a fair value hedge, the inventory's cost basis for purposes of subsequent measurement shall reflect the effect of the adjustments of its carrying amount made in accordance with ASC 815-25-35-1(b).

      Note: ASC 815-25-35-1(b) states that the gain or loss (based on the change in fair value) on a hedge item attributable to the hedged risk shall adjust the carrying amount of the hedged and is recognized currently in earnings.

5. Once written down to either lower of cost and net realizable value or lower of cost or market, the written down amount becomes the new cost:

   a. The write-down cannot be reversed under U.S. GAAP.

   b. IFRS permits the write-down to be reversed up the original cost.

6. Depending on the character and composition of the inventory, the inventory measurement (lower of cost and net realizable value or lower of cost or market) may properly be applied in either of the following *three approaches* based on which one most clearly reflects periodic income:

   - Directly to each individual item
   - To the total inventory, or,
   - To the total of the components of each major category.

a. The ASU provides guidance on determining how to apply the lower of cost and net realizable value or lower of cost or market test:

Note: The purpose of reducing the carrying amount of inventory is to reflect fairly the income of the period. The most common practice is to apply the applicable subsequent measurement guidance separately to each item of the inventory. However, if there is only one end-product category, the application of the applicable subsequent measurement guidance to inventory in its entirety may have the greatest significance for accounting purposes.

Similarly, where more than one major product or operational category exists, the application of the applicable subsequent measurement guidance to the total of the items included in such major categories may result in the most useful determination of income.

Note further that the Internal Revenue Code requires that the lower of cost or market test must be performed on an individual-item basis and not for the inventory as a whole.

6. Market decline in interim period

a. If near-term price recovery is uncertain, a decline in the market value (for inventory measured using LIFO or the retail inventory method) or net realizable value (for all other inventory) of inventory below cost during an interim period shall be accounted for consistent with annual periods.

Examples**:**

ASU 2015-11 provides that the lower of cost and net realizable value may be applied at either:

- Directly to each individual item
- To the total inventory, or,
- To the total of the components of each major category.

Following are examples of the application of ASU 2015-11.

Example 1: Lower of Cost or Net Realizable Value – Distributor

Company X is a distributor of wholesale products which are complete and ready to sell.

The selling prices of certain items within its inventory have declined due to competition.

Costs to dispose (sell) and transportation are as follows, as a percentage of gross sales:

Commissions	8%
Freight out	4%
Sales discounts and allowances	3%
	15%

The company had no write-down of inventory in the prior year, 2016.

At December 31, 2017, inventory information for its five products (A, B, C, D and E) follows:

Product	**A**	**B**	**C**	**D**	**E**
Cost- FIFO	$110	$155	$165	$140	$70
NRV:					
Estimated selling price	$140	160	180	120	100
Cost to dispose and transportation (15%)	(21)	(24)	(27)	(18)	(15)
Net realizable value	$119	$136	$153	$102	$85

Computation of Lower of Cost and Net Realizable Value
December 31, 2017

Item	**Quantity (given) (a)**	**Unit cost (b)**	**NRV (c)**	**Total cost (a) x (b)**	**Total at NRV (a) x (c)**	**Lower of cost and NRV**
A	1,000	$110	$119	$110,000	$119,000	$110,000
B	2,000	155	136	310,000	272,000	272,000
C	3,000	165	153	495,000	459,000	459,000
D	4,000	140	102	560,000	408,000	408,000
E	2,000	70	85	140,000	170,000	140,000
				$1,615,000	$1,428,000	$1,389,000

If X computes lower of cost and net realizable value on an individual-item basis, the write-down is as follows:

Inventory at cost	$1,615,000
Inventory at NRV	1,389,000
Write-down	$(226,000)

Entry at December 31, 2017:

	dr	cr
Cost of goods sold- inventory write-down	226,000	
Allowance for inventory write-down		226,000[2]

If X computes lower of cost and net realizable value based on the total inventory, the write-down is as follows:

Inventory at cost	$1,615,000
Inventory at NRV	1,428,000
Write-down	$(187,000)

Entry at December 31, 2017:

	dr	cr
Cost of goods sold- inventory write-down	187,000	
Allowance for inventory write-down		187,000

How should a manufacturer apply ASU 2015-11?

A manufacturer has a challenge in applying the ASU if that entity uses FIFO or average cost to value its inventory.

Because the computation is based on the lower of cost and net realizable value, the only way to perform the test is to do so in total for the entire inventory, either by segment or in total.

Performing a lower of cost and net realizable value on an individual-item basis is not possible if there are raw materials. The prime reason is because replacement cost is no longer used in the computation. Thus, an entity must compute net realizable value. Because raw materials become part of finished goods, net realizable value must be computed based on the final finished goods product, and cannot be performed on raw materials, by itself.

Consider the following:

Example 2: Lower of Cost and Net Realizable Value – Manufacturer

Company X is a manufacturer which has the following inventory at December 31, 2017:

Raw materials (RM)	$5,000,000
Work in process (WIP)	1,000,000
Finished goods (FG)	4,000,000

[2] Alternatively, the entry could be made as a credit directly to inventory and avoid use of an allowance account.

	$10,000,000

Costs to dispose (sell) and transportation are as follows, as a percentage of gross sales:

Commissions	8%
Freight out	4%
Sales discounts and allowances	3%
	15%

Costs of completion are as follows:

- Direct labor to convert WIP inventory to FG inventory: $200,000.
- Direct labor to convert RM to FG inventory: 80% of materials cost.
- Fixed and variable overhead: Allocated based on 50% of materials and labor in finished goods inventory.

Conclusion:

X's computation of lower of cost and net realizable value is as follows:

Estimated sales of all inventory upon conversion to finished goods (given)		$22,000,000
Costs to dispose (sell) and transportation (15% x $22,000,000)		(3,300,000)
Costs to complete: Conversion of RM and WIP to FG:		
Direct labor to convert WIP to FG (a)	200,000	
Direct labor to convert RM to FG (b)	4,000,000	
Fixed overhead – to convert RM and WIP to finished goods (c)	5,100,000	
Total costs to convert RM and WIP to FG		(9,300,000)
Net realizable value (NRV)		$9,400,000
Inventory at cost		$10,000,000
Lower of cost and net realizable value		**$9,400,000**

(a): Additional labor required to complete the WIP inventory to finished goods is $200,000.
(b): Information given is that direct labor in the finished product is 80% of materials cost:
RM cost $5,000,000 x 80% = $4,000,000.
(c): Fixed and variable overhead is 50% of direct labor and materials in finished goods inventory.
Fixed and variable overhead is allocated to RM and WIP upon completion as finished goods:
RM cost $5,000,000 + direct labor $4,000,000 = $9,000,000 x 50% = $4,500,000
WIP: $1,000,000 + direct labor $200,000 = $1,200,000 x 50% = $600,000
Total fixed overhead to complete inventory: $4,500,000 + $600,000 = $5,100,000.

The entry to adjust the inventory to the lower of cost and net realizable value is as follows:

Inventory at cost	$10,000,000
Inventory at NRV	9,400,000
Write-down	$(600,000)

Entry at December 31, 2017:

	dr	cr
Cost of goods sold- inventory write-down	600,000	
Allowance for inventory write-down		600,000

Can a manufacturer ignore the test of lower of cost and net realizable value on raw materials if those materials are immaterial?

As previously show in Example 2, a manufacturer must test lower of cost and net realizable value in the aggregate for all inventory, including raw materials. The reason is because the test must be based on net realizable value and no longer involves use of replacement cost.

When raw materials inventory exists, that inventory must be included in an overall test that includes finished goods and work-in-process inventory. That test is performed by working backwards from final estimated sales at the finished goods level, reduced by costs to complete, dispose (sell) and transportation, to arrive at net realizable value.

Although it is relatively easy to compute net realizable value if only finished goods and work-in-process inventory exists, it is far more difficult for raw materials inventory

The question is whether an entity must consider lower of cost and net realizable value with respect to raw materials inventory if that inventory is not material to the overall inventory?

There may be instances in which a test of raw materials for lower of cost or net realizable value may not be required when those materials will be ultimately part of finished goods inventory.

Two examples follow:

1. Materials cost is not significant to the total product and/or not significant in comparison to the inventory as a whole, or

2. Evidence indicates that there is no write-down of work in process and finished goods inventory to lower of cost and net realizable value.

If raw materials inventory is *not a significant* component of the ending finished goods product, an entity should be able to test lower of cost and net realizable value for finished goods and work-in-process inventory only, and exclude any raw material inventory in that test. The assumption is that if raw materials inventory is not significant, any possible write-down would not be significant.

But what if raw materials inventory is significant?

ASC 330-10-35-10 provides some limited guidance:

> *When no loss of income is expected to take place as a result of a reduction of cost prices of certain goods because others forming components of the same general categories of finished products have a market value (for inventory measured using LIFO or the retail inventory method) or net realizable value (for all other inventory) equally in excess of cost, such components need not be adjusted ….”*

Although the above citation is not precisely on point with raw materials inventory, the substance of the message is essentially the same.

If raw material inventory is a significant component of finished goods and work in process inventory, it would appear that an entity could avoid testing that raw material inventory as part of an overall lower of cost and net realizable value *if evidence exists that the finished goods and work-in-process inventory has no write-down when tested*.

After all, the raw materials inventory ultimately becomes part of the work in process and finished goods inventory. If an entity first tests work in process and finished goods inventory for lower of cost and net realizable value and there is no write-down, that would suggest that a component of that inventory (materials cost) should have no impairment, as well.

Observation: Example 2 demonstrates a test of lower of cost and net realizable value for a manufacturer. In looking at that test, extensive work is required to gather information when raw materials inventory exists and is included in the test. For example, costs to complete the raw materials inventory (e.g., convert the raw materials to finished goods inventory) must be calculated. Those costs to complete include direct labor and fixed and variable overhead. Eliminating raw materials inventory from that test altogether saves considerable time. The author believes that with respect to a manufacturer, an entity should do the following:

a. First perform a test of lower of cost and net realizable value on finished goods and work-in-process inventory, without raw materials inventory.

b. If the test in (a) shows no write-down of finished goods and work-in-process inventory, there should be no need to include raw materials inventory in the lower of cost and net realizable value test.

The theory behind this approach is that raw materials inventory ultimately becomes part of work- in-process and finished goods inventory. If there is no indication of an impairment of work-in-process and finished goods inventory (e.g., cost exceeds net realizable value), that should indicate that the raw materials component also has no impairment.

How do the changes in ASU 2015-11 impact the IRS rules for lower of cost or market?

IRC § 1.471-4 *Inventories at Cost or Market, whichever is Lower*, permits, but does not require, an entity to use lower of cost or market for its inventory valuation. Lower of cost or market is not permitted for LIFO inventory valuations, but is permitted for all other methods such as FIFO, average cost, etc.

In comparing the new ASU 2015-11 to the Internal Revenue Code, there are a few key variations:

a. ASU 2015-11 now uses lower of cost and net realizable value, while the IRC continues to use lower of cost or market.

b. The IRC requires its lower of cost or market test be performed on an *individual-item basis*, and not for the inventory in total.

In particular, IRC 471.4 defines market as:

> "the aggregate of the *current bid prices* prevailing at the date of the inventory…"

In applying the lower of cost or market method, the IRS regulations require that an entity:

> "compare the market value of *each item on hand* on the inventory date with its cost and use the lower value as its inventory value…"

Therefore, with the changes made by ASU 2015-11, there are certainly differences in the way in which lower of cost and net realizable value (for GAAP) and lower of cost or market (for tax purposes) are computed, thereby likely to result in a book-tax difference, if material.

Why didn't the FASB apply lower of cost and net realizable value to LIFO and retail method?

As previously noted, the FASB decided to exclude from the ASU's scope, inventory measured using LIFO or the retail inventory method. Therefore, the subsequent measurement guidance is unchanged for inventory measured using LIFO or the retail inventory method. Those inventory methods continue to use the lower of cost or market approach.

All other inventory (primarily FIFO and average cost) is measured at ASU 2015-11's lower of cost and net realizable value.

The question is why didn't the FASB extend the lower of cost and net realizable value measurement to LIFO and retail methods.

The FASB notes that some third-party users had concerns about applying the ASU to LIFO and retail method for the following reasons:

1. The amendments would result in potentially significant costs, particularly upon transition, and would not simplify the subsequent measurement of inventory nor result in significantly more useful information for users of financial statements.

2. The amendments also might not simplify the accounting for those entities because of the inherent complexities involved in estimating cost under LIFO and the retail inventory method and the related complexities involved in estimating impairment.

3. Under existing GAAP, inventory is not comparable across entities that use different inventory methods. Therefore, the FASB concluded that making subsequent measurement consistent across all methods would not improve comparability in any meaningful way.

4. Some respondents did not want to eliminate the current use of replacement cost in LIFO inventory valuations because they thought it was useful.

5. Under the ASU, at the beginning of the year of adoption of the ASU, any previous write-downs from lower of cost or market are treated as part of the inventory cost. That means that if the new ASU rules were applied to LIFO, any previous write-downs would have to be allocated to LIFO layers to create the opening cost in the year the ASU is implemented. Such an allocation would add complexity to the LIFO valuation.

6. Eliminating use of the existing floor (net realizable value less normal profit) would remove an existing practice used to value some retail inventories.

   Note: Under some approaches to applying the retail inventory method, the cost of inventory is estimated by multiplying the retail price of inventory by a margin that excludes the effect of permanent markdowns, which is similar to valuing inventory using net realizable value less normal profit margin (commonly referred to as the "floor" in practice). The floor is one of the measures that is eliminated by the ASU. Some users were concerned that this approach to applying the retail inventory method would no longer be permitted.

   The changes FASB originally proposed for inventory accounting applied to all companies, regardless of how they measured inventory. However, some large retailers, including Target and Wal-Mart, complained that the proposal didn't take into account the nuances of calculating inventory under the last-in, first-out (LIFO) or retail inventory methods. Thus, the FASB decided to exclude LIFO and the retail inventory methods from the scope of ASU 2015-11.

Does ASU 2015-11 actually achieve its objective of simplifying the measurement of inventory?

There are questions as to whether the ASU will actually simplify the existing lower of cost or market model for inventory.

On the positive side, advocates for the ASU's changes suggest the following:

a. For FIFO and average cost inventory, the ASU does in fact eliminate the three-outcome approach to determine market: replacement cost, net realizable value (ceiling) and net realizable value less normal profit (floor).

b. The new model avoids having to determine a floor based on a normal profit margin.

c. The new model simplifies the test for a non-manufacturer who now only has to compute net realizable value instead of a replacement cost and normal profit.

Critics suggest the following:

a. The ASU fails to change the model for LIFO and retail method inventory thereby providing two different approaches: one for FIFO and average cost, while another for LIFO and retail method.

b. The split approach is not consistent with international standards which apply the net realizable value approach to all inventory.

c. The model relies on net realizable value, which is based on sales in the normal course of business. There may be products that do not have active markets that require unreliable estimates of sales.

d. The new model places great reliance on selling price which is subject to internal manipulation and subjectivity, particularly if an item is sold within an inactive market.

VI. Disclosures

ASU 2015-11 and ASC 330 requires the following disclosures among others:

1. Any losses from measuring inventory at lower of cost and net realizable value (for FIFO or average cost) or lower of cost or market (for LIFO and retail methods) should be disclosed in the financial statements.

2. An entity is required to disclose the nature of and reason for the change in accounting principle in the first interim and annual period of adoption of ASU 2015-11.

3. An entity should continue to disclose the inventory valuation method (FIFO, etc.) in its summary of significant accounting policies.

Examples of disclosures:

- Assume an entity adopts the ASU for calendar year 2017.
- The company uses the lower of cost and net realizable value which results in a write-down in the amount of $100,000.
- There was no write-down in 2016.

2017 disclosures:

Note X: Inventory
Effective in 2017, the Company adopted Accounting Standards Update (ASU) 2015-11, *Inventory (Topic 330)-Simplifying the Measurement of Inventory* to simplify the measurement of its inventory. In accordance with ASU 2015-11, the Company is required to measure its inventory at the *lower of cost and net realizable value*. The December 31, 2016 inventory was measured at the lower of cost or market and has not been remeasured to reflect the change made by ASU 2015-11. (2)

Note XX: Summary of Significant Accounting Policies:

Inventory:
For the year 2017, the Company values its inventories at *lower of cost and net realizable value*, using the first-in, first-out (FIFO) method. Net realizable value is defined as the estimated selling prices of the inventory in the ordinary course of business, less reasonably predictable costs of completion, disposal and transportation. (3)

For the year ended 2016, the Company valued its inventories at *lower of cost or market*, using the first-in, first-out (FIFO) method.

In 2017, the company recorded a loss in the amount of $100,000 due to a write-down of its inventory to lower of cost and net realizable value. (1)

Observation: The ASU requires disclosure of the following items:

1. Any losses from measuring inventory at lower of cost and net realizable value (for FIFO or average cost) or lower of cost or market (for LIFO and retail methods) should be disclosed in the financial statements.

2. An entity is required to disclose the nature of and reason for the change in accounting principle in the first interim and annual period of adoption of ASU 2015-11.

3. An entity should continue to disclose the inventory valuation method (FIFO, etc.) in its summary of significant accounting policies.

Each of these disclosures above is identified parenthetically with the numbers (1), (2), and (3).

VII. Implementation of ASU 2015-11

1. An entity shall use the following transition guidance to implement ASU 2015-11:

   a. For public business entities, the ASU is effective for *fiscal years beginning after December 15, 2016* (calendar 2017), including interim periods within those fiscal years.

   b. For all other entities (including nonpublic entities), the ASU is effective for fiscal years *beginning after December 15, 2016* (calendar 2017), and interim periods within fiscal years beginning after December 15, 2017.

   c. An entity shall apply the changes in the ASU *prospectively* to the measurement of inventory after the date of adoption.

      Note: If an entity has written down inventory measured using any method other than last-in, first-out (LIFO) or the retail inventory method below its cost before the adoption of the ASU, that reduced amount is considered the cost upon adoption.

   d. Earlier application is permitted as of the beginning of an interim or annual reporting period.

   e. An entity is required only to disclose the nature of and reason for the change in accounting principle in the first interim and annual period of adoption.

Implementing the ASU- pre-adoption write-downs

ASU 2015-11 requires that at the date of adoption, any previous write-downs to lower of cost or market are considered part of the cost upon adoption.

Example: Company X is a nonpublic entity that adopts ASU 2015-11 for calendar year 2017.

At December 31, 2016, the inventory was as follows:

Inventory at cost	$10,000,000
Allowance – lower of cost or market	(500,000)
Inventory- LCM	$9,500,000

Conclusion: In the year of adoption (2017) any previous write-downs of inventory become part of the beginning inventory cost. In this example, X makes the following entry on January 1, 2017:

Entry at January 1, 2017:	dr	cr
Allowance- lower of cost or market	500,000	
Inventory		500,000

After the entry, the beginning inventory on January 1, 2017 is as follows:

Inventory at cost	$9,500,000
Allowance – lower of cost or market	(0)
Inventory- LCM	$9,500,000

The previous write-down of $500,000 becomes part of the beginning cost.

Continuing with the example:

At December 31, 2017, X values its inventory under ASU 2015-11 at lower of cost and net realizable value as follows:

Inventory at cost	$11,000,000
Inventory at net realizable value	11,700,000
Allowance required for write-down	$(0)

Conclusion:

There is no write-down entry in 2017 (first year of adoption of ASU 2015-11) as net realizable value ($11,700,000) exceeds cost ($11,000,000).

Is an entity permitted to reverse a previous write-down of inventory if there is a recovery of that loss?

No. ASC 330-10-35-14, *Inventories- Overall- Subsequent Measurement*, states:

> *"In the case of goods which have been written down below cost at the close of a fiscal year, such reduced amount is to be considered the cost for subsequent accounting purposes."*

What the above statement means is that once a write-down is recorded (through an allowance or a direct write-down against the inventory), recovery (reversal) is not permitted.

Although U.S. GAAP does not permit a write-down to be recovered, international standards do permit a reversal up to the amount of the original cost.

The SEC affirms this treatment

SAB 5.BB-*Inventory Valuation Allowance* (ASC 330.10-S99-2) addresses the issue of restoration of write-downs under the previous lower of cost or market rules. The conclusion still applies to the new lower of cost and net realizable value requirements in ASU 2015-11.

Question: Does the write-down of inventory to the lower of cost or market, as required by FASB ASC Topic 330, create a new cost basis for the inventory or may a subsequent change in facts and circumstances allow for restoration of inventory value, not to exceed original historical cost?

Interpretative Response: Based on FASB ASC paragraph 330-10-35-14, the (SEC) staff believes that a write-down of inventory to the lower of cost or market at the close of a fiscal period creates a new basis that subsequently cannot be marked up based on changes in underlying facts and circumstances.

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. Company Z uses LIFO for its inventory valuation and must measure its inventory at lower of cost or market. Market is defined as which of the following:
   a. Fair value
   b. Replacement cost with limits
   c. Net realizable value
   d. Normal profit

2. Which of the following is part of the formula for net realizable value. Estimated selling price _____:
   a. Less normal profit
   b. Less costs of completion
   c. Less fixed costs
   d. Plus discounts and allowances

3. Company M uses FIFO to value its inventory. At the end of the year, how should M measure its inventory under ASU 2015-11:
   a. Net realizable value
   b. Lower of cost and net realizable value
   c. Cost
   d. Lower of cost or fair value

4. Company J is a manufacturer who measures all inventories at FIFO. J wants to perform a lower of cost and net realizable value test on its inventory in accordance with ASU 2015-11. How should J perform the test:
   a. J should perform the test on individual items in raw materials
   b. J should perform the test on total inventory
   c. J should perform a test on raw materials using replacement cost
   d. J is exempt from the test because it uses FIFO inventory

5. Which of the following was a reason why the FASB decided not to apply ASU 2015-11 to LIFO inventories:
   a. The amendments would require an elimination of the LIFO reserve
   b. The amendments would provide a new requirement to use replacement cost
   c. The amendments would result in significant costs
   d. The amendments would provide a new requirement to use normal profit

SUGGESTED SOLUTIONS

1. Company Z uses LIFO for its inventory valuation and must measure its inventory at lower of cost or market. Market is defined as which of the following:
   a. Incorrect. Fair value is not used in inventory valuation making the answer incorrect.
   b. Correct. For companies using LIFO, market value is defined as replacement cost subject to a ceiling and a floor.
   c. Incorrect. Net realizable value is the ceiling for market but is not market. Market is replacement cost, subject to a ceiling and a floor. The ceiling is defined as net realizable value.
   d. Incorrect. Normal profit is not market. Normal profit is merely a reduction made to net realizable value to compute the floor. The floor represents the lowest amount for market.

2. Which of the following is part of the formula for net realizable value. Estimated selling price _____:
   a. Incorrect. Normal profit is not part of the formula for net realizable value. Instead, normal profit is used to adjust net realizable value to a floor in determining lower of cost or market for LIFO and retail inventory methods.
   b. Correct. Costs of completion, disposal and transportation are deduced from estimated selling price to compute net realizable value.
   c. Incorrect. Fixed costs are not part of the formula for net realizable value. Instead, costs that are adjustments represent variable costs related to completion, disposal and transportation.
   d. Incorrect. Any discounts and allowances are considered disposal costs and are deducted, not added, to estimated selling price to compute net realizable value.

3. Company M uses FIFO to value its inventory. At the end of the year, how should M measure its inventory under ASU 2015-11:
   a. Incorrect. Inventory is measured at net realizable value only if cost is higher than net realizable value. If, however, cost is lower than net realizable value, inventory would be measured at cost, making the answer incorrect.
   b. Correct. ASU 2015-11 requires FIFO inventory to be measured at lower of cost and net realizable value making the answer correct.
   c. Incorrect. Although inventory might be measured initially at cost, the subsequent measurement is not cost but rather lower of cost and net realizable value.
   d. Incorrect. The ASU does not use the term “fair value” and instead uses the term “net realizable value” making the answer incorrect.

4. Company J is a manufacturer who measures all inventories at FIFO. J wants to perform a lower of cost and net realizable value test on its inventory in accordance with ASU 2015-11. How should J perform the test:

a. Incorrect. Because the test requires use of net realizable value, it is not possible for J to perform the test on an individual items in raw materials basis. In particular, those materials ultimately become part of finished goods inventory so that the test should be performed on total inventory.
b. Correct. The best way to perform the test is to perform it on total inventory that includes raw materials, work in process and finished goods inventory. In doing so, net realizable value can be computed based on the finished goods inventory.
c. Incorrect. Because FIFO is used, the previous lower of cost or market method, which uses replacement cost, is no longer available under ASU 2015-11.
d. Incorrect. ASU 2015-11 has no exemption from the test for FIFO inventory.

5. Which of the following was a reason why the FASB decided <u>not</u> to apply ASU 2015-11 to LIFO inventories:
   a. Incorrect. The amendments would have required a revaluation of the LIFO lawyers which could impact the amount of the LIFO reserve but certainly not an elimination of it.
   b. Incorrect. Existing GAAP already requires use of replacement cost under the existing lower of cost or market computation. The ASU makes no changes to that requirement for LIFO inventories, making the answer incorrect.
   c. Correct. One particular criticism of the ASU is that it would result in significant costs particularly for the transition into the ASU due to allocating any previous write-downs to inventory layers.
   d. Incorrect. Existing GAAP requires use of normal profit in computing the floor amount of market. The ASU requires entities that use LIFO to continue existing practice. Thus, there would not be a new requirement to use normal profit because it is already used in existing GAAP.

Glossary

Direct effects of a change in accounting principle: Those recognized changes in assets or liabilities necessary to effect a change in accounting principle. An example of a direct effect is an adjustment to an inventory balance to effect a change in inventory valuation method. Related changes, such as an effect on deferred income tax assets or liabilities or an impairment adjustment resulting from applying the subsequent measurement guidance in Subtopic 330-10 to the adjusted inventory balance, also are examples of direct effects of a change in accounting principle.

Market: As used in the phrase lower of cost or market, the term market means current replacement cost (by purchase or by reproduction, as the case may be) provide that it meets both of the following conditions: a) Market shall not exceed the net realizable value, b) Market shall not be less than net realizable value reduced by an allowance for an approximately normal profit margin.

Net realizable value: Estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation.

Nonpublic entity: An entity that does not meet any of the following criteria: a) Its debt or equity securities are traded in a public market, including those traded on a stock exchange or in the over-the-counter market (including securities quoted only locally or regionally), b) It is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets), and c) Its financial statements are filed with a regulatory agency in preparation for the sale of any class of securities.

Public entity: An entity that meets any of the following criteria: a) Its debt or equity securities are traded in a public market, including those traded on a stock exchange or in the over-the-counter market (including securities quoted only locally or regionally), b) It is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets), and c) Its financial statements are filed with a regulatory agency in preparation for the sale of any class of securities.

Chapter 2: ASU 2015-17- Income Taxes (Topic 740)

Balance Sheet Classification of Deferred Taxes

Issued: November 2015

Effective date: ASU 2015-17 is effective as follows:

For public entities: the amendments in the ASU are effective for financial statements issued for annual periods *beginning after December 15, 2016*, and interim periods within those annual periods.

All other entities: (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.

Earlier application is permitted for all entities as of the beginning of an interim or annual reporting period.

The ASU may be applied either prospectively to all deferred tax liabilities and assets or retrospectively to all periods presented.

- If an entity applies the guidance prospectively, the entity should disclose in the first interim and first annual period of change, the nature of and reason for the change in accounting principle and a statement that prior periods were not retrospectively adjusted.

- If an entity applies the guidance retrospectively, the entity should disclose in the first interim and first annual period of change, the nature of and reason for the change in accounting principle and quantitative information about the effects of the accounting change on prior periods.

I. Objective

The objective of ASU 2015-17 is to simplify the balance sheet presentation of deferred income taxes as part of the FASB's Simplification Initiative. The amendments in the ASU align the presentation of deferred tax assets and liabilities with International Financial Reporting Standards (IFRS).

II. Background

The FASB issued ASU 2015-17 as part of its *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.

On January 22, 2015, the FASB issued an exposure draft, Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes, for public comment. Most respondents were supportive of the FASB's exposure draft.

Current GAAP requires an entity to separate deferred income tax liabilities and assets into current and noncurrent amounts in a classified balance sheet.

More specifically, the *existing rules* found in ASC 740 provide the following requirements for classifying deferred tax assets and liabilities on the balance sheet:

1. In a classified balance sheet, an entity shall separate deferred tax assets and liabilities into a current amount and a noncurrent amount.

2. Deferred tax assets and liabilities shall be classified as *current or noncurrent* based on the classification of the related asset or liability for the financial reporting.

3. A deferred tax asset or liability that is not related to an asset or liability (such as deferred tax assets related to an NOL carryforward), are classified based on the expected reversal date of the temporary difference.

4. The valuation allowance for a particular tax jurisdiction shall be allocated between current and noncurrent deferred tax assets for that tax jurisdiction on a pro rata basis.

5. For each particular tax jurisdiction, all deferred tax assets and liabilities shall be presented on a net current and net noncurrent basis.

According to the FASB, third parties have informed the FASB that the current GAAP requirement is not meaningful for several reasons:

1. The classifying deferred tax assets and liabilities have little or no benefit to users of financial statements. In particular, in most cases, the classification does not typically reflect when the deferred tax amounts are expected to reverse.

2. There are costs incurred by an entity to separate deferred income tax liabilities and assets into a current and noncurrent amount.

Therefore, to simplify the presentation of deferred income taxes, the ASU does the following:

- Requires that deferred tax liabilities and assets be classified as noncurrent in a classified balance sheet.

- Maintains the current requirement that deferred tax liabilities and assets of a tax-paying component of an entity be offset and presented as a single amount.

The ASU eliminate the requirement that an entity separate deferred tax liabilities and assets into a current amount and a noncurrent amount in a classified statement of financial position. The amendments in the ASU have no effect on entities that do not present a classified statement of financial position.

The amendments align the presentation of deferred tax assets and liabilities with IAS 1, *Presentation of Financial Statements*, which requires deferred tax assets and liabilities to be classified as noncurrent in a classified statement of financial position.

III. Rules

1. In a classified statement of financial position, an entity shall classify deferred tax liabilities and assets as *noncurrent amounts*.

2. For a particular tax-paying component of an entity and within a particular tax jurisdiction, all deferred tax liabilities and assets, as well as any related valuation allowance, shall be offset and presented as a single noncurrent amount.

a. An entity shall not offset deferred tax liabilities and assets attributable to different tax-paying components of the entity or to different tax jurisdictions.

3. The ASU makes no changes to existing disclosures related to deferred income taxes.

4. The changes made by the ASU apply only to entities that present a classified balance sheet.

Note: During deliberations, the FASB considered an alternative to the final ASU under which it would have required an entity to classify deferred tax assets and liabilities as current and noncurrent based on the estimated reversal date. Some FASB members observed that the reversal date of a temporary difference did not necessarily equate to a cash inflow or outflow. One example noted was a deferred tax asset that exists at the end of a reporting period and was expected to reverse within the next 12 months so that it would be classified as current. That reversal could result in a conversion into a different deferred tax asset such as a net operating loss carryforward or an income tax receivable. Thus, the

deferred tax asset would not result in any cash flow during the 12 months even though presented as a current asset.

The FASB decided not to adopt this alternative because it would increase cost and complexity with no further benefit as compared with current GAAP and the amendments in the final ASU.

IV. Transition

1. The ASU is effective as follows:

   a. For public business entities, for financial statements issued for annual periods *beginning after December 15, 2016*, and interim periods within those annual periods.

   b. For entities other than public business entities, for financial statements issued for annual periods *beginning after December 15, 2017*, and interim periods within annual periods beginning after December 15, 2018.

2. Earlier application of the ASU is permitted for all entities as of the beginning of any interim or annual reporting period.

3. The ASU may be applied prospectively or retrospectively as follows:

   a. *Prospective application*: If the ASU is applied *prospectively*, the following rules apply:

      1) The prospective application must be applied to all deferred tax liabilities and assets

      2) The entity that applies the ASU prospectively shall disclose the following in the first interim and first annual period of adoption:

         - The nature of and reason for the change in accounting principle
         - A statement that prior periods were not retrospectively adjusted.

   b. *Retrospective application*: If the ASU is applied *retrospectively*, the following rules apply:

      1) The entity that applies the ASU retrospectively shall disclose the following in the first interim and first annual period of adoption:

         - The nature of and reason for the change in accounting principle

- Quantitative information about the effects of the accounting change on prior periods.

Example 1: Company X is a nonpublic entity that adopts ASU 2015-17 effective for the year ended December 31, 2018.

X's deferred tax liability for 2017 is presented as current because the underlying assets and liabilities that create the temporary difference are presented current on the balance sheet.

X chooses to apply ASU 2015-17 prospectively for 2018.

X's balance sheet for December 31, 2017 is noted below.

Company X
Balance Sheet
December 31, 2017

ASSETS	
Current assets:	
Cash	$100,000
Trade receivables	2,000,000
Inventories	2,900,000
Total current assets	5,000,000
Property, plant and equipment:	
Cost	8,000,000
Accumulated depreciation	(5,000,000)
Total property, plant and equipment	3,000,000
	$8,000,000
LIABILITIES AND STOCKHOLDER'S EQUITY	
Current liabilities:	
Accounts payable	$2,500,000
Accrued expenses and other liabilities	500,000
Current portion of long-term debt	200,000
Deferred tax liability	**100,000**
Total current liabilities	3,300,000
Long-term debt (net of current portion)	2,700,000
Stockholder's equity:	

Common stock	200,000
Retained earnings	1,800,000
Total stockholder's equity	2,000,000
	$8,000,000

Conclusion: X's balance sheet for 2018 is presented as follows:

Company X
Balance Sheets
December 31, 2018 and 2017

	2018	2017
ASSETS		
Current assets:		
Cash	$200,000	$100,000
Trade receivables	3,000,000	2,000,000
Inventories	3,300,000	2,900,000
Total current assets	6,500,000	5,000,000
Property, plant and equipment:		
Cost	8,400,000	8,000,000
Accumulated depreciation	(5,200,000)	(5,000,000)
Total property, plant and equipment	3,200,000	3,000,000
	$9,700,000	$8,000,000
LIABILITIES AND STOCKHOLDER'S EQUITY		
Current liabilities:		
Accounts payable	$3,200,000	$2,500,000
Accrued expenses and other liabilities	850,000	500,000
Current portion of long-term debt	200,000	200,000
Deferred tax liability	**0**	**100,000**
Total current liabilities	4,250,000	3,300,000
Long-term liabilities:		
Long-term debt (net of current portion)	2,500,000	2,700,000
Deferred tax liability	**150,000**	**0**
	2,650,000	2,700,000
Stockholder's equity:		
Common stock	200,000	200,000

Retained earnings	2,600,000	1,800,000
Total stockholder's equity	2,800,000	2,000,000
	$9,700,000	$8,000,000

The 2018 notes include the following disclosure required by ASU 2015-17 for a prospective application.

Note X: Income Taxes

> Effective in 2018, the Company adopted Accounting Standards Update (ASU) 2015-17, *Income Taxes (Topic 740)-Balance Sheet Classification of Deferred Taxes* to simplify the balance sheet presentation of its deferred tax assets and liabilities. In accordance with ASU 2015-17, the Company is required to classify all deferred tax assets and liabilities as long-term on its balance sheet regardless of the classification of the underlying asset or liability that creates the deferred income taxes. The December 31, 2017 deferred tax liability in the amount of $100,000 has not been reclassified from a current to long-term liability.

Observation: Example 1 illustrates the adoption of the ASU prospectively under which the deferred tax liability for 2017 in the amount of $100,000 is not restated to reflect the new ASU.
The ASU requires that if the prospective application is elected, the note disclosure must have two elements as follows:

- The nature of and reason for the change in accounting principle, and
- A statement that prior periods were not retrospectively adjusted.

Example 2: Same facts as Example 1 except that X adopts ASU 2015-17 retrospectively by restating 2017 financial statements.

Conclusion: X's balance sheet for 2018 is presented below. The 2017 deferred tax liability is reclassified as a long-term liability.

Company X
Balance Sheets
December 31, 2018 and 2017

	2018	2017
ASSETS		
Current assets:		
Cash	$200,000	$100,000
Trade receivables	3,000,000	2,000,000
Inventories	3,300,000	2,900,000
Total current assets	6,500,000	5,000,000
Property, plant and equipment:		
Cost	8,400,000	8,000,000
Accumulated depreciation	(5,200,000)	(5,000,000)
Total property, plant and equipment	3,200,000	3,000,000
	$9,700,000	$8,000,000
LIABILITIES AND STOCKHOLDER'S EQUITY		
Current liabilities:		
Accounts payable	$3,200,000	$2,500,000
Accrued expenses and other liabilities	850,000	500,000
Current portion of long-term debt	200,000	200,000
Total current liabilities	4,250,000	3,200,000
Long-term liabilities:		
Long-term debt (net of current portion)	2,500,000	2,700,000
Deferred tax liability	**150,000**	**100,000**
Total long-term liabilities	2,650,000	2,800,000
Stockholder's equity:		
Common stock	200,000	200,000
Retained earnings	2,600,000	1,800,000
Total stockholder's equity	2,800,000	2,000,000
	$9,700,000	$8,000,000

The 2018 notes include the following disclosure required by ASU 2015-17 for a retrospective application.

> **Note X: Income Taxes**
>
> Effective in 2018, the Company adopted Accounting Standards Update (ASU) 2015-17, *Income Taxes (Topic 740)-Balance Sheet Classification of Deferred Taxes* to simplify the balance sheet presentation of its deferred tax assets and liabilities. In accordance with ASU 2015-17, the Company is required to classify all deferred tax assets and liabilities as long-term on its balance sheet regardless of the classification of the underlying asset or liability that creates the deferred income taxes. The December 31, 2017 balance sheet has been restated to reflect the reclassification of a deferred tax liability in the amount of $100,000 from a current to long-term liability.

Observation: In Example 2, the deferred tax liability is reclassified from current to long-term liability. The ASU requires that if the retrospective application is elected, the note disclose must have two elements as follows:

- The nature of and reason for the change in accounting principle
- Quantitative information about the effects of the accounting change on prior periods.

Should companies adopt the ASU early?

The ASU is effective:

a. For public business entities, for financial statements issued for annual periods *beginning after December 15, 2016*, which is calendar year 2017.

b. For entities other than public business entities, for financial statements issued for annual periods *beginning after December 15, 2017*, which is calendar year 2018.

The ASU permits an entity to *apply the amendments early* as of the beginning of any interim or annual reporting period. Because the effective date of a nonpublic entity is calendar year 2018, an entity should decide whether it makes sense to adopt the ASU early for calendar year ending 2016 or 2017.

The author sees no reason why an entity should not adopt the ASU early and that any adoption should be made *prospectively and not retrospectively*. After all, the adoption is relatively easy and merely involves presenting the deferred tax asset or liability as long-term (noncurrent) in the year of adoption (2016 or 2017).

The author suggests a prospective application by not restating the prior year comparative balance sheet. That is, if an entity adopts the ASU for calendar year 2016, the entity should classify its deferred tax asset or liability as long-term (non-current) in 2016, and should not reclassify its deferred tax asset or liability for its 2015 comparative balance sheet.

Few third-party users care about the classification of the deferred tax asset or liability on the balance sheet.

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 with respect to existing GAAP for deferred tax assets and liabilities:
   a. Deferred tax assets are presented long-term, while deferred tax liabilities are presented current on the balance sheet.
   b. Deferred tax assets are presented as current or long-term based on when the asset is going to be converted to cash flow
   c. Deferred tax assets and liabilities are classified as current or noncurrent based on the classification of the related asset or liability.
   d. Deferred tax assets and liabilities are always presented as current on the balance sheet.

2. Company Y has a $100,000 deferred tax asset related to a federal net operating loss carryforward and a $150,000 deferred state tax liability related to a state temporary difference. Which of the following is correct:
   a. Y should net the deferred tax asset and liability and present a net $50,000 liability on the balance sheet.
   b. Y should record the $150,000 liability, but not record the asset.
   c. Y should present a $100,000 asset and a $150,000 liability and not net the two amounts.
   d. Y must record a valuation account against the asset.

3. Company L has an unclassified balance sheet. How should L present its deferred tax liability:
   a. As a current liability
   b. As a noncurrent liability
   c. As a liability
   d. Disclosed only

4. Company X is adopting ASU 2015-17 with respect to its deferred tax assets and liabilities. X is adopting the new ASU effective in 2018 and will present a comparative

balance sheet for 2017. X wants to adopt the ASU prospectively. Which of the following is correct:

a. X must restate the 2017 balance sheet
b. Is does not restate the 2017 balance sheet
c. X should reverse off the 2017 liability under the ASU
d. X should revise the 2017 balance sheet to gross up the asset and liability for that year

SUGGESTED SOLUTIONS

1. Which of the following is correct with respect to existing GAAP for deferred tax assets and liabilities:
   a. Incorrect. ASC 740 does not provide for deferred tax assets being presented long-term while deferred tax liabilities are presented current on the balance sheet. Instead, the classification follows the classification of the underlying asset or liability.
   b. Incorrect. ASC 740 does not use the conversion or reversal date for classification unless there is no identified asset or liability that created the temporary difference.
   c. Correct. ASC 740 classifies the deferred tax assets and liabilities based on how the related asset or liability is classified on the balance sheet.
   d. Incorrect. ASU 740 does not provide for deferred tax assets and liabilities automatically being presented as current on the balance sheet. To do so would distort the balance sheet because the classification would not match to reversal date.

2. Company Y has a $100,000 deferred tax asset related to a federal net operating loss carryforward and a $150,000 deferred state tax liability related to a state temporary difference. Which of the following is correct:
   a. Incorrect. ASU 740 states that an entity shall not offset deferred tax liabilities and assets attributable to different tax-paying jurisdictions. Thus, netting a state liability against a federal asset is not allowed.
   b. Incorrect. There is no reason not to record the asset unless it will not be realized, in which case a valuation account is required.
   c. Correct. Because there are two different tax jurisdictions (federal and state), netting is not permitted. Therefore, the liability and asset should be recorded.
   d. Incorrect. There is nothing that indicates that the asset requires a valuation account.

3. Company L has an unclassified balance sheet. How should L present its deferred tax liability:
   a. Incorrect. The balance sheet is unclassified so that there is no current liability category.
   b. Incorrect. Because there is an unclassified balance sheet, there is no section referred to as a noncurrent liability.
   c. Correct. Due to there being an unclassified balance sheet, the deferred tax liability is presented as an unclassified liability because there are no current and noncurrent categories.
   d. Incorrect. A deferred tax liability must be recorded and not just disclosed.

4. Company X is adopting ASU 2015-17 with respect to its deferred tax assets and liabilities. X is adopting the new ASU effective in 2018 and will present a comparative balance sheet for 2017. X wants to adopt the ASU prospectively. Which of the following is correct:
   a. Incorrect. Under the prospective application, X does not restate the 2017 balance sheet as the change is made prospectively for 2018 and later years.
   b. Correct. Under the ASU's prospective application rules, the new ASU is applied in 2018 with no restatement of 2017, making the answer correct.
   c. Incorrect. The ASU addresses the deferred tax presentation and not the measurement, making the answer incorrect.
   d. Incorrect. The ASU change relates to the presentation of the liability or asset and does not make any changes to the netting rules for deferred taxes.

Glossary

Carryforwards: Deductions or 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.

Deferred tax asset: The deferred tax consequences attributable to deductible temporary differences and carryforwards. A deferred tax asset is measured using the applicable enacted tax rate and provisions of the enacted tax law. A deferred tax asset is reduced by a valuation allowance if, based on the weight of evidence available, it is more likely than not that some portion or all of a deferred tax asset will not be realized.

Deferred tax liability: The deferred tax consequences attributable to taxable temporary differences. A deferred tax liability is measured using the applicable enacted tax rate and provisions of the enacted tax law.

Nonpublic entity: An entity that does not meet any of the following criteria: a) Its debt or equity securities are traded in a public market, including those traded on a stock exchange or in the over-the-counter market (including securities quoted only locally or regionally), b) It is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets), and c) Its financial statements are filed with a regulatory agency in preparation for the sale of any class of securities.

Public entity: An entity that meets any of the following criteria: a) Its debt or equity securities are traded in a public market, including those traded on a stock exchange or in the over-the-counter market (including securities quoted only locally or regionally), b) It is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets), and c) Its financial statements are filed with a regulatory agency in preparation for the sale of any class of securities.

Temporary difference: A difference between the tax basis of an asset or liability for tax positions, and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the asset or liability is recovered or settled, respectively.

Chapter 3: ASU 2015-02: Consolidation (Topic 810)

Amendments to the Consolidation Analysis

Issued: February 2015

Effective date: ASU 2015-02 is effective as follows:

For public business entities for fiscal years, and for interim periods within those fiscal years, *beginning after December 15, 2015*.

For all other entities, fiscal years *beginning after December 15, 2016*, and for interim periods within fiscal years beginning after December 15, 2017.

Early adoption is permitted, including adoption in an interim period.

I. Objective

The objective of ASU 2015-02 is to provide guidance as to the accounting for consolidation of certain legal entities.

A. Overview of Existing GAAP Rules for Investments and Consolidations

This section summarizes the existing (pre-ASU 2015-02) general accounting rules for investments and consolidations.

The accounting for investments is generally based on the percentage ownership of the voting interest that one entity holds in another entity.

The three tiers of ownership and the accounting rules related to each are summarized as follows:

Ownership level	General accounting treatment
1. Ownership of less than 20% of the voting shares	Investment recorded at cost or fair value depending on whether the investment is a security or non-security.
2. Ownership of 20-50% of the voting shares or when one entity has *significant influence* over another entity	Use the equity method
3. Ownership of more than 50% of the voting shares	Consolidate the entities (controlling financial interest)

The following chart summarizes the accounting treatment in greater detail for all three tiers.

GAAP for Investments	
Ownership of voting stock	**Accounting Treatment**
TIER 1: Less than 20% ownership[3]	
a. Non-securities- closely held investments	ASC 210 (formerly ARB No. 43) - Investments recorded at amortized cost. A write-down is made to lower of cost or fair value if a loss is other-than temporary (permanent)
b. Securities- debt or equity- placed into three categories:	ASC 320 (formerly FASB No. 115) - Securities are recorded at fair value or cost based on three investment categories: 1. *Held to maturity securities*- Recorded at amortized cost 2. *Trading securities*- Recorded at fair value- gain/loss presented on the income statement 3. *Available-for-sale securities*- Recorded at fair value- gain/loss presented in stockholders' equity, net of taxes (other comprehensive income)

[3] In January 2016, the FASB issued ASU 2016-01, *Financial Instruments—Overall (Subtopic 825-10) Recognition and Measurement of Financial Assets and Financial Liabilities*, which changes the accounting for certain equity investments. The ASU is effective for 2018 for public entities, and 2019 for non-public entities. The changes made in ASU 2016-01 are not reflected in this chapter due to the delayed effective date.

TIER 2: 20-50% or significant influence	ASC 323 (formerly APB No. 18): Use the equity method
TIER 3: Consolidation or Combined Financial Statements	
a. Consolidation based on more than 50% ownership of voting stock	ASC 810 (formerly ARB No. 51 and FASB No. 94)- Consolidate in all cases
b. Exceptions where consolidation is based on other than ownership. [controlling financial interest]	**Four exceptions to the more than 50% consolidation rules- Consolidate even if more-than-50% ownership threshold is not met:** **1. Entities controlled by contract** **2. General partner that controls a limited partnership** **3. Miscellaneous transactions involving research and development arrangements and rabbi trusts** **4. Variable interest entities (VIEs)**
c. Combined financial statements	Option to combine financial statements of two or more entities when it is more meaningful to do so.

Following this section, the author focuses only on Tier 3 of the ownership hierarchy, involving consolidation.

B. Consolidations and Combined Statements

General:

The rules for consolidations are found in ASC 810, *Consolidation* (formerly Accounting Research Bulletin (ARB) 51 and FASB No. 94).

ASC 810 states:

> *"There is a presumption that consolidated statements are more meaningful than separate statements…"*

In general, ASC 810 requires the consolidation of all majority-owned subsidiaries; that is, a situation in which one entity has a *controlling financial interest* (through ownership of more than 50% voting shares) in another entity.

Exceptions to the more than 50% ownership test – consolidations:

Under existing GAAP (pre ASU 2015-02), the general rule is that consolidation is required when one entity has a *controlling financial interest* in another entity *through owning more than 50% of that entity's voting stock (controlling financing interest)*. For tax purposes, consolidation generally occurs when an 80% or more ownership threshold is met.

Although more-than-50% ownership is the minimum threshold for consolidation, existing GAAP provides *four exceptions* in which consolidation may be required even though more-than-50% majority ownership is not achieved.

In such cases, an entity has a *controlling financial interest* through other than ownership.

Those exceptions are:

1. **Entities controlled by contract**
2. **General partner that controls a limited partnership (ASC 810-20)**
3. **Miscellaneous transactions involving research and development arrangements and rabbi trusts**
4. **Variable interest entities (VIEs)**

Each of these exceptions is discussed below.

EXISTING GAAP: Exception 1: Entities Controlled by Contract

ASC 810-10-15, *"Consolidation of Entities Controlled by Contract,"* provides an exception to the more-than-50% ownership threshold. Specifically, there are situations in which one entity *controls* another through a *contractual management agreement* without having ownership of a majority of the outstanding voting equity.

The most common example of this arrangement is found in the medical field in which a physician practice (PP) engages in a contract with a practice management entity (PPME) for the PPME to manage the PP. In such cases, it is typical for the PPME to control to PP but have no ownership in the practice. In such circumstances, the PPME should consolidate with the physician's practice.

In particular, ASC 810-10-15 applies to contractual management arrangements with *both* of the following characteristics:

- Relationships between more than one physician practices (PP) that operate in the health care industry including the practices of medicine, dentistry, veterinary science, and chiropractic medicine, and

- Relationships in which the physician practice management entity (PPME) does not own the majority of the outstanding voting equity of the physician practices either because the PPME is precluded by law from owning the equity, or because the PPME has elected not to own the equity.

If the following criteria are met, the PPME *has a controlling financial interest* in the physician practice and *should consolidate the physician practice*.

1. The contractual arrangement a) has a term that is either the entire remaining legal life of the physician practice entity or a period of 10 years or more, and b) Is not terminable by the physician practice except in cases of gross negligence, fraud, other illegal acts, or bankruptcy by the PPME.

2. The PPME has exclusive authority over all decision making involving the practice operations and compensation of the medical professionals,

3. The PPME must have a significant (but not necessarily majority) financial interest in the physician practice that meets certain criteria.

Observation: ASC 810-10-15 states that the guidance for entities controlled can be used in other industries and similar circumstances. The conclusion suggests that in other circumstances in which control is determined by a contract other than ownership, entities may consolidate. However, the author believes that the guidance should not be taken out of context. Because ASC 810-10-15 gives no examples of where circumstances would be considered "similar," it may not be prudent to apply a control standard that is measured on other-than majority ownership (e.g., more than 50% ownership).

EXISTING GAAP: Exception 2: General Partner in a Limited Partnership

ASC 810-20, *Consolidation- Control of Partnerships and Similar Entities*, applies to general partners in limited partnerships or similar entities (such as limited liability companies that have governing provisions that are the functional equivalent of a limited partnership) that are not variable interest entities under FIN 46R.

The general rules follow:

a. A general partner that controls a limited partnership should consolidate the partnership into its financial statements.

b. There is a presumption that general partners *control* a limited partnership regardless of the extent of the general partners' ownership interest in the limited partnership.

c. The presumption that general partners control a partnership is overcome (the general partners *do not control* the limited partnership) if the limited partners have either:

   1) *Substantive kick-out rights*: The substantive ability to dissolve (liquidate) the limited partnership or otherwise remove the general partners without cause, or

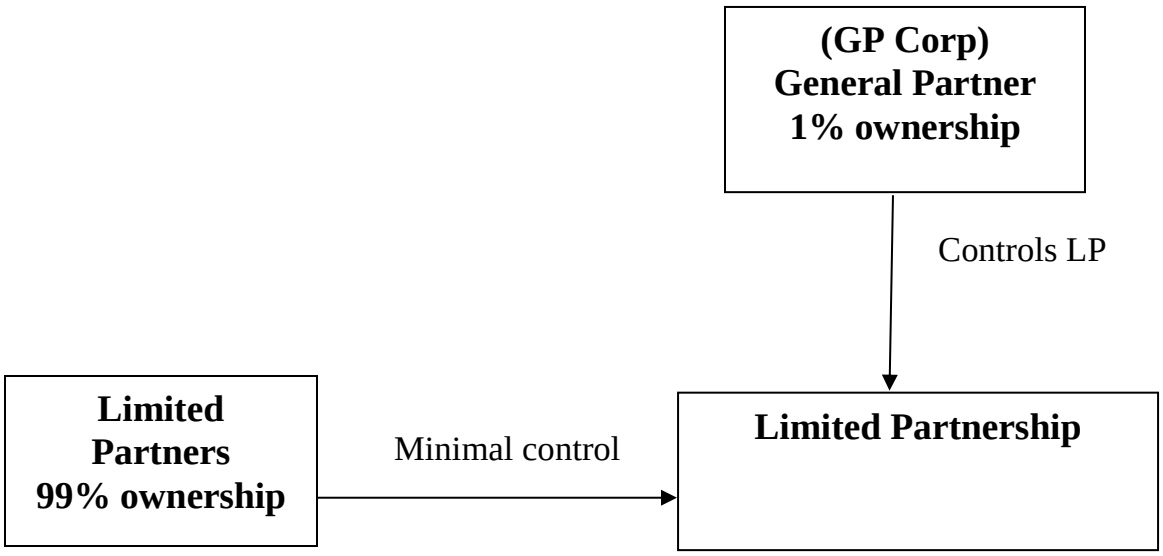
   2) *Substantive participating rights*: The ability to effectively participate in certain actions of the limited partnership.

Note: Protective rights that would allow the limited partners to block partnership actions (e.g., amendments to the agreement, pricing on transactions, liquidation of the partnership, or acquisitions and dispositions of assets) would be considered protective (rather than participating) rights and would not overcome the presumption of control by the general partners.

A limited partner's unilateral right to withdraw from the partnership in whole or in part (withdrawal right) that does not require dissolution or liquidation of the entire limited partnership would not overcome the presumption that the general partners control the limited partnership.

Example: Assume that a general partner (GP Corp) controls a real estate limited partnership, yet owns only 1% of the limited partnership. The remaining 99% is owned by the limited partners who have minimal control over the limited partnership. Further, there are no restrictions on the general partner and the limited partners do not have the right to remove the general partner unless there is proven fraud.

The ownership structure looks like this:



99% ownership

Conclusion: Under existing GAAP, the GP would consolidate with the limited partnership even though it has only 1% ownership. This conclusion is based on the fact that the general partner *controls* the partnership with minimal restrictions on that control.

Change the facts: The partnership agreement restricts certain rights of the general partner by giving those rights to the limited partners. Those restrictive rights include the right to replace the general partner by a super majority vote, approval required for the sale of assets, and refinancing or acquisition of principal assets.

Conclusion: Because the general partner's control is restricted by additional rights given to the limited partners, the general partner would not consolidate with the limited partnership.

EXISTING GAAP: Exception 3: Miscellaneous Transactions involving Research and Development Arrangements and Rabbi Trusts

Under existing GAAP, ASC 810-10-15, *Consolidation-Overall, Scope and Scope Exceptions*, provides limited exceptions under which an entity should consolidate another entity even though there is no majority ownership among the entities. One situation is where there is a research and development arrangement among the entities. The other is in circumstances in which an employer should consolidate into its financial statements the accounts of a Rabbi Trust.

EXISTING GAAP: Exception 4: The Variable Interest Entity (VIE) Rules- FIN 46R

Under existing GAAP, the fourth exception to the more-than-50%-ownership rule for consolidation, is where there is an off-balance entity that is categorized as a variable interest entity (VIE) as discussed in FASB Interpretation No. 46R, *Consolidation of Variable Interest Entities- An Interpretation of ARB No. 51*, now part of ASC 810, *Consolidation.*

FIN 46R requires a primary beneficiary to consolidate a variable interest entity (VIE). In general, a VIE is an entity that is *not self-supportive*.

An entity is considered a VIE if, by design[4], it has *one or both* of the following *two conditions:*

[4] FIN 46R states that the phrase "by design" refers to entities that meet the conditions of being a VIE because of the way they are structured. For example, an entity under the control of its equity holders that originally was not a VIE does not become one because of operating losses.

1. The total equity investment at risk is not sufficient to permit it to finance its activities without obtaining additional subordinated financial support provided by any parties (e.g., individual or entity), including equity holders.

2. As a group, the holders of equity investments at risk lack any one of the following three characteristics:

   a. Lack the *power* through voting rights or similar rights to *direct* the entity's activities that most significantly impact the entity's economic performance.

   b. Lack the *obligation to absorb the expected losses* of the entity.

   c. Lack the *right to receive expected residual returns* of the entity.

A VIE is consolidated by a primary beneficiary entity if that entity has a controlling financial interest in the VIE model through having *both of the following*:

a. The power to direct the activities that most significantly impact the VIE's economic performance, and

b. The obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE.

VIE exemption for private companies in common control leasing arrangements

In March 2014, the Private Company Council (PCC) issued and the FASB endorsed ASU 2014-07: *Consolidation (Topic 810)- Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements-A consensus of the Private Company Council (ASUs).*

ASU 2014-07 provides a private company exemption from consolidation under FIN 46R VIE rules.

The general provisions of ASU 2014-07 are summarized below:

a. A private company lessee (the reporting entity) may elect an accounting alternative not to apply the FIN 46R VIE guidance to a lessor entity (not consolidate a real estate lessor) if *four criteria* are met:

   1) The private company lessee and the lessor entity are under *common control.*

   2) The private company lessee has a *lease arrangement* with the lessor entity.

3) *Substantially all of the activities* between the private company lessee and the lessor entity are *related to leasing activities* (including supporting leasing activities) between those two entities, and,

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, the *principal amount of the obligation* at inception of the guarantee or collateral arrangement *does not exceed the value of the asset* leased by the private company from the lessor entity.

b. A private company lessee that elects the accounting alternative not to consolidate the real estate lessor is required to expand certain disclosures.

The ASU 2014-07 exemption only applies to private company leasing arrangements and does not exempt private companies from applying the VIE consolidation rules to other non-leasing arrangements such as management contracts, etc.

Combined Financial Statements:

In some instances, the issuance of combined financial statements is an optional alternative to consolidated financial statements. ASC 810 provides guidance on the preparation of combined financial statements where a controlling financial interest does not rest directly or indirectly with one of the companies included in the consolidation.

Issuing combined financial statements is not an alternative to consolidated financial statements in situations in which an entity is required to issue consolidated financial statements. Instead, use of combined financial statements is an option where consolidation is not otherwise required, yet an entity wants to present statements that have the appearance of consolidation.

ASC 810 states:

> *"There are instances, however, where combined financial statements (as distinguished from consolidated financial statements) of commonly controlled companies are likely to be more meaningful than their separate statements."*

Examples where combined financial statements may be useful:

1. There is a group of unconsolidated subsidiaries.

2. One individual owns a controlling interest in several corporations, which are related in their operations, markets or industries.

3. One individual owns a controlling interest in an operating company that is the sole lessee of a real estate trust or partnership.

4. An off-balance sheet entity is not a VIE and does not meet the criteria for consolidation under FIN 46R.

Example 1: Harry owns 100% of company A and B, yet there is no direct ownership between A and B. A sells 25% of its product to B but there is no indication of control, financial support or ownership between A and B. Further, the two entities are not required to be consolidated under the VIE rules of FIN 46R. Because consolidation is not required for the two entities, the entities may elect to issue combined financial statements.

Example 2: Harry owns 100% of Company A. Company A rents the real estate used in its operations from Company B, which is an LLC, solely owned by Harry. The two entities are not required to be consolidated under FIN 46R. Because consolidation is not required, issuing combined financial statements is an option and may be more meaningful.

Combined financial statements *are never required*, but may be useful in certain cases. Also, although there are similarities, combined financial statements differ from consolidated financial statements in several ways noted below.

1. Combining is treated essentially in the **same manner** as a consolidation with all intercompany transactions eliminated.

2. Stockholders' equity is combined, not eliminated, because there is no investment to eliminate.

3. The report must be altered to reflect the combined entities.

Example 3: Assume that Company X and Y, both corporations, are combined with Company Z, a real estate LLC. The combined equity looks like this:

Combined equity	
Common stock: X Corporation	$xx
Y Corporation	xx
	xx
Retained Equity:	
X Corporation	xx

Y Corporation	xx
Z Company LLC	xx
	xx
Total combined equity	xx

The report language looks like this:

Example of Report Language- Compilation Report- SSARS No. 21:

Management is responsible for the **accompanying combined financial statements of X Company, Y Company, and Z Company**, which comprise the **combined balance sheets** as of December 31, 20X2 and 20X1 and the related **combined statements of income and retained earnings, and cash flows** for the years then ended, and the related notes to the financial statements in accordance with accounting principles generally accepted in the United States of America. (We) have performed a compilation engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. I (we) did not audit or review the financial statements nor was (were) I (we) required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, I (we) do not express an opinion, a conclusion, nor provide any form of assurance on these financial statements.

[Signature of accounting firm or accountant, as appropriate]
[Accountant's city and state]
[Date of the accountant's report]

Is an entity permitted to issue combined financial statements in lieu of consolidated financial statements?

No. If an entity is required to issue consolidated financial statements under ASC 810, it must issue such statements. Issuing combined financial statements instead of consolidated statements where consolidated statements are required, is not an option. If, instead, an entity is not required to consolidate, it may choose to issue combined financial statements if it is meaningful to do so.

II. Background

The FASB issued ASU 2015-02 to respond to stakeholders' comments about the current accounting for consolidation of certain legal entities. Stakeholders expressed concerns that current GAAP for consolidations required modifications.

As a result, the FASB issued amendments in ASU 2015-02, which change the analysis that a reporting entity must perform to determine whether it should consolidate certain types of legal entities.

The amendments in the ASU affect reporting entities that are required to evaluate whether they should consolidate certain legal entities. All legal entities are subject to reevaluation under the revised consolidation model. Specifically, the amendments:

a. Reduce the number of consolidation models by eliminating the special model for limited partnerships.

b. Modify the evaluation of whether limited partnerships and similar legal entities are variable interest entities (VIEs) or voting interest entities.

c. Eliminate the presumption that a general partner should consolidate a limited partnership.

d. Affect the consolidation analysis of reporting entities that are involved with VIEs, particularly those that have fee arrangements and related party relationships.

e. Provide a scope exception from consolidation guidance for most money market funds; reporting entities with interests in legal entities that are required to comply with or operate in accordance with requirements that are similar to those in Rule 2a-7 of the Investment Company Act of 1940 for registered money market funds.

The amendments in ASU 2015-02 affect the following areas:

1. Limited partnerships and similar legal entities
2. Evaluating fees paid to a decision maker or a service provider as a variable interest
3. The effect of fee arrangements on the primary beneficiary determination
4. The effect of related parties on the primary beneficiary determination, and
5. An exemption for certain investment funds.

Limited Partnerships and Similar Legal Entities

The ASU changes *three main provisions* that affect the consolidation of limited partnerships and similar legal entities, such as LLCs:

1. There is an additional requirement that limited partnerships and similar legal entities must meet to qualify for consolidation as voting interest entities.

- A limited partnership must provide partners with *either* *substantive kick-out rights* *or* *substantive participating rights* over the general partner to meet this requirement.

2. The specialized consolidation model and guidance for limited partnerships and similar legal entities have been eliminated.

   - There is no longer a presumption that a general partner should consolidate a limited partnership.

3. For limited partnerships and similar legal entities that qualify as voting interest entities, a limited partner with a controlling financial interest should consolidate a limited partnership.

   - A controlling financial interest may be achieved through holding a limited partner interest that provides a majority of substantive kick-out rights.

Evaluating Fees Paid to a Decision Maker or a Service Provider as a Variable Interest

In the VIE model, a reporting entity must determine whether it has a variable interest in the entity being evaluated for consolidation.

Current GAAP provides *six criteria* that must be met in order for fees paid by a legal entity (VIE) to a decision maker or a service provider not to be a variable interest in the legal entity (VIE).

1. The ASU *eliminates three of the six conditions* for evaluating whether a fee paid to a decision maker or a service provider represents a variable interest.

2. If a reporting entity (decision maker or service provider) fails any of the three conditions in (1) above, it has a variable interest in a VIE. Consequently, the reporting entity (decision maker or service provider) must evaluate whether its variable interest represents a controlling financial interest in the VIE; that is, whether the reporting entity is the primary beneficiary that should consolidate the VIE.

Because only three conditions must be met for fees not to be a variable interest, the change is likely to result in fewer decision makers and service providers consolidating VIEs.

The Effect of Fee Arrangements on the Primary Beneficiary Determination

Under both current GAAP requirements and the amendments in ASU 2015-02, a decision maker is determined to be the primary beneficiary of a VIE if it satisfies both the power

and the economics criteria. The primary beneficiary consolidates a VIE because it has a controlling financial interest.

1. Under existing GAAP, if a fee arrangement paid to a decision maker, (such as an asset management fee), is determined to be a variable interest in a VIE (it fails 6 conditions), the decision maker must include the fee arrangement in its determination as to whether it is the primary beneficiary analysis that consolidates the VIE. Consequently, the fees paid to the decision maker give considerable weight to concluding that the decision maker is the primary beneficiary.

2. Under existing GAAP, in making the determination as to whether the decision maker or service provider is the primary beneficiary that consolidates the VIE, the decision maker must satisfy both of the following criteria:

   The decision maker must have:

   a. *Power criterion*: The power to direct the activities that most significantly impact the VIE's economic performance (power criterion), and

   b. *Economics criterion*: The obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE (economics criterion).

3. Under existing GAAP, the decision maker or service provider uses the fees it has received in performing the analysis as to whether the decision maker meets both the power criterion and economic criterion. If both are satisfied, the decision maker or service provider is considered the primary beneficiary and must consolidate the VIE.

   a. The amendments in the ASU specify that some fees paid to a decision maker or service provider are *excluded from the evaluation of the economics criterion* (second criterion) if the fees are both customary and commensurate with the level of effort required for the services provided.

   b. The ASU amendments make it *less likely* for a decision maker or service provider to meet the economics criterion solely on the basis of a fee arrangement.

      Thus, fewer decision makers and service providers will be considered a primary beneficiary and will not likely consolidate a VIE to which it provides services.

The Effect of Related Parties on the Primary Beneficiary Determination

In instances in which no single party has a controlling financial interest in a VIE, current GAAP requires interests held by a reporting entity's related parties to be treated as though they belong to the reporting entity when evaluating whether a related-party group has the characteristics of a primary beneficiary.

The amendments in ASU 2015-02 reduce the application of the related party guidance for VIEs on the basis of the following *three changes*:

1. For single decision makers, related party relationships must be considered indirectly on a proportionate basis, rather than in their entirety.

2. After the assessment in (1) above is performed, related party relationships should be considered in their entirety for entities that are under common control only if that common control group has the characteristics of a primary beneficiary. That is, the common control group collectively has a controlling financial interest.

3. If the second assessment is not applicable, but substantially all of the activities of the VIE are conducted on behalf of a single variable interest holder (excluding the decision maker) in a related party group that has the characteristics of a primary beneficiary, that single variable interest holder must consolidate the VIE as the primary beneficiary.

The ASU does not amend the related party guidance for situations in which power is shared between two or more entities that hold variable interests in a VIE.

Exemption for Certain Investment Funds

The amendments in the ASU:

1. Rescind the indefinite deferral of FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R)*, included in FASB Accounting Standards Update No. 2010-10, *Consolidation (Topic 810): Amendments for Certain Investment Funds*.

2. Provide a scope exception from the consolidation requirements for reporting entities with interests in legal entities that are required to comply with or operate in accordance with requirements similar to those in Rule 2a-7 of the Investment Company Act of 1940 for registered money market funds.

What are the key changes in the ASU versus existing GAAP?

1. Under the amendments in the ASU, all reporting entities are within the scope of ASC 810-10, *Consolidation—Overall*, including limited partnerships and similar legal entities, unless a scope exception applies.

2. The presumption that a general partner controls a limited partnership has been eliminated.

3. Fees paid to decision makers that meet three conditions no longer cause decision makers to consolidate VIEs.

4. The amendments in the ASU reduce the extent to which related-party arrangements cause an entity to be considered a primary beneficiary, under the VIE model rules.

5. The indefinite deferral of Statement 167 for certain investment funds has been eliminated and a scope exception from ASC 810 has been added for reporting entities with interests in legal entities that are required to comply with or operate in accordance with requirements that are similar to those in Rule 2a-7 of the Investment Company Act of 1940 for registered money market funds.

Comparison of Consolidation Models Existing ASC 810 GAAP Versus Changes by ASU 2015-02 [General Rule: Consolidate if there is a controlling financial interest]	
Existing GAAP- ASC 810	**Changes to ASC 810 by ASU 2015-02**
Voting interest entity model: Consolidate based on ownership of more than 50% of voting shares	No change
VIE Model: Variable interest entities	Several changes involving: • Fees paid to decision makers and service providers • Determination of the primary beneficiary including related parties
Entities controlled by contract: Physician Practice Management Entities (PPME)	No change
General partner that controls a limited partnership	Changed under the voting interest entity model: • Presumption that GP consolidates LP is eliminated • Rules changes to provide that investor with majority of kick-out rights consolidates LP (voting interest entity model)
Miscellaneous transactions involving R&D arrangements and Rabbi Trusts	No change

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. If one entity has between 20-50% of the voting shares in another entity, what is the general accounting treatment for the investment:
   a. Consolidate the entities
   b. Investment recorded at cost
   c. Investment recorded at fair value
   d. Use the equity method

2. The general rule for consolidation of entities found in ASC 810, *Consolidation* (formerly ARB No. 51), is that consolidation occurs when:
   a. One entity manages, but does not own, another entity
   b. One entity directly or indirectly has a controlling financial interest in another entity
   c. One entity owns less than 50% of the voting shares of another entity
   d. There is an off-balance sheet entity

3. Under GAAP in effect prior to ASU 2015-02, a general partner who controls a limited partnership should account for the limited partnership using which of the following:
   a. By recording any investment that the GP has in the LP at amortized cost
   b. By recording any investment that the GP has in the LP at fair value
   c. By recording any investment that the GP has in the LP using the equity method
   d. By consolidating the LP into the GP's financial statements

4. Under which of the following situations would it make sense for an entity to combine financial statements with another entity:
   a. An entity owns none of another entity's voting stock. The entity has several different owners and no common ownership
   b. An entity owns more than 50% of another entity's voting stock
   c. An off-balance sheet entity is a VIE and meets certain criteria under FIN 46R
   d. Two entities under common control that do not meet the criteria for consolidation under FIN 46R

SUGGESTED SOLUTIONS

1. If one entity has between 20-50% of the voting shares in another entity, what is the general accounting treatment for the investment:
   a. Incorrect. Consolidation occurs if there is more than 50% of the voting shares in another entity.
   b. Incorrect. The cost method applies if one entity owns less than 20% of the voting shares in another entity and the investment is a non-security.
   c. Incorrect. The fair value method may be applied if one entity owns less than 20% of the voting shares in another entity and the investment is a security. Fair value does not apply if ownership of voting equity exceeds 50 percent.
   d. **Correct. If one entity owns between 20-50% of the voting shares or where one entity has significant influence over another, the accounting treatment for the investment generally is to use the equity method. Significant influence is assumed at between 20 percent and 50 percent ownership.**

2. The general rule for consolidation of entities found in ASC 810 (formerly ARB No. 51), is that consolidation occurs when:
   a. Incorrect. With respect to an entity that manages, but did not own, another entity, consolidation is unlikely unless that entity has a controlling financial interest in the other entity.
   b. **Correct. The general rule for consolidation of entities found in ASC 810, is that consolidation occurs when one entity directly or indirectly has a controlling financial interest in another entity.**
   c. Incorrect. Although consolidation can occur at less than 50% ownership through one of the consolidation exceptions, the general rule does not state that consolidation occurs at less than 50% ownership.
   d. Incorrect. Under the VIE rules, consolidation can occur with respect to an off-balance sheet entity but that entity must first be a variable interest entity (VIE).

3. Under GAAP in effect prior to ASU 2015-02, a general partner who controls a limited partnership should account for the limited partnership using which of the following:
   a. Incorrect. The cost method does not apply to the GP's investment in situations in which the GP controls the LP.
   b. Incorrect. When a GP controls an LP, recording the fair value is not appropriate making the answer incorrect.
   c. Incorrect. The equity method is not appropriate when a GP controls an LP, making the statement incorrect.
   d. Correct. Existing GAAP provides that when a GP controls an LP, the GP should consolidate the LP, regardless of ownership percentage.

4. Under which of the following situations would it make sense for an entity to combine financial statements with another entity:
   a. Incorrect. An entity that owns less than 20% of another entity's voting stock records the investment at cost or fair value. Because there is no common ownership, it is unlikely that combining financial statements would be meaningful.
   b. Incorrect. An entity that owns more than 50% of another entity's voting stock is required to consolidate and does not have the option to combine financial statements.
   c. Incorrect. An off-balance sheet entity that is a VIE and meets certain criteria to consolidate under FIN 46R is required to consolidate. Therefore, combining financial statements is not an option.
   d. Correct. Two entities with common ownership that do not meet the criteria for consolidation may elect to issue combined financial statements even though such combining is never required. The issue is whether combining is meaningful.

III. Definitions

ASU 2015-02 adds the following definitions to the Master Glossary in ASC 810, *Consolidations.*

Kick-Out Rights (VIE Definition): The ability to remove the entity with the power to direct the activities of a VIE that most significantly impact the VIE's economic performance or to dissolve (liquidate) the VIE without cause.

Kick-Out Rights (Voting Interest Entity Definition): The rights underlying the limited partner's or partners' ability to dissolve (liquidate) the limited partnership or otherwise remove the general partners without cause.

Participating Rights (VIE Definition): The ability to block or participate in the actions through which an entity exercises the power to direct the activities of a VIE that most significantly impact the VIE's economic performance. Participating rights do not require the holders of such rights to have the ability to initiate actions.

Participating Rights (Voting Interest Entity Definition): Participating rights allow the limited partners or non-controlling shareholders to block or participate in certain significant financial and operating decisions of the limited partnership or corporation that are made in the ordinary course of business. Participating rights do not require the holders of such rights to have the ability to initiate actions.

Protective Rights (VIE Definition): Rights designed to protect the interests of the party holding those rights without giving that party a controlling financial interest in the entity to which they relate. For example, they include any of the following:

a. Approval or veto rights granted to other parties that do not affect the activities that most significantly impact the entity's economic performance. Protective rights often apply to fundamental changes in the activities of an entity or apply only in exceptional circumstances.

   Examples include both of the following:

   1) A lender might have rights that protect the lender from the risk that the entity will change its activities to the detriment of the lender, such as selling important assets or undertaking activities that change the credit risk of the entity.

   2) Other interests might have the right to approve a capital expenditure greater than a particular amount or the right to approve the issuance of equity or debt instruments.

b. The ability to remove the reporting entity that has a controlling financial interest in the entity in circumstances such as bankruptcy or on breach of contract by that reporting entity.

c. Limitations on the operating activities of an entity. For example, a franchise agreement for which the entity is the franchisee might restrict certain activities of the entity but may not give the franchisor a controlling financial interest in the franchisee. Such rights may only protect the brand of the franchisor.

Protective Rights (Voting Interest Entity Definition): Rights that are only protective in nature and that do not allow the limited partners or non-controlling shareholders to participate in significant financial and operating decisions of the limited partnership or corporation that are made in the ordinary course of business.

Decision Maker: An entity or entities with the power to direct the activities of another legal entity that most significantly impact the legal entity's economic performance according to the provisions of the Variable Interest Entities Subsections of Subtopic 810-10.

Decision-Making Authority: The power to direct the activities of a legal entity that most significantly impact the entity's economic performance according to the provisions of the Variable Interest Entities Subsections of Subtopic 810-10.

Ordinary Course of Business: Decisions about matters of a type consistent with those normally expected to be addressed in directing and carrying out current business activities, regardless of whether the events or transactions that would necessitate such decisions are expected to occur in the near term. However, it must be at least reasonably possible that those events or transactions that would necessitate such decisions will occur. The ordinary course of business does not include self-dealing transactions.

With Cause: With cause generally restricts the limited partners' ability to dissolve (liquidate) the limited partnership or remove the general partners in situations that include, but that are not limited to, fraud, illegal acts, gross negligence, and bankruptcy of the general partners.

Without Cause: Without cause means that no reason need be given for the dissolution (liquidation) of the limited partnership or removal of the general partners.

IV. Rules

1. The general rule is that consolidation is required when one entity has a *controlling financing interest* in another entity.

2. There are *two primary models* for determining whether one entity has a controlling financing interest in another entity:

   a. The voting interest entity model (more than 50% ownership in voting shares)
   b. The variable interest entity (VIE) model.

Also, additional analysis is required for consolidation of entities controlled by contract, and a carve out exception for R&D and miscellaneous other activities, which is applicable to entities that are not VIEs.

To review, the general rule in consolidation is this:

A reporting entity (the one issuing the financial statements) consolidates another entity if the reporting entity has a controlling financial interest in the other entity.

Voting interest entity model:

Under the voting interest entity model:

a. For legal entities ***other than limited partnerships,*** the usual condition for a controlling financial interest is ownership by one reporting entity, directly or indirectly, of more *than 50 percent of the outstanding voting shares of another entity.*

b. *For limited partnerships*: The usual condition for a controlling financial interest is ownership by one limited partner, directly or indirectly, of more than 50 percent of the limited partnership's kick-out rights through voting interests.

   1) **Exception:** If noncontrolling shareholders or limited partners have *substantive participating rights*, the majority shareholder or limited partner with a majority of kick-out rights through voting interests does not have a controlling financial interest and would not consolidate the limited partnership.

VIE model:

Under the VIE model:

a. FIN 46R uses the following terms that are used throughout this chapter:

   Variable interest entity (VIE): An entity is considered a VIE if, by design, it has *one or both* of the following *two conditions:*

1) The total equity investment at risk is not sufficient to permit it to finance its activities without obtaining additional subordinated financial support provided by any parties (e.g., individual or entity), including equity holders.

2) As a group, the holders of equity investments at risk *lack any one* of the following three characteristics:

   a) Lack the *power* through voting rights or similar rights to *direct* the entity's activities that most significantly impact the entity's economic performance.

   b) Lack the *obligation to absorb the expected losses* of the entity.

   c) Lack the *right to receive* *expected residual returns* of the entity.

Variable interest (VI): A form of financial support given by one entity or individual to a VIE in the form of a guarantee, loan, certain lease payments, certain management fees, etc.

Primary beneficiary (PB): The entity or individual that has a controlling financial interest in a VIE by having a) the power to direct the VIE's significant activities, and b) the obligation to absorb the VIE's losses and right to receive the VIE's benefits that are significant to the VIE. If the primary beneficiary is an entity, it consolidates the VIE, while if it is an individual, it does not consolidate the VIE.

b. In the VIE model, a controlling financial interest is assessed differently than under the voting interest entity model.

   1) This difference in assessment is required because a controlling financial interest may be achieved *other than by ownership of shares or voting interests*.

   2) Under the VIE model, a controlling financial interest requires a reporting entity to have *both of the following* with respect to a VIE:

      a) Power criterion: The power to direct the activities that most significantly impact the VIE's economic performance, and

      b) Economic criterion: The obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE.

c. A reporting entity with a controlling financial interest in a VIE is referred to as *the primary beneficiary.*

Note: The reporting entity could be, but is not limited to being, an equity investor, some other capital provider such as a debt holder, or a party with another contractual arrangement such as a guarantor. This model applies to all types of legal entities.

d. To determine which accounting model applies (voting interest or VIE model) and which reporting entity, if any, must consolidate a particular legal entity (VIE), after a reporting entity determines that it has a variable interest, it must determine whether the legal entity is a VIE.

3. Key Changes Made by ASU 2015-02:

ASU 2015-02 amends ASC 810, Consolidations to reflect five key changes discussed further on in this chapter, as follows:

1. Limited partnerships and similar legal entities
2. Evaluating fees paid to a decision maker or a service provider as a variable interest
3. The effect of fee arrangements on the primary beneficiary determination
4. The effect of related parties on the primary beneficiary determination
5. Certain investment funds

CHANGE 1: Limited Partnership Interests and Similar Legal Entities

EXISTING GAAP RULES:

a. A general partner that controls a limited partnership consolidates the partnership into its financial statements.

b. There is a presumption that general partners *control* a limited partnership regardless of the extent of the general partners' ownership interest in the limited partnership.

c. The presumption that general partners control a partnership is overcome (the general partners *do not control* the limited partnership) if the limited partners have either:

1) *Substantive kick-out rights*: The substantive ability to dissolve (liquidate) the limited partnership or otherwise remove the general partners without cause, or

2) *Substantive participating rights*: The ability to effectively participate in certain actions of the limited partnership.

NEW RULES PER ASU 2015-02:

1. The ASU changes three main provisions that affect the consolidation of limited partnerships and similar legal entities:

   a. There is an additional requirement that limited partnerships and similar legal entities must meet to use the voting interest entity model.

      - A limited partnership must provide partners with *either* substantive kick-out rights *or* substantive participating rights over the general partner to qualify for the voting interest entity model.

   b. The specialized consolidation model and guidance for limited partnerships and similar legal entities has been eliminated.

      - The ASU eliminates the presumption that a general partner should consolidate a limited partnership.

      - In most instances, a general partner will not consolidate a limited partnership.

      - Under the new rules, a limited partnership is evaluated for consolidation using either the *voting interest entity model* or *the VIE model*.

   c. For limited partnerships and similar legal entities that qualify as voting interest entities, a limited partner with a controlling financial interest should consolidate a limited partnership.

      - A single limited partner has a controlling financial interest if it holds a limited partner interest that provides *more than 50% of the substantive kick-out rights*.

2. **Definition:**

   a. Limited partnership, as used in ASC 810, includes limited partnerships and *similar legal entities*.

   Note: A *similar legal entity* is an entity (such as a limited liability company) that has governing provisions that are the functional equivalent of a limited partnership. In such entities, a managing member is the functional equivalent of a general partner, and a nonmanaging member is the functional equivalent of a limited partner.

   The terms *limited partner* and *general partner* refer to one or more limited or general partners.

3. The ASU amends ASC 810 to eliminate *a presumption that a general partner should consolidate a limited partnership*.

a. Under the ASU, consolidation of a limited partnership occurs only if the new rules found in the ASU are met.

4. General rule for consolidation of a limited partnership

Voting interest entity model:

a. To be evaluated for consolidation under the voting interest entity model, the limited partnership must give its limited partners *substantive kick-out rights* or *substantive participating rights* over the general partner.

   Note: If a limited partnership *does not* give its limited partners substantive kick-out rights or substantive participating rights, the limited partnership is evaluated for consolidation using the VIE model (discussed below)

b. In a limited partnership, *kick-out rights,* through voting interests, are the same as voting rights held by shareholders of a corporation.

c. Under the voting interest entity model, a *single limited partner consolidates a limited partnership* if:

   - The single limited partner holds a controlling financial interest by holding *more than 50% of the limited partnership's kick-out rights* through voting interests,

   - The kick-out rights must be *substantive*, and

   - Noncontrolling limited partners *must not* have *substantive participating rights* that block the single limited partner's kick-out rights.

     Substantive participating rights: The ability to effectively participate in certain actions of the limited partnership.

   Note: In measuring whether a single limited partner holds more than 50% of the kick-out rights, the kick-out rights held by general partners through voting interests are ignored.

d. Under the new ASU rules, a general partner no longer consolidates the limited partnership under the voting interest entity model.

e. Under the voting interest entity model, the limited partnership cannot be a VIE. If it is a VIE, the limited partnership is evaluated for being consolidated using the VIE model, and not the voting interest entity model.

f. *Kick-Out Rights* are defined as the rights underlying the limited partners' ability to:

- Dissolve (liquidate) the limited partnership, or
- Remove the general partners without cause.

Kick-Out Rights

a. For limited partnerships, the determination of whether kick-out rights are *substantive* shall be based on a consideration of all relevant facts and circumstances.

1) For kick-out rights to be considered *substantive*, the limited partners holding the kick-out rights must have the ability to exercise those rights if they choose to do so; that is, there are *no significant barriers* to the exercise of the rights to:

- Dissolve (liquidate) the limited partnership, or
- Remove the general partners without cause.

b. Barriers that may make kick-out rights *less substantive* include the following:

1) Kick-out rights subject to conditions that make it unlikely they will be exercisable, for example, conditions that narrowly limit the timing of the exercise

2) Financial penalties or operational barriers associated with dissolving (liquidating) the limited partnership or replacing the general partners that would act as a significant disincentive for dissolution (liquidation) or removal

3) The absence of an adequate number of qualified replacement general partners or the lack of adequate compensation to attract a qualified replacement

4) The absence of an explicit, reasonable mechanism in the limited partnership's governing documents or in the applicable laws or regulations, by which the limited partners holding the rights can call for and conduct a vote to exercise those rights

5) The inability of the limited partners holding the rights to obtain the information necessary to exercise them.

c. *Withdrawal right*: The limited partners' unilateral right to withdraw from the partnership in whole or in part (withdrawal right) that does not require dissolution or liquidation of the entire limited partnership *would not be deemed a kick-out right*.

1) The requirement to dissolve or liquidate the entire limited partnership upon the withdrawal of a limited partner shall not be required to be contractual for a withdrawal right to be considered as a potential kick-out right.

d. *Rights to remove general partners and management:*

1) Rights held by limited partners to remove the general partner(s) from the partnership shall be evaluated as kick-out rights based on the requirements of (b)(1) through (5) above.

2) Rights of the limited partners to participate in the *termination of management* (for example, management is outsourced to a party other than the general partner) or the individual members of management of the limited partnership may be substantive participating rights.

VIE Model:

a. A limited partnership is evaluated for consolidation under the VIE model (and not the voting interest entity model) if it does not qualify for the voting interest entity model because it is a VIE.

b. An LP entity is considered a VIE if, by design, it has *one or both* of the following *two conditions:*

1) The total equity investment at risk is not sufficient to permit it to finance its activities without obtaining additional subordinated financial support provided by any parties (e.g., individual or entity), including equity holders, or

2) As a group, the holders of equity investments at risk lack any one of the following three characteristics:

a) Lack the *power* through voting rights or similar rights to *direct* the entity's activities that most significantly impact the entity's economic performance.

b) Lack the *obligation to absorb the expected losses* of the entity.

c) Lack the *right to receive expected residual returns* of the entity.

c. A limited partnership is a VIE and is tested for consolidation under the VIE model if the limited partnership *does not provide to its limited partners*:

- Substantive kick-out rights, or
- Substantive participating rights

Note: If a limited partnership does not provide its limited partners with substantive kick-out rights or substantive participating rights, then the holders of equity investments (LPs) lack the power to direct the LP's activities (requirement (b)(2)(a) above) and the LP is a VIE.

d. Under the VIE model, the party that consolidates the limited partnership is called the primary beneficiary, which is the party that has a controlling financial interest in the limited partnership through *both of the following*:

   1) The power to direct the activities that most significantly impact the limited partnership's (VIE's) economic performance, and

   2) The obligation to absorb losses of the limited partnership (VIE) that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE.

e. Under the VIE model, a general partner might be considered the primary beneficiary that consolidates the limited partnership (VIE). Under the voting interest model, the GP would not consolidate an LP unless the GP owns more than 50% of the kick-out rights through ownership of the LP interest.

5. Effect of noncontrolling rights on consolidation of limited partnerships

a. In some instances, the powers of a limited partner with a majority of kick-out rights through voting interests to control the operations or assets of the investee *are restricted* in certain respects by approval or veto rights granted to a limited partner (referred to as *noncontrolling rights*).

b. The guidance in this section on noncontrolling rights *does not apply* in either of the following situations:

   1) Entities that, in accordance with GAAP, carry substantially all of their assets, including investments in controlled entities, at *fair value* with changes in value reported in a statement of net income or financial performance, or

   2) Investments in variable interest entities (VIEs).

c. The assessment of whether the rights of a noncontrolling limited partner should overcome the presumption of consolidation by the limited partner with a majority of kick-out rights in its investee is a matter of judgment that depends on facts and circumstances.

1) The determination is based on whether the noncontrolling rights, individually or in the aggregate, allow the noncontrolling limited partner to *effectively participate* in *certain significant financial and operating decisions of the investee* that are made in the *ordinary course of business*.

Effective participation means the ability to *block significant decisions* proposed by the investor who has a majority voting interest or the general partner.

Note: When a noncontrolling limited partner has effective participation, control does not rest with the majority owner because the investor with the majority voting interest *cannot cause the investee to take an action that is significant* in the ordinary course of business if it has been vetoed by the noncontrolling shareholder.

2) For limited partnerships, control *does not rest* with the limited partner with the majority of kick-out rights if the *limited partner cannot cause the general partner to take an action that is significant in the ordinary course of business* if it has been vetoed by other limited partners.

Note: This assessment of noncontrolling rights shall be made at the time a majority of kick-out rights through voting interests is obtained and shall be reassessed if there is a significant change to the terms or in the exercisability of the rights of the noncontrolling limited partner.

d. All noncontrolling rights may be described as *protective* of the noncontrolling limited partner's investment in the investee.

1) Some noncontrolling rights allow the noncontrolling limited partner to participate in determining certain significant financial and operating decisions of the investee that are made in the ordinary course of business (referred to as participating rights).

Note: Participation means the ability to block actions proposed by the investor that has a majority voting interest or the general partner. Thus, the investor with the majority voting interest or the general partner must have the agreement of the noncontrolling shareholder or limited partner to take certain actions. Participation does not mean the ability of the limited partner to initiate actions.

2) *Protective rights*: Noncontrolling rights that are *only protective* in nature (protective rights) would not overcome the presumption that the limited partner with a majority of kick-out rights through voting interests shall consolidate its investee.

e. Substantive noncontrolling rights that allow the noncontrolling limited partner to effectively *participate in certain significant financial and operating decisions of the investee that are made in the investee's ordinary course of business*, (although also protective of the noncontrolling shareholder's or limited partner's investment), *shall overcome* the presumption that the investor with a majority voting interest or limited partner with a majority of kick-out rights through voting interests shall consolidate its investee.

1) Decisions made in the ordinary course of business are defined as:

> *"Decisions about matters of a type consistent with those normally expected to be addressed in directing and carrying out the entity's current business activities, regardless of whether the events or transactions that would necessitate such decisions are expected to occur in the near term."*

Note: It must be at least reasonably possible that those events or transactions that would necessitate such decisions will occur. The ordinary course of business definition would not include self-dealing transactions with controlling limited partners.

f. An entity that is not controlled by a limited partner who holds the majority of kick-out rights because of noncontrolling limited partner veto rights (through participating rights) is not a VIE if the partners as a group (the holders of the equity investment at risk) have the power to control the entity and the equity investment meets the other requirements.

g. The following guidance addresses considerations of noncontrolling limited partner rights, specifically:

1) Protective rights
2) Participating rights
3) Factors to consider in evaluating whether noncontrolling rights are substantive participating rights.

Protective Rights

Noncontrolling rights (whether granted by contract or by law) that would allow the noncontrolling limited partner to *block partnership actions* would be considered *protective rights and would not overcome* the presumption of consolidation by the limited partner with a majority of kick-out rights through voting interests in its investee.

The following list is illustrative of the protective rights that often are provided to the noncontrolling shareholder or limited partner, but is not all-inclusive:

a. Amendments to articles of incorporation or partnership agreements of the investee

b. Pricing on transactions between the owner of a majority voting interest or limited partner with a majority of kick-out rights through voting interests and the investee and related self-dealing transactions

c. Liquidation of the investee in the context of ASC 852 on reorganizations or a decision to cause the investee to enter bankruptcy or other receivership

d. Acquisitions and dispositions of assets that are not expected to be undertaken in the ordinary course of business (noncontrolling rights) relating to acquisitions and dispositions of assets that are expected to be made in the ordinary course of business are participating rights; determining whether such rights are substantive requires judgment in light of the relevant facts and circumstances

e. Issuance or repurchase of equity interests.

Participating Rights

Participating rights held by a noncontrolling limited partner may overcome the limited partner with the majority of kick-out rights ability to consolidate the limited partnership, depending on whether such rights are substantive or not.

> *Substantive participating rights*: Overcome the presumption that the limited partner with the majority of kick-out rights shall consolidate the limited partnership.
>
> *Non-substantive participating rights*: Do not overcome the presumption that the limited partner with the majority of kick-out rights shall consolidate the limited partnership.

1. Substantive participating rights: Noncontrolling rights (whether granted by contract or by law) that would allow the noncontrolling limited partner to effectively participate in either of the following partnership actions shall be considered *substantive participating rights* and *would overcome the presumption* that the limited partner with a majority of kick-out rights through voting interests shall consolidate its investee.

The following list is illustrative of *substantive participating rights*, but is not necessarily all-inclusive:

a. Selecting, terminating, and setting the compensation of management responsible for implementing the investee's policies and procedures

b. Establishing operating and capital decisions of the investee, including budgets, in the ordinary course of business.

Note: The rights noted above in (a) and (b) are participating rights because, in the aggregate, the rights allow the noncontrolling limited partner to effectively participate in certain significant financial and operating decisions that occur as part of the ordinary course of the investee's business and are significant factors in directing and carrying out the activities of the business. Individual rights, such as the right to veto the termination of management responsible for implementing the investee's policies and procedures, should be assessed based on the facts and circumstances to determine if they are substantive participating rights in and of themselves.

The likelihood that the veto right will be exercised by the noncontrolling limited partner should not be considered when assessing whether a noncontrolling right is a substantive participating right.

2. *Non-substantive participating rights*: Noncontrolling rights that appear to be participating rights but that by themselves are *not substantive* would *not overcome the presumption* of consolidation by the investor with a limited partner with a majority of kick-out rights through voting interests in its investee.

Factors to Consider in Evaluating Whether There Are Substantive Participating Rights

The following factors shall be considered in evaluating whether noncontrolling rights that appear to be participating are *substantive participating rights*, and therefore, whether these factors provide for effective participation in certain significant financial and operating decisions that are made in the investee's ordinary course of business:

a. Consideration shall be given to situations in which a limited partner with a majority of kick-out rights through voting interests owns such a significant portion of the investee that the noncontrolling limited partner has a small economic interest.

   Note: As the disparity between the limited partner with a majority of kick-out rights through voting interests and noncontrolling limited partners increases, the rights of the noncontrolling limited partner are presumptively more likely to be protective rights and shall raise the level of skepticism about the substance of the right.

   Similarly, although a majority owner is presumed to control an investee, the level of skepticism about such ability shall increase as the limited partner's economic interest in the investee decreases.

b. The governing documents shall be considered to determine at what level decisions are made, whether at the limited partner level or at the board level, and the rights at each level also shall be considered.

   Note: In all situations, any matters that can be put to a vote of the limited partners shall be considered to determine if other investors, individually or in the aggregate, have substantive participating rights by virtue of their ability to vote on matters submitted to a limited partner vote.

c. Relationships between the majority and noncontrolling partners (other than an investment in the common investee) that are of a related-party nature, as defined in ASC 850, shall be considered in determining whether the participating rights of the noncontrolling limited partner are substantive.

   Note: One example is if the noncontrolling limited partner in an investee is a member of the immediate family of the majority shareholder, general partner, or limited partner with a majority of kick-out rights through voting interests of the investee, then the rights of the noncontrolling limited partner likely would not overcome the presumption of consolidation by the limited partner with a majority of kick-out rights through voting interests in its investee.

d. Certain noncontrolling rights may deal with operating or capital decisions that are not significant to the ordinary course of business of the investee.

Note: Noncontrolling rights related to decisions that are not considered significant for directing and carrying out the activities of the investee's business are not substantive participating rights and would not overcome the presumption of consolidation by the limited partner with a majority of kick-out rights through voting interests in its investee.

Examples of such noncontrolling rights include all of the following:

- Location of the investee's headquarters
- Name of the investee
- Selection of auditors
- Selection of accounting principles for purposes of separate reporting of the investee's operations.

e. Certain noncontrolling rights may provide for the noncontrolling limited partner to participate in certain significant financial and operating decisions that are made in the investee's ordinary course of business; however, the existence of such noncontrolling rights shall not overcome the presumption that the majority owner shall consolidate, if it is remote that the event or transaction that requires noncontrolling limited partner approval will occur. Remote is defined in ASC 450, *Contingencies*, as the *chance of the future event or events occurring being slight.*

f. A limited partner with a majority of kick-out rights who has a contractual right to buy out the interest of the noncontrolling limited partner in the investee for fair value or less shall consider the feasibility of exercising that contractual right when determining if the participating rights of the noncontrolling limited partner are substantive.

1) If such a buyout is prudent, feasible, and substantially within the control of the majority owner, the contractual right to buy out the noncontrolling limited partner demonstrates that the participating right of the noncontrolling limited partner is not a substantive right.

Note: The existence of such call options negates the participating rights of the noncontrolling limited partner to veto an action of the majority general partner, rather than create an additional ownership interest for that majority shareholder. It would not be prudent, feasible, and substantially within the control of the majority owner to buy out the noncontrolling limited partner if, for example, *either* of the following conditions exists:

- The noncontrolling limited partner controls technology that is critical to the investee.

- The noncontrolling limited partner is the principal source of funding for the investee.

Examples of Assessing Individual Noncontrolling Rights-Participating or Protective Rights

An assessment is relevant for determining whether noncontrolling rights overcome the presumption of control by the limited partner with a majority of kick-out rights.

Although the following examples illustrate the assessment of participating rights or protective rights the evaluation should consider all factors to determine whether the noncontrolling rights, individually or in the aggregate, provide for the holders of those rights to effectively participate in certain significant financial and operating decisions that are made in the ordinary course of business:

a. The rights of the noncontrolling limited partner relating to the approval of acquisitions and dispositions of assets that are expected to be undertaken in the ordinary course of business may be *substantive participating rights*.

    1) Rights related only to acquisitions that are not expected to be undertaken in the ordinary course of the investee's existing business usually are *protective* and would not overcome the presumption of consolidation by the investor with a limited partner with a majority of kick-out rights through voting interests in its investee.

    2) Whether a right to approve the acquisition or disposition of assets is in the ordinary course of business should be based on an evaluation of the relevant facts and circumstances. In addition, if approval by the limited partner is necessary to incur additional indebtedness to finance an acquisition that is not in the investee's ordinary course of business, then the approval by the noncontrolling limited partner would be considered a protective right.

b. Existing facts and circumstances should be considered in assessing whether the rights of the noncontrolling limited partner relating to an investee's incurring additional indebtedness are protective or participating rights.

    1) If is reasonably possible or probable that the investee will need to incur the level of borrowings that requires noncontrolling limited partner approval in its ordinary course of business, the rights of the noncontrolling limited partner would be viewed as substantive participating rights.

c. The rights of the noncontrolling limited partner relating to dividends or other distributions may be protective or participating and should be assessed in light of the available facts and circumstances.

    1) Rights to block customary or expected dividends or other distributions may be substantive participating rights, while rights to block extraordinary distributions would be protective rights.

d. The rights of the noncontrolling shareholder or limited partner relating to an investee's specific action (such as leasing property) in an existing business may be protective or participating and should be assessed in light of the available facts and circumstances.

    1) For example, if the investee had the ability to purchase, rather than lease, the property without requiring the approval of the noncontrolling shareholder or limited partner, then the rights of the noncontrolling shareholder or limited partner to block the investee from entering into a lease would not be substantive.

e. The rights of the noncontrolling limited partner relating to an investee's negotiation of collective bargaining agreements with unions may be protective or participating and should be assessed in light of the available facts and circumstances.

    1) If an investee does not have a collective bargaining agreement with a union or if the union does not represent a substantial portion of the investee's work force, then the rights of the noncontrolling limited partner to approve or veto a new or broader collective bargaining agreement are not substantive.

f. Provisions that govern what will occur if the noncontrolling limited partner blocks the action of an owner of a majority voting interest or general partner need to be considered to determine whether the right of the noncontrolling limited partner to block the action has substance.

    1) If the partnership agreement provides that if the noncontrolling limited partner blocks the approval of an operating budget, then the budget simply defaults to last year's budget adjusted for inflation, and if the investee is a mature business for which year-to-year operating budgets would not be expected to vary significantly, then the rights of the noncontrolling limited partner to block the approval of the operating budget do not allow the noncontrolling limited partner to effectively participate and are not substantive.

g. Noncontrolling rights relating to the initiation or resolution of a lawsuit may be considered protective or participating depending on the available facts and circumstances.

   1) If lawsuits are a part of the entity's ordinary course of business, as is the case for some patent-holding companies and other entities, then the noncontrolling rights may be considered substantive participating rights.

h. Veto rights:

   Example: A noncontrolling limited partner has the right to veto the annual operating budget for the first X years of the relationship.

   Conclusion: Based on the facts and circumstances, during the first X years of the relationship this right may be a substantive participating right. However, following Year X there is a significant change in the exercisability of the noncontrolling right (for example, the veto right terminates). As of the beginning of the period following Year X, that right would no longer be a substantive participating right and would not overcome the presumption of consolidation by the investor with a majority voting interest or limited partner with a majority of kick-out rights through voting interests in its investee.

Example 1: Two Limited Partners and General Partner

Facts:

- Company L is a limited partnership. There are two limited partners, with 60% and 40%, respectively, and one general partner.

- The GP holds *no interest* in the limited partnership.

- Under the partnership agreement, the limited partners have kick-out rights in terms of the right to terminate the general partner with a vote of more than 50% of the limited partner interests.

- The 40% LP does not have any substantive participating rights that can block the 60% limited partner from exercising its kick-out rights.

Conclusion: Because the limited partnership offers its limited partners with kick-out rights, L should be evaluated for consolidation using the *voting interest entity model*.

- Under this model, the LP that has, through voting interests, more *than 50% of the kick-out rights*, should consolidate the limited partnership.

- In this case, the 60% limited partner holds more than 50% of the kick-out rights through its voting interests.
- Further, there are no substantive participating rights held by the 40% partner that could block the 60% LP's kick-out rights.
- Therefore, the 60% LP should consolidate the limited partnership.

Example 2: Limited Partner and General Partner

Facts:

- Company L is a limited partnership.

- The 100% interest in the limited partnership is held as follows:

  80% held by one LP who is not related to the GP
  20% held by GP

- The general partner owns 20% of the equity of the limited partnership

- The limited partner has kick-out rights through voting interests, and a vote of a simple majority of the kick-out rights through voting interests to remove the general partner is required.

- There are no substantive participating rights

Conclusion:

- Because the LPs have kick-out rights, the limited partnership is evaluated for consolidation under the *voting interest entity model*.

- In evaluating whether the LPs have kick-out rights, the rights held by the GP are ignored.

- Because the single limited partner (exclusive of the limited interests held by the GP) holds more than 50% of the kick-out rights, and there are no substantive participating rights that block the kick-out rights, the 80% single limited partner should consolidate the LP.

- The GP does not consolidate the limited partnership. Under the voting interest entity model, in general, a GP does not consolidate a limited partnership.

Example 3: Four Equal Limited Partners

Facts:

- Company LP is a limited partnership.

- There are four independent limited partners that each own 10 percent of the equity of the limited partnership in the form of limited partnership voting interests.

- The general partner owns 60 percent of the equity of the limited partnership and *does not have* kick-out rights through voting interests.

- The limited partners have kick-out rights through voting interests, and a vote of a *simple majority of the kick-out rights* through voting interests to remove the general partner is required.

Conclusion:

- Because the partnership gives its limited partners kick-out rights, the LP is evaluated for consolidation using the voting interest entity model.

- Accordingly, no partner would be deemed to have a controlling financial interest in the limited partnership because *no single limited partner* owns a majority of the limited partnership's kick-out rights through voting interests.

- Therefore, *no partner consolidates the limited partnership*.

Example 4: No Kick-out Rights

Facts:

- Company L is a limited partnership with 4 independent limited partners (none of which have any relationship to the general partner) that each owns 20 percent of the equity of the limited partnership in the form of limited partnership voting interests.

- The general partner owns 20 percent of the equity of the limited partnership

- The limited partners have no kick-out rights and have no participating rights through voting interests

Conclusion:

- First, the limited partnership should be evaluated for consolidation using the *VIE model* because the limited partnership is a VIE.

Reviewing the VIE rules, one way in which an entity may be a VIE is if, as a group, the holders of equity investments at risk lack *any one* of the following three characteristics:

a. Lack the *power* through voting rights or similar rights to *direct* the VIE's activities that most significantly impact the VIE's economic performance.

b. Lack the *obligation to absorb the expected losses* of the VIE.

c. Lack the *right to receive expected residual returns* of the VIE.

In this example, the limited partners lack kick-out and participating rights. Therefore, the equity holders (limited partners, in this case) lack the power to direct the (VIE's) LP's activities.

Thus, the limited partnership is a VIE and should be evaluated for consolidation using the *VIE model*, not the voting interest entity model.

- Next, because the VIE model is used, an evaluation must be performed to determine who is the primary beneficiary that should consolidate the limited partnership.

- Under the VIE model, the party that consolidates the limited partnership is called the primary beneficiary, which is the party that has a controlling financial interest in the limited partnership through *both of the following*:

  a. The *power to direct the activities* that most significantly impact the limited partnership's (VIE's) economic performance, and

  b. The *obligation to absorb losses* of the limited partnership (VIE) that could potentially be significant to the VIE or the *right to receive benefits* from the VIE that could potentially be significant to the VIE.

- Based on the facts given, it would appear that the *GP is the primary beneficiary that should consolidate the limited partnership.* The GP has the power to direct the limited partnership's activities. Second, through its 20% interest in the limited partnership, the GP has the obligation to absorb losses or the right to receive benefits of the limited partnership.

Observation: Under the revised voting interest entity model in ASU 2015-02, a general partner will not consolidate a limited partnership because only the limited partner with the majority of kick-out rights would consolidate the partnership.

However, if the limited partnership is a VIE, the VIE model is used. Under the VIE model, the party that consolidates the limited partnership is the one with the:

a. The power to direct the limited partnership's (VIE's) activities that most significantly impact the limited partnership's (VIE's) economic performance, and

b. The obligation to absorb losses of the limited partnership (VIE) that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE.

Under this VIE model, in many cases, the general partner will meet the two criteria above and will consolidate the limited partnership.

CHANGE 2: Fees Paid to Decision Makers or Service Provider as a Variable Interest

EXISTING GAAP RULES:

Examples of fees paid to decision makers or service providers include those fees paid to:

- Asset managers
- Real-estate property managers
- Oil and gas operators, and
- Outsourced R&D providers

Under existing GAAP's VIE model for consolidation, contracts related to fees paid to a decision maker or service provider, such as management or service fees, are generally *not variable interests* if *all six conditions* below are met:

1. The fees are compensation for services provided and are *commensurate with the level of effort required to provide those services* (e.g., the fees are at an arms-length rate).

2. Substantially all of the fees are at or above the same level of seniority as other operating liabilities of the entity that arise in the normal course of the entity's activities, such as trade payables.

3. The decision maker or service provider, if any, *does not hold other interests* in the variable interest entity that individually, or in the aggregate, would absorb more than an insignificant amount of the entity's expected losses or receive more than an insignificant amount of the entity's expected residual returns.

4. The service arrangement includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length.

5. The total amount of anticipated fees are insignificant relative to the total amount of the variable interest entity's anticipated economic performance.

6. The anticipated fees are expected to absorb an insignificant amount of the variability associated with the entity's anticipated economic performance.

Fees paid to decision makers or service providers that meet all of the above conditions (1-6) are not considered variable interests. Therefore, if the decision maker or service provider has no variable interest in the VIE, the decision maker or service provider will not consolidate the VIE.

If not all of the six conditions are met, the fees are a variable interest and the fee provider (reporting enterprise) must determine if it is a primary beneficiary that consolidates a VIE.

NEW RULES PER ASU 2015-02:

ASU 2015-02 changes existing GAAP as follows:

1. The ASU *eliminates three of the six conditions* for evaluating whether a fee paid to a decision maker or a service provider represents a variable interest.

   Fees paid to a legal entity's decision maker(s) or service provider(s) are *not variable interests* if *all of the following three conditions are met*:

   a. The fees are compensation for services provided and are *commensurate* with the level of effort required to provide those services.

   b. The decision maker or service provider *does not hold other interests in the VIE* that individually, or in the aggregate, would absorb more than an insignificant amount of the VIE's expected losses or receive more than an insignificant amount of the VIE's expected residual returns.

   c. The service arrangement includes only terms, conditions, or amounts that are *customarily present* in arrangements for similar services negotiated at arm's length.

   Note: ASU 2015-02 reduces the conditions that must be met for fees not to be variable interests, from six to three.

2. Facts and circumstances should be considered when assessing the three conditions in paragraph (1) above.

a. An arrangement that is designed in a manner such that the fee is inconsistent with the decision maker's or service provider's role or the type of service would not meet those conditions.

b. To assess whether a fee meets the three conditions, a reporting entity may need to analyze similar arrangements among parties outside the relationship being evaluated.

c. A fee would not presumptively fail the three conditions if similar service arrangements did not exist in the following circumstances:

   1) The fee arrangement relates to a unique or new service.
   2) The fee arrangement reflects a change in what is considered customary for the services.

   Note: In addition, the magnitude of a fee, in isolation, would not cause an arrangement to fail the conditions.

3. If the decision maker or service provider (reporting entity) concludes that fees received represent a variable interest in a VIE (because all three of the conditions are not met), the reporting entity must evaluate whether it is the primary beneficiary that should consolidate the VIE.

   Under the VIE model, the decision maker or service provider would evaluate whether it is the primary beneficiary by evaluating whether it has:

   a. <u>Power criterion</u>: The power to direct the VIE's activities that most significantly impact the VIE's economic performance, and

   b. <u>Economic criterion</u>: The obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE.

4. Certain fees or payments in connection with agreements that expose a reporting entity (the decision maker or the service provider) to risk of loss in the VIE are variable interests in the VIE because it would not satisfy the three conditions in paragraph (1) above. Thus, in testing to determine if the decision maker or service provider is the primary beneficiary, the decision maker or service provider could satisfy the economic criterion by absorbing some of the VIE's losses.

   Such fees that may absorb some of the VIE's losses include, but are not limited to, the following:

   a. Those related to guarantees of the value of the assets or liabilities of a VIE

b. Obligations to fund operating losses
c. Payments associated with written put options on the assets of the VIE
d. Similar obligations, such as some liquidity commitments or agreements (explicit or implicit) that protect holders of other interests from suffering losses in the VIE.

5. For purposes of evaluating the three conditions in paragraph (1) above, any interest in an entity that is held by a related party of the decision maker or service provider should be considered in the analysis.

   a. A decision maker or service provider should include its direct economic interests in the entity and its indirect economic interests in the entity held through related parties, considered on a proportionate basis.

      1) Indirect interests held through related parties that are under common control with the decision maker should be considered the equivalent of direct interests in their entirety.

      Note: The term *related parties* includes those parties identified in ASC 850, *Related Party Disclosures,* and certain de facto agents or principals of the variable interest holder.

   b. The term *related parties* includes those parties identified in ASC 850 and certain other parties that are acting as de facto agents or de facto principals of the variable interest holder.

      All of the following are considered to be de facto agents of a reporting entity:

      1) A party that cannot finance its operations without subordinated financial support from the reporting entity, for example, another VIE of which the reporting entity is the primary beneficiary

      2) A party that received its interests as a contribution or a loan from the reporting entity

      3) An officer, employee, or member of the governing board of the reporting entity

      4) A party that has an agreement that it cannot sell, transfer, or encumber its interests in the VIE without the prior approval of the reporting entity. The right of prior approval creates a de facto agency relationship only if that right could constrain the other party's ability to manage the economic risks or realize the economic rewards from its interests in a VIE through the sale, transfer, or encumbrance of those interests.

However, a de facto agency relationship does not exist if both the reporting entity and the party have right of prior approval and the rights are based on mutually agreed terms by willing, independent parties.

5) A party that has a close business relationship like the relationship between a professional service provider and one of its significant clients.

Example 1:

[Source: ASU 2015-02, Case J: Investment Fund 1—Annual and Performance-Based Fees and Additional Interests, as modified by the author]

Facts:

- A fund manager (general partner) creates and sells partnership interests in an investment fund (limited partnership) to external investors (limited partners).

- The general partner is not liable for any losses beyond the interest that the general partner owns in the fund.

- The general partner has a 15% ownership interest in the LP.

- The general partner's 15% ownership interest in the fund is expected to absorb more than an insignificant amount of the fund's expected losses and receive more than an insignificant amount of the fund's expected residual returns.

- The individual limited partners do not hold any substantive rights (no kick-out or participating rights) that would affect the decision-making authority of the general partner, but they can redeem their interests within particular limits set forth by the fund.

The limited partners *do not* have either of the following abilities (e.g., no kick-out rights):

a. The ability to remove the general partner from its decision-making authority or to dissolve (liquidate) the fund without cause (as distinguished from with cause)

b. The ability to block or participate in certain significant financial and operating decisions of the limited partnership that are made in the ordinary course of business.

The limited partners also do not have the ability to direct the activities that most significantly impact the economic performance of the fund.

- Therefore, the limited partnership is a VIE because the limited partners do not have kick-out or participating rights. Thus, the limited partners *lack the power*, through voting rights or similar rights, to direct the activities of a legal entity that most significantly impact the entity's economic performance.

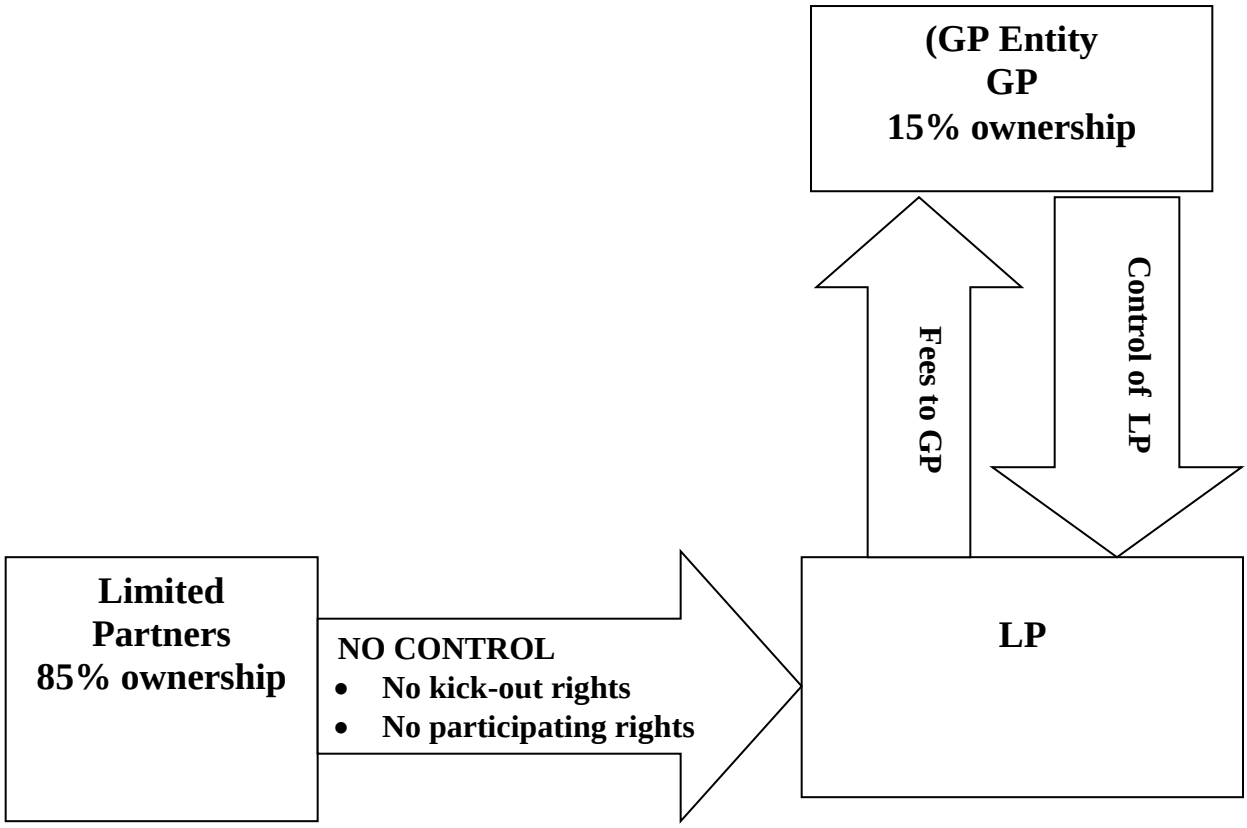
- The general partner is paid the following:

  - An annual fixed fee for the assets under management, and
  - A performance-based fee based on the fund's profits if it achieves a specified annual profit level.

  The annual and performance-based fees paid to the general partner are both of the following:

  a. Compensation for services provided and commensurate with the level of effort required to provide those services

  b. Part of a compensation arrangement that includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length.



Conclusion:

Under the ASU, fees paid to a legal entity's decision maker(s) or service provider(s) are *not variable interests* if *all of the following three conditions are met*:

a. The fees are compensation for services provided and are *commensurate* with the level of effort required to provide those services.

b. The decision maker or service provider *does not hold other interests in the VIE* that individually, or in the aggregate, would absorb more than an insignificant amount of the VIE's expected losses or receive more than an insignificant amount of the VIE's expected residual returns.

c. The service arrangement includes only terms, conditions, or amounts that are *customarily present* in arrangements for similar services negotiated at arm's length.

Based on an evaluation of the three conditions above, the fees paid to the general partner meet two of the three conditions as follows:

a. The fees are compensation for services provided and are *commensurate* with the level of effort required to provide those services. -**YES- GIVEN**

b. The decision maker or service provider *does not hold other interests in the VIE* that individually, or in the aggregate, would absorb more than an insignificant amount of the VIE's expected losses or receive more than an insignificant amount of the VIE's expected residual returns. **NO- GP HOLDS 15% OF LP INTEREST**

c. The service arrangement includes only terms, conditions, or amounts that are *customarily present* in arrangements for similar services negotiated at arm's length. **YES- GIVEN**

The general partner and the limited partners are the variable interest holders in the VIE.

The fees paid to the general partner (in its role as fund manager) represent a variable interest because the fees paid to the GP fails one of the three conditions ((b) above), because of the general partner holding ownership interests that are expected to absorb more than an insignificant amount of the fund's expected losses and receive more than an insignificant amount of the fund's expected residual returns.

If the general partner was only receiving fees and did not hold ownership interests and if its related parties did not hold any variable interests in the VIE, then the fees would not be a variable interest.

Next, the GP has to test to determine whether it is the primary beneficiary that consolidates the LP.

Under the VIE model, the decision maker (GP in this case) would evaluate whether it is the entity that has:

a. Power criterion: The power to direct the VIE's activities that most significantly impact the VIE's economic performance, and

b. Economic criterion: The obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE.

As to the *power criterion*, the GP must identify which activities of the LP most significantly impact the VIE's (LP's) economic performance and determine whether the GP has the power to direct those activities.

- The activities that most significantly impact the VIE's economic performance are the activities that significantly impact the performance of the managed securities portfolio.

- The general partner manages the operations of the VIE. Specifically, the general partner establishes the terms of the VIE, approves the assets to be purchased and sold by the VIE, and administers the VIE by monitoring the assets and ensuring compliance with the VIE's investment policies.

- The limited partners of the VIE have no voting rights and no other rights that provide them with the power to direct the activities that most significantly impact the VIE's economic performance.

Thus, it is apparent that the GP satisfies the power criterion.

Next, the GP must determine whether it satisfies the economic criterion. by having the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE.

The annual and performance based fees paid to the general partner are both of the following:

1. Compensation for services provided and commensurate with the level of effort required to provide those services

2. Part of a compensation arrangement that includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length.

The general partner, through its investment in the fund, has the obligation to absorb losses of the VIE that could potentially be significant to the VIE and the right to receive benefits from the VIE that could potentially be significant to the VIE.

On the basis of the specific facts and circumstances presented, the GP would be the primary beneficiary of the VIE because:

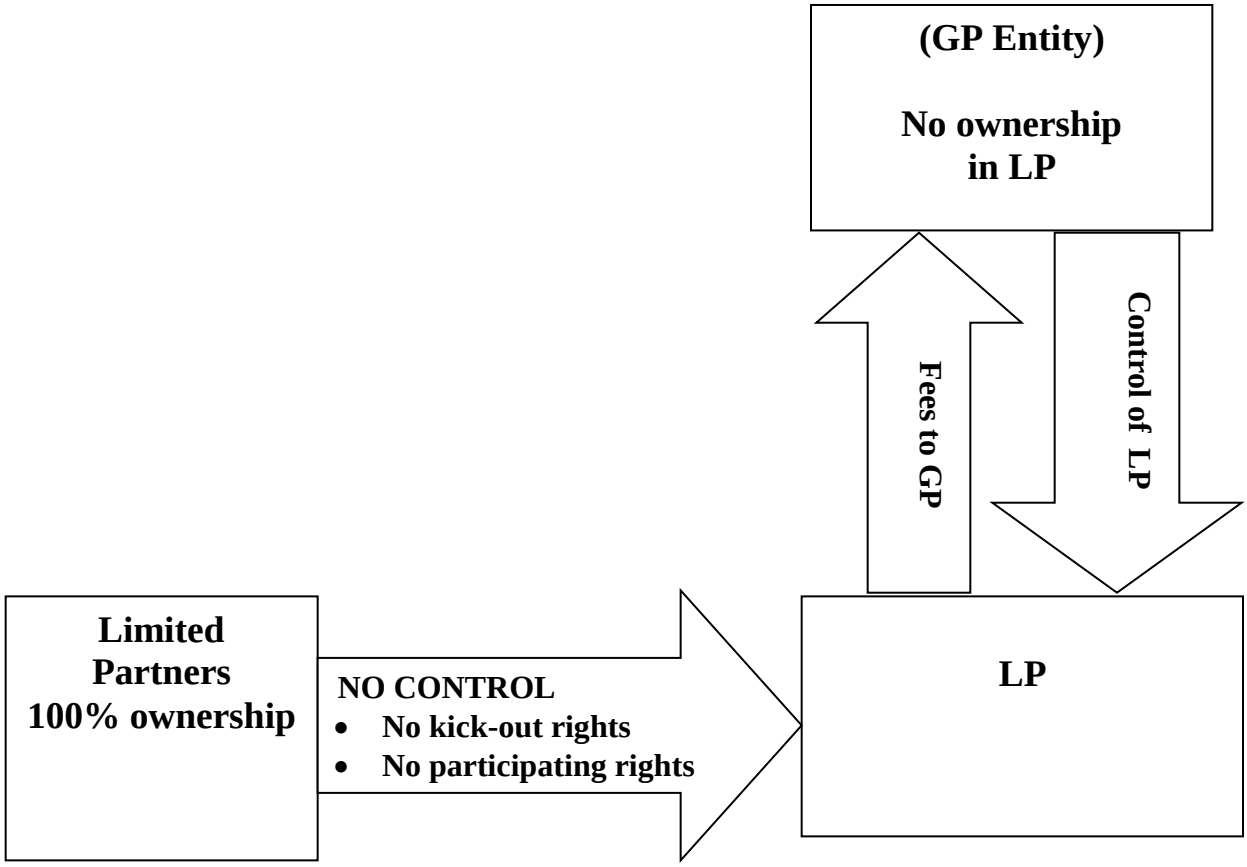
1. *It satisfies the power criterion*: It is the variable interest holder with the power to direct the activities of the VIE that most significantly impact the VIE's economic performance.

2. *It satisfies the economic criterion*: Through its investment in the fund, it has the obligation to absorb losses of the VIE that could potentially be significant to the VIE and the right to receive benefits from the VIE that could potentially be significant to the VIE.

Example 2:

Same facts as Example 1, except for the following:

The GP has no ownership in the LP.



Conclusion:

The GP *would not consolidate* the LP. In fact, no one would consolidate the LP.

Here is the analysis:

Recall that fees paid to a legal entity's decision maker(s) or service provider(s) are *not variable interests* if *all of the following three conditions are met*:

1. The fees are compensation for services provided and are *commensurate* with the level of effort required to provide those services. **YES- GIVEN**

2. The decision maker or service provider *does not hold other interests in the VIE* that individually, or in the aggregate, would absorb more than an insignificant amount

of the VIE's expected losses or receive more than an insignificant amount of the VIE's expected residual returns. **YES- GIVEN**

3. The service arrangement includes only terms, conditions, or amounts that are *customarily present* in arrangements for similar services negotiated at arm's length. **YES- GIVEN**

In this second example, the *GP does not hold any interests* in the limited partnership. Therefore, it satisfies all three of the conditions noted above. First, the fees are commensurate with the level of effort required. Second, the GP holds no other interests in the limited partnership (VIE). Third, the service arrangement includes terms, conditions and amounts that are customarily present in similar arrangements.

The result is that the GP does not hold any variable interests in the LP (VIE). Because the GP holds no variable interests in the LP, the *GP cannot consolidate the LP*.

What about the limited partners consolidating the LP?

Recall that under the voting interest entity model, a limited partner consolidates an LP only if there is a *single limited partner that holds the majority of kick-out rights* (more than 50%) and there are no substantive participating rights held by non-controlling limited partners that block the single limited partner from exercising its kick-out rights.

In this example, there is *no single limited partner that has kick-out rights* because it has been stated in the example that no limited partners hold kick-out or participating rights. Thus, there is no consolidation using the voting interest entity model.

As to the VIE model, there is no limited partner who satisfies the power criterion or economic criterion. In fact it has been clearly stated in the example that the limited partners have no control or power over the management of the LP.

The conclusion in this case is that no one consolidates the LP.

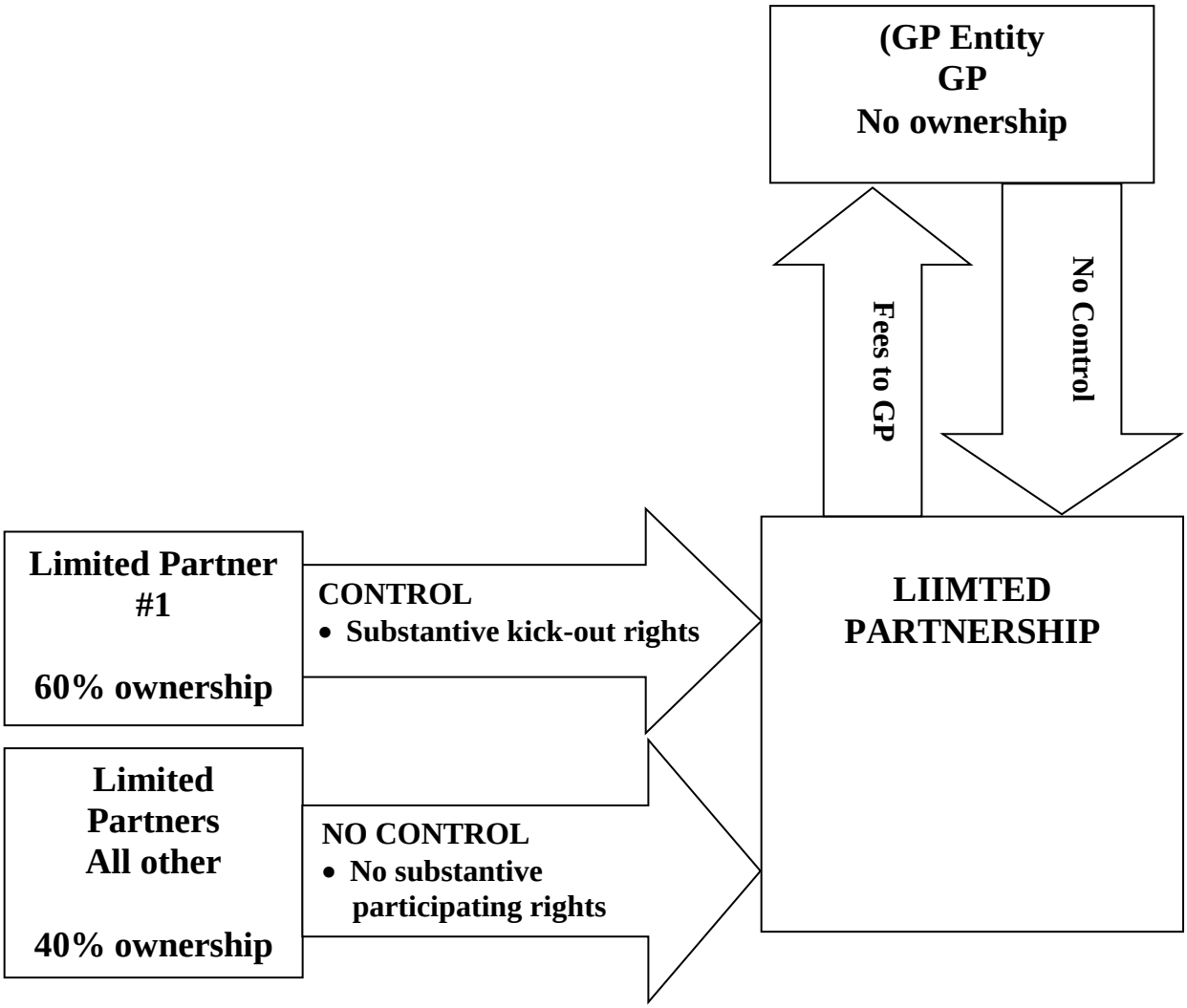
Observation: In reviewing Examples 1 and 2, it should be clearer to the reader that the new rules found in ASU 2015-02 make it unlikely that a GP will consolidate an LP in situations in which the GP holds no LP interests. As long as the GP compensation (fixed and variable) is commensurate with the services provided, the GP holds no variable interests in the LP and will not have to test to determine whether the GP is the primary beneficiary that consolidates the LP.

Example 3:

Same facts as Example 1, except for the following:

- The GP has no ownership in the LP.
- The limited partners have substantive kick-out rights under which they can terminate the GP without cause.
- One limited partner (#1) holds 60% of the limited partnership interest and 60% of the kick-out rights.

The other 40% is held by numerous LPs that have no substantive participating rights that can block the 60% limited partner.



Conclusion:

Because one limited partner holds, through its ownership interest, *more than 50% of the kick-out rights*, that *one limited partner consolidates the LP* using the voting interest entity model. Under that model, a limited partner consolidates the LP provided that limited partner a) holds more than 50% of the kick-out rights of the LP and, b) the other noncontrolling limited partners (40%) do not hold any substantive participating rights that could block the controlling limited partner's rights under the kick-out rights.

How do related parties apply to the determination of whether the GP should consolidate the LP?

Under the ASU, in evaluating the three conditions to determine whether fees paid to a decision maker or service provider are a variable interest, any interest in the LP held by a related party of the decision maker or service provider should be considered in the analysis.

The term *related parties* includes traditional related parties, as identified in ASC 850, *Related Party Disclosures*, and certain de facto agents or principals of the variable interest holder.

Once again, fees paid to a legal entity's decision maker(s) or service provider(s) are *not variable interests* if *all of the following three conditions are met*:

a. The fees are compensation for services provided and are *commensurate* with the level of effort required to provide those services.

b. The decision maker or service provider *does not hold other interests in the VIE* that individually, or in the aggregate, would absorb more than an insignificant amount of the VIE's expected losses or receive more than an insignificant amount of the VIE's expected residual returns.

c. The service arrangement includes only terms, conditions, or amounts that are *customarily present* in arrangements for similar services negotiated at arm's length.

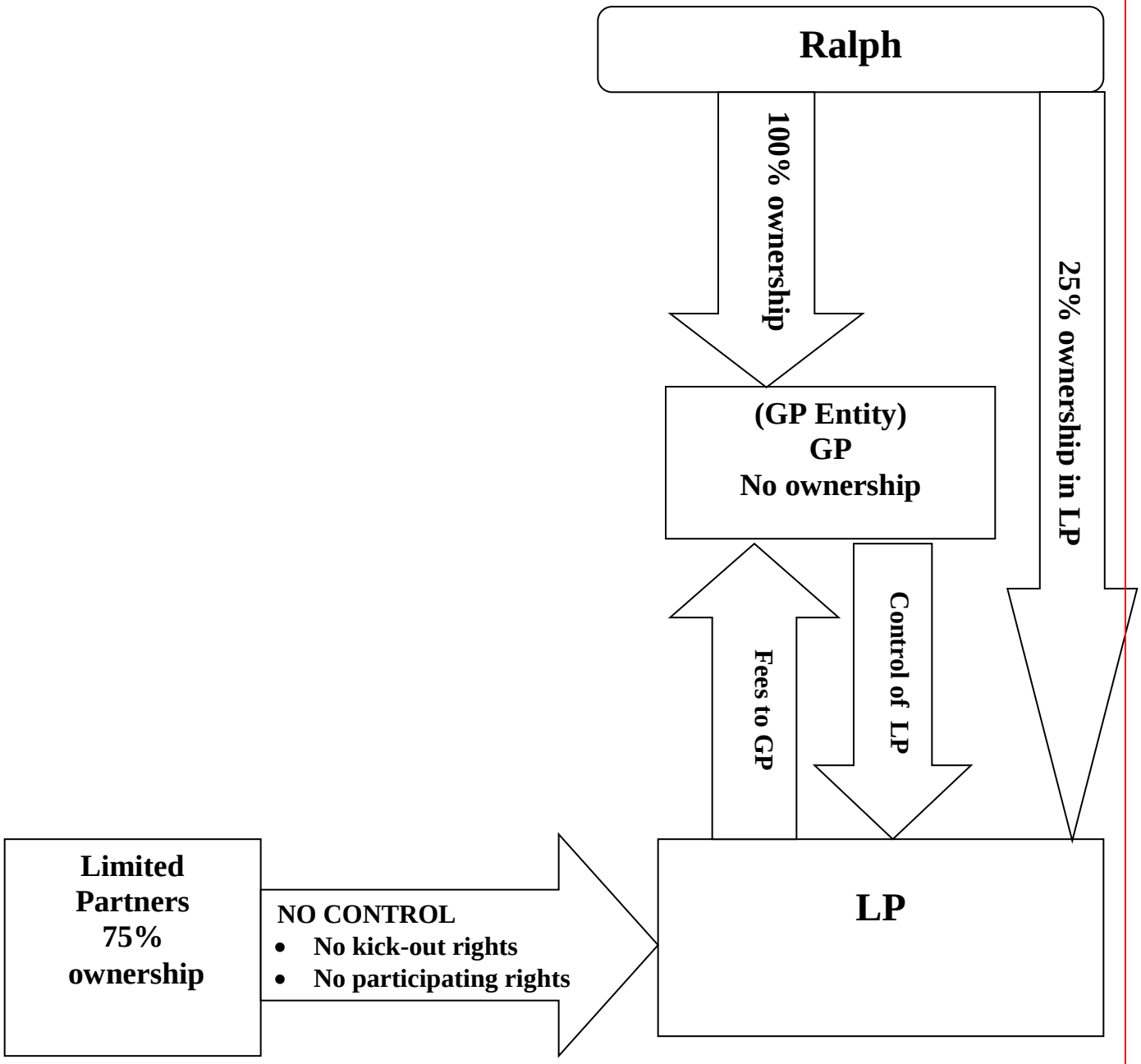
If a related party holds an interest in the VIE (LP), that interest is deemed to be held by the GP.

Example 4:

Same facts as Example 1, except for the following:

The GP has no ownership.

However, GP's owner, Ralph, has a 25% interest in the limited partnership.



Conclusion:

The GP *would consolidate* the limited partnership.

Here is the analysis:

Recall that fees paid to a legal entity's decision maker(s) or service provider(s) are *not variable interests if all of the following three conditions are met*:

1. The fees are compensation for services provided and are *commensurate* with the level of effort required to provide those services.

2. The decision maker or service provider *does not hold other interests in the VIE* that individually, or in the aggregate, would absorb more than an insignificant amount of the VIE's expected losses or receive more than an insignificant amount of the VIE's expected residual returns.

3. The service arrangement includes only terms, conditions, or amounts that are *customarily present* in arrangements for similar services negotiated at arm's length.

In this example, the GP does hold an interest in the limited partnership. The 25% limited partnership interest held by GP's owner, Ralph, is assigned to the GP under the related-party rules.

Therefore, Conditions (1) and (3) are satisfied, but Condition (2) is not.

First, in condition (1), the fees are commensurate with the level of effort required. In Condition (2), the GP does, in fact, hold a 25% interest in the limited partnership (VIE) through Ralph's ownership. Third, in condition (3), the service arrangement includes terms, conditions and amounts that re customarily present in similar arrangements.

Because only two of the three conditions are satisfied, the fees paid to the decision maker (GP), are *considered a variable interest*.

Further, LP is a VIE because there are no kick-out rights or participating rights held by the LPs.

Now that GP has a variable interest and the LP is a VIE, GP now must test the LP to determine whether GP is the primary beneficiary that consolidates LP.

Under the VIE model, the decision maker (GP in this case) would evaluate whether it is the entity that has:

a. Power criterion: The power to direct the LP's (VIE's) activities that most significantly impact the VIE's economic performance, and

b. Economic criterion: The obligation to absorb losses of the LP (VIE) that could potentially be significant to the LP (VIE) or the right to receive benefits from the LP (VIE) that could potentially be significant to the LP (VIE).

In this example, the GP does satisfy the power criterion because it is the only one that has the power to direct the LP's activities. The limited partners do not hold any kick-out rights or participating rights that could result in the limited partners participating in the operations of the LP.

As for the economic criterion, because the GP has a 25% ownership in the LP (through Ralph's interest), GP does have the obligation to absorb losses of the LP or the right to receive benefits from the LP.

The result is that GP satisfies both the power criterion and economic criterion and is considered the *primary beneficiary that consolidates LP* under the VIE consolidation model.

CHANGE 3: The Effect of Fee Arrangements on the Primary Beneficiary Determination

EXISTING GAAP RULES:

Under current GAAP a decision maker or service provider (reporting entity) is determined to be the primary beneficiary of a VIE that consolidates the VIE if it has a controlling financial interest, by having *both* of the following *two characteristics:*

a. Power criterion: The power to direct the activities of a VIE that most significantly impact the VIE's economic performance, and

b. Economic criterion: The obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE.

Under current GAAP, if a fee paid to a decision maker (such as an asset management fee), is determined to be a variable interest in a VIE, the decision maker must include the fee in its primary beneficiary determination and could consolidate the VIE by satisfying both the power criterion and economic criterion through the fees paid to the decision maker.

NEW RULES PER ASU 2015-02:

1. The amendments in the ASU specify that some fees paid to a decision maker are excluded from the evaluation of whether the decision maker is the primary beneficiary of a VIE.

   Note: The amendments make it less likely for a decision maker to meet the economics criterion solely on the basis of a fee arrangement.

2. In performing the primary beneficiary test, fees paid to a reporting entity (decision maker or service provider) (other than those included in arrangements that expose a reporting entity to risk of loss) that meet *both* of the following conditions shall be *excluded:*

   a. The fees are compensation for services provided and are *commensurate* with the level of effort required to provide those services.

   b. The service arrangement includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length.

3. Facts and circumstances shall be considered when assessing the conditions in paragraph (2) above.

   a. An arrangement that is designed in a manner such that the fee is inconsistent with the reporting entity's role or the type of service *would not* meet those conditions in (2)(a) and (b) above.

   b. To assess whether a fee meets the conditions in (2)(a) and (b) above, a reporting entity may need to analyze similar arrangements among parties outside the relationship being evaluated. However, a fee would not presumptively fail those conditions if similar service arrangements did not exist in the following circumstances:

      1) The fee arrangement relates to a unique or new service.
      2) The fee arrangement reflects a change in what is considered customary for the services.

   c. In addition, the magnitude of a fee, in isolation, would not cause an arrangement to fail those conditions.

4. Fees or payments in connection with agreements that expose a reporting entity (the decision maker or service provider) to risk of loss in the VIE shall not be eligible for the evaluation in paragraph (2). Such fees include, but are not limited to, the following:

   a. Those related to guarantees of the value of the assets or liabilities of a VIE
   b. Obligations to fund operating losses
   c. Payments associated with written put options on the assets of the VIE
   d. Similar obligations such as some liquidity commitments or agreements (explicit or implicit) that protect holders of other interests from suffering losses in the VIE.

CHANGE 4: The Effect of Related Parties on the Primary Beneficiary Determination

EXISTING GAAP RULES:

Under the VIE consolidation model, in instances in which no single party has a controlling financial interest in a VIE, current GAAP requires interests held by a reporting entity's related parties to be treated as though they belong to the reporting entity when evaluating whether a related party group has the characteristics of a primary beneficiary, to consolidate the VIE.

NEW RULES PER ASU 2015-02:

The fourth primary change made by ASU 2015-02 to the consolidation rules involves considering the effect of related parties on the determination of the primary beneficiary under the variable interest rules.

The amendments in ASU 2015-02 reduce the application of the related party guidance for VIEs on the basis of the following *three changes*:

1. For single decision makers, related party relationships must be considered indirectly on a proportionate basis, rather than in their entirety.

2. After the assessment in (1) above is performed, related-party relationships should be considered in their entirety for entities that are under common control only if that common control group has the characteristics of a primary beneficiary. That is, the common control group collectively has a controlling financial interest.

3. If the second assessment is not applicable, but substantially all of the activities of the VIE are conducted on behalf of a single variable interest holder (excluding the decision maker) in a related party group that has the characteristics of a primary beneficiary, that single variable interest holder must consolidate the VIE as the primary beneficiary.

The ASU does not amend the related party guidance for situations in which power is shared between two or more entities that hold variable interests in a VIE.

CHANGE 5: Certain Investment Funds

EXISTING GAAP RULES:

ASU 2010-10, *Consolidation (Topic 810): Amendments for Certain Investment Funds*, indefinitely deferred the effective date of the VIE consolidation requirements for investment companies.

NEW RULES PER ASU 2015-02:

1. The ASU rescind the indefinite deferral included in ASU 2010-10, *Consolidation (Topic 810): Amendments for Certain Investment Funds*.

2. The ASU provide a scope exception from ASC 810 consolidation rules for reporting entities with interests in legal entities that are required to comply with or operate in accordance with requirements similar to those in Rule 2a-7 of the Investment Company Act of 1940 for registered money market funds.

3. *Scope limitation*: A reporting entity *shall not consolidate* a legal entity that is required to comply with or operate in accordance with requirements that are similar to those included in Rule 2a-7 of the Investment Company Act of 1940 for registered money market funds.

   a. A legal entity that is not required to comply with Rule 2a-7 of the Investment Company Act of 1940 qualifies for this exception if it is similar in its purpose and design, including the risks that the legal entity was designed to create and pass through to its investors, as compared with a legal entity required to comply with Rule 2a-7.

   Note: A reporting entity subject to this scope exception shall disclose any explicit arrangements to provide financial support to legal entities that are required to comply with or operate in accordance with requirements that are similar to those included in Rule 2a-7, as well as any instances of such support provided for the periods presented in the performance statement. For purposes of applying this disclosure requirement, the types of support that should be considered include, but are not limited to, any of the following:

   a. Capital contributions (except pari passu investments)
   b. Standby letters of credit
   c. Guarantees of principal and interest on debt investments held by the legal entity
   d. Agreements to purchase financial assets for amounts greater than fair value (for instance, at amortized cost or par value when the financial assets experience significant credit deterioration)
   e. Waivers of fees, including management fees.

Observation: The FASB observes in its Basis for Conclusions section of ASU 2015-02 that it decided that the consolidation guidance in ASC 810 will not apply to a reporting

entity's interest in an entity that is required to comply with or operate in accordance with requirements that are similar to those included in Rule 2a-7 of the Investment Company Act of 1940 for registered money market funds.

Previously, such funds were exempt from application of the ASC 810 consolidation rules under the indefinite deferral provision found in FASB No. 167. In ASU 2015-02, the FASB removed the indefinite deferral of Statement 167 and provided a permanent exemption for certain money market funds covered under Rule 2a-F of the Investment Company Act of 1940.

The FASB concluded that consolidation does not produce more meaningful financial reporting than nonconsolidated results.

Factors that the FASB considered in making its exemption include:

- Input from respondents indicated that consolidation of money market funds negatively impacts the ability to analyze financial statements to understand a fund manager's compensation and to distinguish between a fund manager's assets and liabilities and those of the consolidated money market fund.

- Consolidation could be distortive due to the regulated nature of registered money market funds, including the portfolio quality, maturity, and diversification of the investments held by the money market funds, in its decision to provide a scope exception.

In conjunction with its decision to provide a scope exception, the FASB decided that the exemption should not be limited to registered money market funds that are required to comply with Rule 2a-7 but that the exemption should also apply to other funds that operate in a manner similar to registered money market funds that are required to comply with that Rule. This decision is consistent with the conclusion for the indefinite deferral of Statement 167 for certain money market funds.

However, the FASB decided to require fund sponsors of money market funds meeting this scope exception to disclose explicit arrangements to provide financial support to the money market funds they manage as well as any instances of financial support provided for the periods presented in the performance statement. Disclosing that information benefits users of financial information and presents minimal costs to preparers of financial information.

Other Issues:

ASU 2015-02 retains the consolidation exception for entities controlled by contract.

ASC 810-10-15, *"Consolidation of Entities Controlled By Contract,"* provides an exception to the more-than-50% ownership threshold. Specifically, there are situations in which one entity controls another through a contractual management agreement without having ownership of a majority of the outstanding voting equity.

The most common example of this arrangement is found in the medical field in which a physician practice (PP) engages in a contract with a practice management entity (PPME) for the PPME to manage the PP. In such cases, it is typical for the PPME to control to PP but have no ownership in the practice. In such circumstances, the PPME should consolidate with the physician's practice.

In particular, ASC 810-10-15 applies to contractual management arrangements with both of the following characteristics:

- Relationships between more than one physician practices (PP) that operate in the health care industry including the practices of medicine, dentistry, veterinary science, and chiropractic medicine, and

- Relationships in which the physician practice management entity (PPME) does not own the majority of the outstanding voting equity of the physician practices either because the PPME is precluded by law from owning the equity, or because the PPME has elected not to own the equity.

If the following criteria are met, the PPME has a controlling financial interest in the physician practice and should consolidate the physician practice.

a. The contractual arrangement: a) has a term that is either the entire remaining legal life of the physician practice entity or a period of 10 years or more, and b) Is not terminable by the physician practice except in cases of gross negligence, fraud, other illegal acts, or bankruptcy by the PPME.

b. The PPME has exclusive authority over all decision making involving the practice operations and compensation of the medical professionals,

c. The PPME must have a significant (but not necessarily majority) financial interest in the physician practice that meets both of the following criteria.

    1) It is unilaterally saleable or transferable by the PPM entity, and
    2) It provides the PPME with the right to receive income, both as ongoing fees and as proceeds from the sale of its interest in the physician practice, in an amount that fluctuates based on the performance of the operations of the physician practice and the change in the fair value.

Observation: ASC 810-10-15 states that the guidance for entities controlled can be used in other industries and similar circumstances. The conclusion suggests that in other circumstances in which control is determined by a contract other than ownership, entities may consolidate. However, the author believes that the guidance should not be taken out of context. Because ASC 810-10-15 gives no examples of where circumstances would be considered "similar," it may not be prudent to apply a control standard that is measured on other-than majority ownership (e.g., more than 50% ownership).

V. Transition Related to ASU 2015-02

The following represents the transition and effective date information related to Accounting Standards Update No. 2015-02, *Consolidation (Topic 810): Amendments to the Consolidation Analysis:*

a. The ASU shall be effective as follows:

   1. For public business entities, for fiscal years, and for interim periods within those fiscal years, *beginning after December 15, 2015*.

   2. For all other entities, for fiscal years *beginning after December 15, 2016*, and for interim periods within fiscal years beginning after December 15, 2017.

b. If a reporting entity is required to consolidate a legal entity as a result of the initial application of the ASU, the initial measurement of the assets, liabilities, and noncontrolling interests of the legal entity depends on whether the determination of their carrying amounts is practicable.

   C*arrying amounts* refers to the amounts at which the assets, liabilities, and noncontrolling interests would have been carried in the consolidated financial statements if the requirements of the pending content that links to this paragraph had been effective when the reporting entity first met the conditions to consolidate the legal entity.

   1. If determining the carrying amounts is practicable, the reporting entity shall initially measure the assets, liabilities, and noncontrolling interests of the legal entity at their carrying amounts at the date the pending content that links to this paragraph first applies.

   2. If determining the carrying amounts is not practicable, the assets, liabilities, and noncontrolling interests of the legal entity shall be measured at fair value at the date the pending content that links to this paragraph first applies.

c. Any difference between the net amount added to the statement of financial position of the reporting entity and the amount of any previously recognized interest in the newly consolidated legal entity shall be recognized as a cumulative-effect adjustment to retained earnings. A reporting entity shall describe the transition method(s) applied and shall disclose the amount and classification in its statement of financial position of the consolidated assets or liabilities by the transition method(s) applied.

d. A reporting entity that is required to consolidate a legal entity as a result of the initial application of the pending content that links to this paragraph may elect the fair value option provided by the Fair Value Option Subsections of Subtopic 825-10 on financial instruments, but only if the reporting entity elects the option for all financial assets and financial liabilities of that legal entity that are eligible for this option under those Fair Value Option Subsections. This election shall be made on a legal entity-by-legal entity basis. Along with the disclosures required in those Fair Value Option Subsections, the reporting entity shall disclose all of the following:

    1. Management's reasons for electing the fair value option for a particular legal entity or group of legal entities.

    2. The reasons for different elections if the fair value option is elected for some legal entities and not others.

    3. Quantitative information by line item in the statement of financial position indicating the related effect on the cumulative-effect adjustment to retained earnings of electing the fair value option for a legal entity.

e. If a reporting entity is required to deconsolidate a legal entity as a result of the initial application of the pending content that links to this paragraph, the initial measurement of any retained interest in the deconsolidated former subsidiary depends on whether the determination of its carrying amount is practicable. In this context, *carrying amount* refers to the amount at which any retained interest would have been carried in the reporting entity's financial statements if the pending content that links to this paragraph had been effective when the reporting entity became involved with the legal entity or no longer met the conditions to consolidate the legal entity.

    1. If determining the carrying amount is practicable, the reporting entity shall initially measure any retained interest in the deconsolidated former subsidiary at its carrying amount at the date the pending content that links to this paragraph first applies.

    2. If determining the carrying amount is not practicable, any retained interest in the deconsolidated former subsidiary shall be measured at fair value at the date the pending content that links to this paragraph first applies.

f. Any difference between the net amount removed from the statement of financial position of the reporting entity and the amount of any retained interest in the newly deconsolidated legal entity shall be recognized as a cumulative-effect adjustment to retained earnings. A reporting entity shall disclose the amount of any cumulative-effect adjustment related to deconsolidation separately from any cumulative-effect adjustment related to consolidation of entities.

g. The determinations of whether a legal entity is a variable interest entity (VIE) and which reporting entity, if any, should consolidate the legal entity shall be made as of the date the reporting entity became involved with the legal entity or, if events have occurred requiring reconsideration of whether the legal entity is a VIE and which reporting entity, if any, should consolidate the legal entity, as of the most recent date at which the ASU would have required consideration.

h. If, at transition, it is not practicable for a reporting entity to obtain the information necessary to make the determinations in (g) as of the date the reporting entity became involved with a legal entity or at the most recent reconsideration date, the reporting entity shall make the determinations as of the date on which the ASU is first applied.

i. If the determinations of whether a legal entity is a VIE and whether a reporting entity should consolidate the legal entity are made in accordance with (h), then the consolidating entity shall measure the assets, liabilities, and noncontrolling interests of the legal entity at fair value as of the date on which the ASU is first applied.

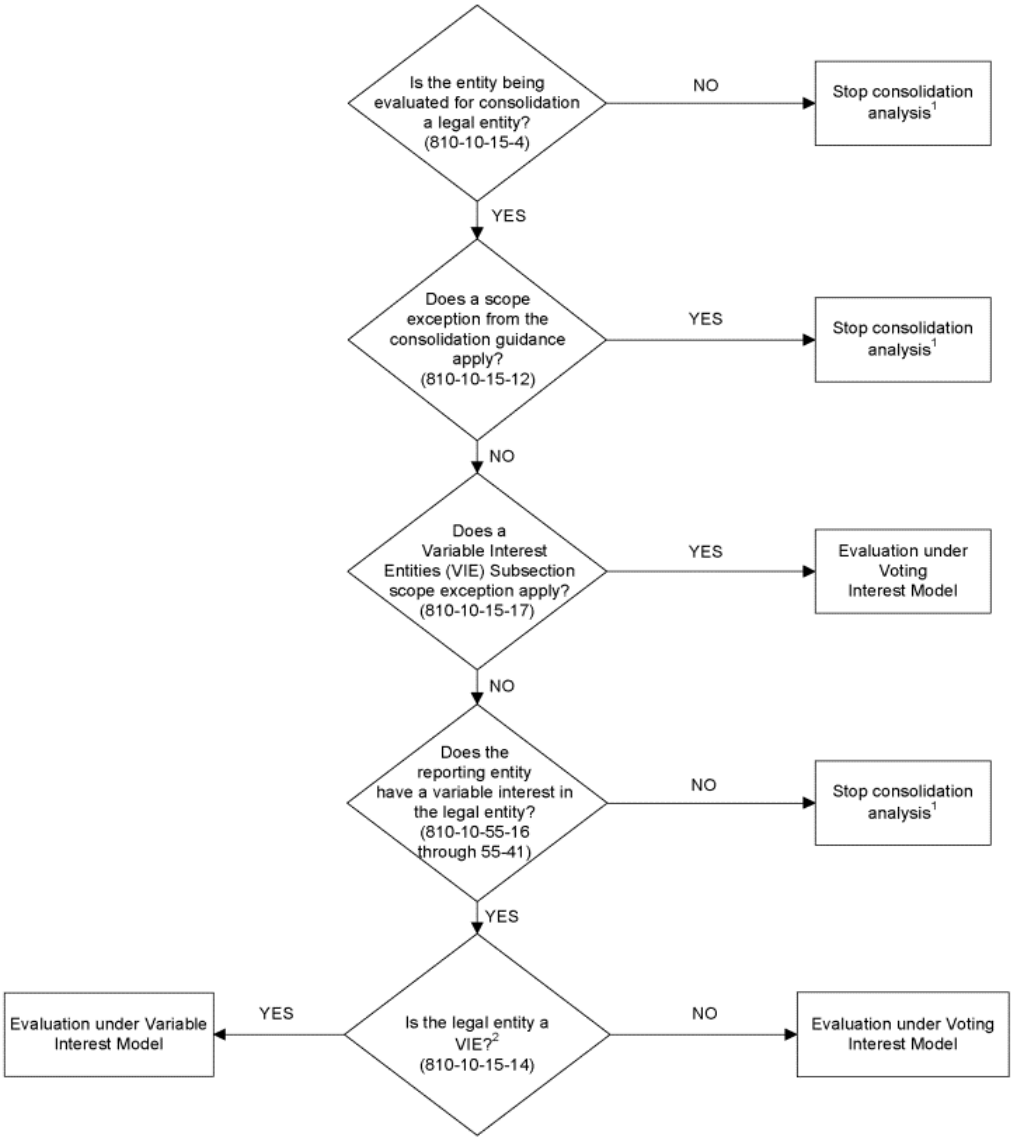
j. The ASU may be applied retrospectively in previously issued financial statements for one or more years with a cumulative-effect adjustment to retained earnings as of the beginning of the first year restated.

k. Early adoption, including adoption in an interim period, is permitted. If an entity early adopts the ASU in an interim period, any adjustments shall be reflected as of the beginning of the fiscal year that includes that interim period.

l. An entity shall provide the disclosures in paragraphs 250-10-50-1 through 50-2 (with the exception of the disclosure in paragraph 250-10- 50-1(b)(2)) in the period the entity adopts the ASU.

On the following pages there are charts extracted from ASU 2015-02.

Consolidation Analysis in Subtopic 810-10



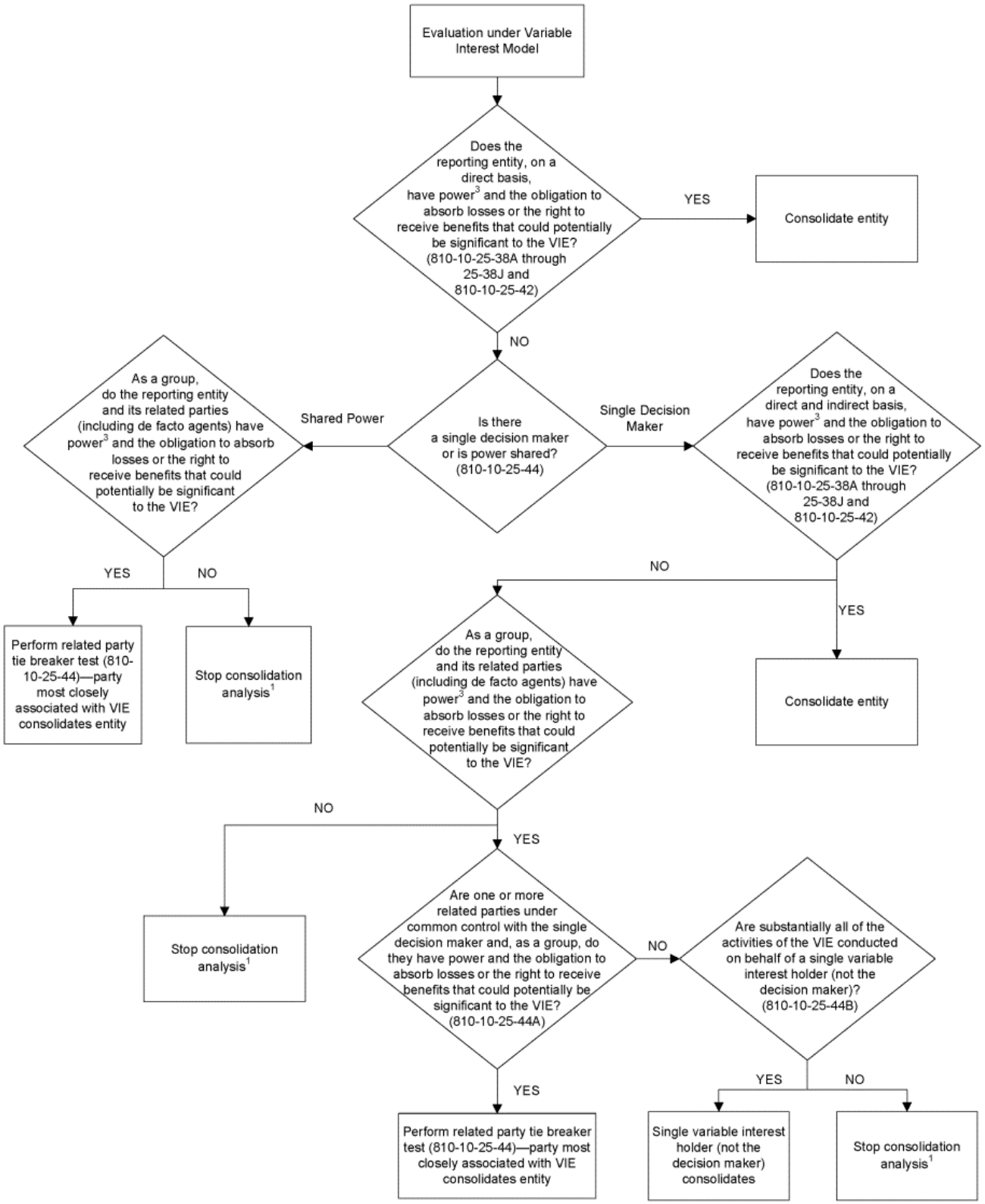
[1]Consolidation not required; however, evaluation of other generally accepted accounting principles (GAAP) may be relevant to determine recognition, measurement, or disclosure.

[2]A legal entity is a VIE if any of the following conditions exist:

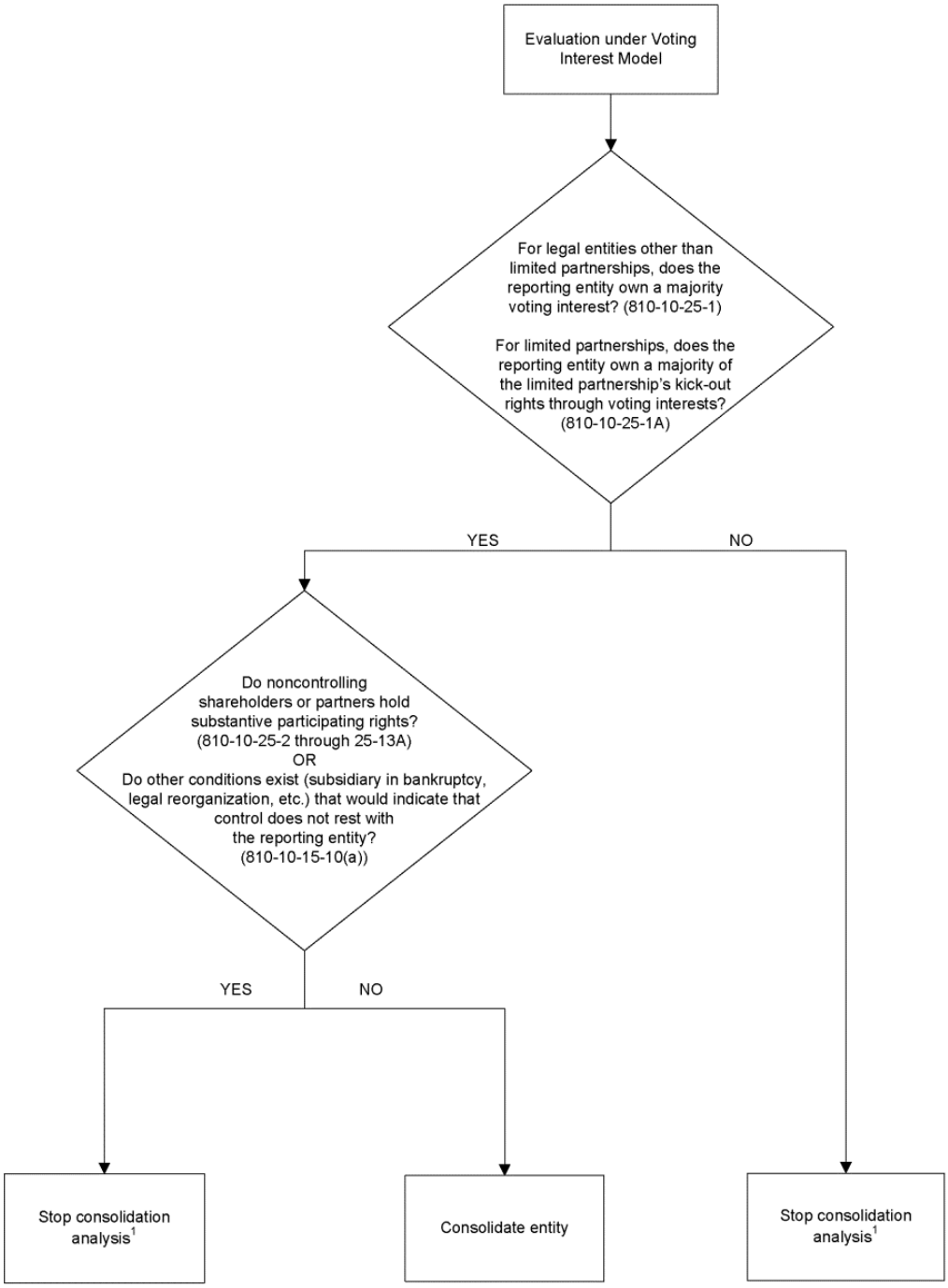
a. The equity investment at risk is not sufficient to finance the activities of the entity without additional subordinated financial support provided by any parties.

b. As a group, the holders of the equity investment at risk lack any of the following characteristics of a controlling financial interest:
   1. The power to direct the activities that most significantly impact the entity's economic performance:
      i. For legal entities other than limited partnerships, investors lack that power through voting rights or similar rights if no owners hold voting rights or similar rights (such as those of a common shareholder in a corporation).
      ii. For limited partnerships, partners lack that power if neither (01) nor (02) below exists:
         01. A simple majority or lower threshold of limited partners (including a single limited partner) with equity at risk is able to exercise substantive kick-out rights through voting interests over the general partner(s).
         02. Limited partners with equity at risk are able to exercise substantive participating rights over the general partner(s).
   2. The obligation to absorb expected losses.
   3. The right to receive expected residual returns.

c. The equity investors' voting rights are not proportional to the economics, and substantially all of the activities of the entity either involve or are conducted on behalf of an investor that has disproportionately few voting rights.



[3] Power is defined as the power to direct the activities of a VIE that most significantly impact the VIE's economic performance.


Evaluation under Voting Interest Model
For legal entities other than limited partnerships, does the reporting entity own a majority voting interest? (810-10-25-1)
For limited partnerships, does the reporting entity own a majority of the limited partnership's kick-out rights through voting interests? (810-10-25-1A)
YES
NO
Do noncontrolling shareholders or partners hold substantive participating rights? (810-10-25-2 through 25-13A)
OR
Do other conditions exist (subsidiary in bankruptcy, legal reorganization, etc.) that would indicate that control does not rest with the reporting entity? (810-10-15-10(a))
YES
NO
Stop consolidation analysis[1]
Consolidate entity
Stop consolidation analysis[1]

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 a characteristic of an entity that is a VIE. The holders of equity investments _____:
   a. Have the obligation to absorb the expected losses of the entity
   b. Have the right to receive expected residual returns of the entity
   c. Lack the power to direct the entity's activities
   d. Created the entity at inception

2. Which of the following is a barrier that may make kick-out rights less substantive:
   a. The limited partners have the ability to obtain the information necessary to exercise the rights
   b. There exists an adequate number of qualified replacement general partners
   c. The kick-out rights are subject to conditions that make it unlikely they will be exercisable
   d. There exists an explicit, reasonable mechanism by which the LPs holding the rights can conduct a vote to exercise the rights

3. Which of the following rights is considered a protective right:
   a. Acquisitions of assets undertaken in the ordinary course of business
   b. Dispositions of assets undertaken in the ordinary course of business
   c. Amendments to articles of incorporation
   d. Selecting and setting compensation of management

4. Which kind of rights may overcome the presumption that a limited partner with the majority of kick-out rights shall consolidate the limited partnership:
   a. Non-substantive participating rights
   b. Participating rights
   c. Substantive participating rights
   d. Protective rights

5. Company Z is a decision maker for Company Y and receives management fees from Y for its services. Under ASU 2015-02, fees paid to a legal entity's decision maker are not variable interests if three conditions are met. Which of the following is one of the three conditions:

a. Substantially all of the fees are at or above the same level of seniority as other operating liabilities of the entity that arise in the normal course of the entity's activities, such as trade payables.
b. The total amount of anticipated fees are insignificant relative to the total amount of the variable interest entity's anticipated economic performance.
c. The fees are compensation for services provided and are commensurate with the level of effort required to provide those services (e.g., the fees are at an arms-length rate).
d. The anticipated fees are expected to absorb an insignificant amount of the variability associated with the entity's anticipated economic performance.

6. Company X is performing a primary beneficiary test on Company VIE to determine whether X should consolidate VIE. In performing the test, how should X account for fees paid to X:

a. The fees paid are excluded if two conditions are met
b. The fees are included in all instances
c. The fees are excluded even if they expose the entity to risk of loss
d. Fees paid to a service provider are not considered fees paid to a reporting entity

SUGGESTED SOLUTIONS

1. Which of the following is a characteristic of an entity that is a VIE. The holders of equity investments _____:
   a. Incorrect. One characteristic is that they lack the obligation to absorb the expected losses of the entity.
   b. Incorrect. A characteristic is that the holders lack the right (not have the right) to receive expected residual returns of the entity.
   c. Correct. One of the characteristics is that as a group, the holders of equity investments at risk lack the power to direct the entity's activities, making the answer correct.
   d. Incorrect. Creating the entity at inception is not one of the characteristics under the variable interest entity model.

2. Which of the following is a barrier that may make kick-out rights less substantive:
   a. Incorrect. One of the barriers is that the limited partners have the inability (not ability) to obtain the information necessary to exercise the rights.
   b. Incorrect. The absence (not existence) of an adequate number of qualified replacement general partners is a barrier.
   c. Correct. ASU 2015-02 states that one barrier that could make kick-out rights less substantive is if the rights are subject to conditions that make it unlikely they will be exercisable. One example given is if there are conditions that narrowly limit the timing of the exercise.
   d. Incorrect. One barrier is the absence (not existence) of an explicit, reasonable mechanism by which the LPs holding the rights can conduct a vote to exercise the rights.

3. Which of the following rights is considered a protective right:
   a. Incorrect. Typically acquisitions of assets undertaken not in the ordinary course of business are considered protective rights while those undertaken in the ordinary course of business are participating rights.
   b. Incorrect. Dispositions of assets undertaken not in the ordinary course of business are protective rights, not those in the ordinary course of business.
   c. Correct. ASU 2015-02 identifies amendments to articles of incorporation or the partnership agreement of an investee as typically being considered protective rights.
   d. Incorrect. Selecting and setting compensation of management is typically a participating right.

4. Which kind of rights may overcome the presumption that a limited partner with the majority of kick-out rights shall consolidate the limited partnership:
   a. Incorrect. Non-substantive participating rights do not overcome the presumption because they do not allow the LP to participate in certain partnership actions.
   b. Incorrect. Participating rights, by themselves, may overcome the presumption but only if the rights are substantive. Thus, the answer is incorrect.
   c. Correct. Substantive participating rights overcome the presumption that the LP that holds the majority of the kick-out rights shall consolidate the limited partnership. Substantive participating rights allow the noncontrolling LP to effectively participate in certain partnership actions.
   d. Incorrect. Protective rights only block certain actions and do not impact whether an LP consolidates a limited partnership.

5. Company Z is a decision maker for Company Y and receives management fees from Y for its services. Under ASU 2015-02, fees paid to a legal entity's decision maker are not variable interests if three conditions are met. Which of the following is one of the three conditions:
   a. Incorrect. One of the conditions that was eliminated by ASU 2015-02 is that substantially all of the fees are at or above the same level of seniority as other operating liabilities of the entity that arise in the normal course of the entity's activities, such as trade payables. This condition is no longer one of the conditions under ASU 2015-02.
   b. Incorrect. ASU 2015-02 eliminated three conditions one of which is the total amount of anticipated fees are insignificant relative to the total amount of the variable interest entity's anticipated economic performance.
   c. Correct. One of the three conditions is that the fees are compensation for services provided and are commensurate with the level of effort required to provide those services (e.g., the fees are at an arms-length rate).
   d. Incorrect. One of the conditions eliminated by ASU 2015-02 is that the anticipated fees are expected to absorb an insignificant amount of the variability associated with the entity's anticipated economic performance. This condition no longer applies under ASU 2015-02.

6. Company X is performing a primary beneficiary test on Company VIE to determine whether X should consolidate VIE. In performing the test, how should X account for fees paid to X:
   a. Correct. ASU 2015-02 states that fees paid to a reporting entity are excluded from the primary beneficiary test if two conditions are met. One is that the fees are compensation for services. The other is that the service arrangement terms, conditions or amounts that are customarily present in similar arrangements.
   b. Incorrect. The fees are excluded in certain cases in which two conditions are met, making the answer incorrect.
   c. Incorrect. The ASU states that the exclusion rule does not reflect fees that are part of arrangements that exposes the entity to risk of loss. Thus, the answer is incorrect.
   d. Incorrect. Fees paid to a reporting entity include those fees paid to both a decision maker and a service provider.

Glossary

Economic Criterion: The obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE.

Kick-Out Rights (VIE Definition): The ability to remove the entity with the power to direct the activities of a VIE that most significantly impact the VIE's economic performance or to dissolve (liquidate) the VIE without cause.

Kick-Out Rights (Voting Interest Entity Definition): The rights underlying the limited partner's or partners' ability to dissolve (liquidate) the limited partnership or otherwise remove the general partners without cause.

Participating Rights (VIE Definition): The ability to block or participate in the actions through which an entity exercises the power to direct the activities of a VIE that most significantly impact the VIE's economic performance. Participating rights do not require the holders of such rights to have the ability to initiate actions.

Participating Rights (Voting Interest Entity Definition): Participating rights allow the limited partners or non-controlling shareholders to block or participate in certain significant financial and operating decisions of the limited partnership or corporation that are made in the ordinary course of business. Participating rights do not require the holders of such rights to have the ability to initiate actions.

Power Criterion: The power to direct the VIE's activities that most significantly impact the VIE's economic performance.

Protective Rights (VIE Definition): Rights designed to protect the interests of the party holding those rights without giving that party a controlling financial interest in the entity to which they relate.

Protective Rights (Voting Interest Entity Definition): Rights that are only protective in nature and that do not allow the limited partners or non-controlling shareholders to participate in significant financial and operating decisions of the limited partnership or corporation that are made in the ordinary course of business.

Decision Maker: An entity or entities with the power to direct the activities of another legal entity that most significantly impact the legal entity's economic performance according to the provisions of the Variable Interest Entities Subsections of Subtopic 810-10.

Decision-Making Authority: The power to direct the activities of a legal entity that most significantly impact the entity's economic performance according to the provisions of the Variable Interest Entities Subsections of Subtopic 810-10.

Ordinary Course of Business: Decisions about matters of a type consistent with those normally expected to be addressed in directing and carrying out current business activities, regardless of whether the events or transactions that would necessitate such decisions are expected to occur in the near term. However, it must be at least reasonably possible that those events or transactions that would necessitate such decisions will occur. The ordinary course of business does not include self-dealing transactions.

With Cause: With cause generally restricts the limited partners' ability to dissolve (liquidate) the limited partnership or remove the general partners in situations that include, but that are not limited to, fraud, illegal acts, gross negligence, and bankruptcy of the general partners.

Without Cause: Without cause means that no reason need be given for the dissolution (liquidation) of the limited partnership or removal of the general partners.

a. Power criterion: The power to direct the VIE's activities that most significantly impact the VIE's economic performance, and

b. Economic criterion: The obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE.

Chapter 4: Changes Made to Discontinued Operations and Extraordinary Items

I. General

The author has combined into this chapter two recent changes made by the FASB to the reporting of discontinued operations and extraordinary items, as follows:

ASU 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*, and

ASU 2015-01: *Income Statement—Extraordinary and Unusual Items (Subtopic 225-20) Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items*

Both discontinued operations and extraordinary items relate to presentation issues involving the income statement. The changes made to the presentation of discontinued operations and extraordinary items collectively represent a concerted effort by the FASB to reduce or eliminate the presentation of these items on the income statement. Therefore, discussing these two items together should be meaningful for the reader.

This chapter is segregated into the following sections:

Chapter Section	**Description**
Background- Discontinued Operations and Extraordinary Items	Provides an overview of the GAAP rules that exist prior to the implementation of ASU 2014-08 (discontinued operations) and ASU 2015-01 (extraordinary items)
The Games Are Played in Classification Shifting: Extraordinary Items and Discontinued Operations	Addresses the abuses that have existed under existing GAAP in shifting transactions into the discontinued operations and extraordinary items categories
ASU 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*	Analyzes the new GAAP rules for discontinued operations
ASU 2015-01: *Income Statement—Extraordinary and Unusual Items (Subtopic 225-20) Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items*	Addresses the new GAAP rules for elimination of extraordinary items

II. Background – Discontinued Operations and Extraordinary Items

Over the past two years, the FASB has made efforts to essentially eliminated two items that are presented on the statement of income on a net of tax basis. They are:

- Discontinued operations, and
- Extraordinary items

In 2014, the FASB issued ASU 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,* 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.

Overview of existing GAAP for discontinued operations and extraordinary items

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 those items.

Under current GAAP, two items are presented on the income statement on a net of tax basis. Those items are:

- Discontinued operations, and
- Extraordinary items

Prior to the issuance of FASB No. 154 (currently ASC 250, *Accounting Changes and Error Corrections*), GAAP had a third item, cumulative effect of an accounting change, that was also presented on a net of the tax basis.

FASB No. 154 eliminated the cumulative effect of an accounting change. Now, a company that has a change in accounting principle is required to restate retained earnings for the effect of an accounting change, and not present the change as a cumulative effect on the income statement.

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:

In April 2014, the FASB issued ASU 2014-08 to change the definition of discontinued operations and expand its disclosures. In general, AU 2014-08 applies for years beginning in 2015. Until that time, current GAAP still permits companies significant latitude in classifying discontinued operations below continuing operations, particularly with respect to single transactions involving losses.

Prior to the effective date of ASU 2014-08, existing GAAP found in ASC 205, *Presentation of Financial Statements*, states:

The results of operations of a *component of an entity* that either has been disposed of or is classified as held for sale, is 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.

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 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 (before the changes made by ASU 2014-08) 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.

Existing GAAP- extraordinary items:

ASC 225-20, *Income Statement, Extraordinary and Unusual Items*, defines an extraordinary item as events and transactions that are distinguished by *both* of the following criteria being met:

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.

III. The Games Are Played in Classification Shifting: Extraordinary Items and Discontinued Operations

The purpose of this section is to explain to the reader the actions companies have been taking to shift transactions on their income statements from continuing operations into discontinued operations and extraordinary items. In particular, shifting losses and expenses into discontinued operations and extraordinary items has a correlating effect on an entity's income from continued operations. By shifting loss transactions and expenses to discontinued operations and extraordinary items, an entity increases its income from continued operations. In practice, income from continued operations is a key benchmark used to measure financial performance and is the starting point for measurements that include core earnings, EBITDA and certain cash flow measurements.

Classification shifting is one particular reason why the FASB chose to reduce and eliminate discontinued operations and extraordinary items, both of which are addressed further on in this chapter.

Is a company motivated to move losses and expenses into discontinued operations or extraordinary items?

Companies are highly motivated to shift losses and expenses from continuing operations into either the discontinued operations or extraordinary items category. Conversely, those same entities seek to retain income and gain items within continuing operations.

For years, discontinued operations and extraordinary items have been subject to *classification manipulation*. Companies with losses from discontinued operations and extraordinary items have been motivated to position those items below the line, out of "income from continuing operations."

By moving an expense or loss into discontinued operations or extraordinary items, a company can increase three key measurements that can 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 multiple 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 sale of 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 of 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 discontinued operations	0	65,000
Income from continuing operations	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 in 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 amount 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 and extraordinary items. This trend has occurred particularly with respect to losses and expenses.

Two studies provide empirical evidence that companies have and continue to shift losses and expenses from continuing operations to discontinued operations or extraordinary items.

> *Earnings Management Using Classification Shifting: An Examination of Core Earnings and Special Items* (Sarah Elizabeth McVay)

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 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 and reserve manipulation, classification shifting requires no "settling-up" in the future for past earnings management.

        - If a manager decides to increase earnings using accrual or reserve adjustments, at some point in the future, the accruals and reserves must reverse. The future reversal 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 other 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:

        - With classification shifting, 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 as part of 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."

Next, 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-Oxley Section 302 certification of the financial statements (for SEC companies only) focuses on net income.

2. Sarbanes-Oxley 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 gradually 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.

a. The FASB has removed several transactions from the list of transactions that specifically qualify as extraordinary, and more recently eliminated extraordinary treatment altogether from GAAP with the issuance of ASU 2015-01.

b. The FASB has issued ASU 2014-08, *Discontinued Operations*, that restricts the scope of transactions that qualify as discontinued operations.

First, let's look at the changes that have been made to extraordinary items.

To recap, under the rules in effect prior to the effective date of ASU 2015-01, an entity is classified as extraordinary if it satisfies *two requirements*:

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.

As to extraordinary items, the FASB has eliminated certain specific transactions that had been codified as being extraordinary regardless of whether they met the two criteria: (infrequency of occurrence and unusual in nature.)

Over the past decade, the FASB has issued several statements to eliminate extraordinary treatment for several transactions that were previously categorized as extraordinary:

- Extinguishment of debt should not be considered extraordinary unless they meet the "unusual in nature" and "infrequent in occurrence" criteria (FASB No. 145, Rescission *of FASB Statements No. 4, 44, and 64).*

- FASB No. 109, *Accounting for Income Taxes* (now part of ASC 740), eliminated the rule that the tax benefit of using a net operating loss carryforward should be presented as an extraordinary item when recognized.

- FASB eliminated the provision that in a business combination, a portion of negative goodwill would be recorded as an extraordinary gain.

The following chart summarized the history of events that has lead to the current status of extraordinary treatment prior to the effective date of ASU 2015-01.

Item	**Status**	**Remaining extraordinary [Prior to effective date of ASU 2015-01]**
Extinguishment of debt	Eliminated per FASB No. 145	
Tax benefit from using NOL carryforward	Eliminated per FASB No. 109	
Negative goodwill	Eliminated per FASB No. 141	
Losses related to motor carriers	Eliminated per FASB No. 145	
Net effect of discontinuing the application of regulated operations		**X**
General rules: Transaction that satisfies the two criteria: 1) Unusual nature and 2) Infrequency of occurrence		**X**

The previous chart provides a list of transactions that were codified as being extraordinary regardless of whether they met the two criteria (infrequent and unusual) for extraordinary treatment. Now, prior to the effective date of ASU 2015-01, all but one of them has been eliminated. The result is that in order for a transaction to be presented as an extraordinary item, it must satisfy the two criteria in that it *must be unusual in nature and infrequency of occurrence*.

Acts of God and terrorist attacks don't make the cut for extraordinary treatment

In addition to the FASB pruning specific transactions from the extraordinary list, since 2001, the FASB and AICPA have both had to address the issue as to whether acts of God and terrorist attacks qualify for extraordinary item treatment.

In general, both the FASB and AICPA have opined that transactions related to acts of God (such a nature disasters) and terrorist attacks, by themselves, are not categorized as extraordinary.

In 2001, the FASB EITF ruled that the events of September 11 did not rise to satisfying the two criteria for extraordinary treatment. The FASB EITF argued:

- The magnitude of the events did not result in the transaction being extraordinary.

- Although the September 11 event was unusual in nature, *it did not satisfy the infrequency of occurrence criterion* because the underlying event or transaction (a terrorist attack) was not 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.

The events of Hurricane Katrina were similarly not treated as extraordinary although there was a question as to whether any losses that were due to the failure of the levees could be considered extraordinary, rather than the losses due to the hurricane itself.

In 2011, the AICPA issued a non-authoritative technical practice Aid (TPA) in which the AICPA followed the original guidance found in 2001 by stating that losses due to natural disasters were not extraordinary unless they could satisfy the two criteria for extraordinary treatment. In that TPA, the AICPA restated previous confirmation that the magnitude of a transaction does not, in and of itself, result in the transaction being categorized as extraordinary.

International standards eliminate use of extraordinary items

Going as far back as 2002, the IASB eliminated 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.

According to the IASB, it decided that items treated as extraordinary result from the normal business risks faced by an entity and do not warrant presentation in a separate component of the income statement. The nature or function of a transaction or other event, rather than its frequency, should determine its presentation within the income statement. Items

currently classified as "extraordinary" are only a subset of the items of income and expense that may warrant disclosure to assist users in predicting an entity's future performance.

The IASB indicates 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 nonrecurring.

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. With respect to existing GAAP for discontinued operations prior to the effective date of 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 in 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

2. Under existing GAAP before the effective date 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

3. 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

4. Under GAAP in place prior to the effective date of ASU 2015-01, how has the FASB opined on how losses incurred as a result of a terrorist attack should 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

SUGGESTED SOLUTIONS

1. With respect to existing GAAP for discontinued operations prior to the effective date of 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.

2. Under existing GAAP before the effective date 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.

3. 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.

4. Under GAAP in place prior to the effective date of ASU 2015-01, how has the FASB opined on how losses incurred as a result of a terrorist attack should 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.
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. FASB has argued that a terrorist attack does not satisfy the two criteria so that presently the effect of a terrorist attack is shown 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.

ASU 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

Issued: April 2014

Effective date: ASU 2014-08 is effective as follows:

Public business entities and certain not-for-profit entities: The ASU is applied prospectively to transactions occurring within annual periods *beginning on or after December 15, 2014*, and interim periods within those years.

For all other entities (including non-public entities): The ASU is applied prospectively to transactions occurring within annual periods *beginning on or after December 15, 2014*, and interim periods within annual periods beginning on or after December 15, 2015.

For all entities, early adoption is permitted, but only for disposals (or classifications as held for sale) that have not been reported in financial statements previously issued or available for issuance.

I. Objective

The objective of ASU 2014-08 is to develop improved reporting and disclosures for discontinued operations including:

- Changing the definition of discontinued operation that facilitate convergence of U.S. GAAP and international standards.

- Enhancing disclosures about discontinued operations and individually significant components of an entity that have been (or will be) disposed.

The amendments in the ASU affect an entity that has either of the following:

1. A component of an entity that either is disposed of, or is classified as held for sale, or

2. A business or nonprofit activity that, on acquisition, is classified as held for sale.

II. Background

The authority for classifying transactions as discontinued operations is found in ASC 205-20, *Presentation of Financial Statements- Discontinued Operations.*

Under current rules (prior to the effective date of ASU 2014-08), ASC 205-20-45 states that the results of operations of a component of an entity that either has been disposed of, or is classified as held for sale, must be reported in discontinued operations if *two conditions* are met:

1. 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

2. The entity will not have any *significant continuing involvement* in the operations of the component after the disposal transaction.

Currently, ASC 205 provides that if a component of an entity qualifies as discontinued operations, the results of operations (including any gain or loss from the disposal), is presented on the income statement as a separate component of income before extraordinary items, net of the applicable tax effect.

Investors have noted that the current definition of discontinued operations is broad, and has resulted in the following:

- Too many disposals of single transactions have been classified as discontinued operations

- Many disposals of small groups of assets that are recurring in nature have been classified as discontinued operations

- Some of the guidance on reporting discontinued operations has resulted in higher costs for preparers because those rules can be complex and difficult to apply, and

- There has been not enough emphasis of the impact of discontinued operations on the balance sheet.

One example where the current rules have been too broad is where an entity that sells one single asset (such as a commercial building) might be able to classify that transaction as a discontinued operation as long as there is no significant involvement after the disposal date. In doing so, the gain or loss on disposal, (and net rental income) is presented below the line in discontinued operations, and outside of income from continuing operations.

Financial statement users have asked the FASB to narrow the definition of discontinued operations so that a disposal activity should be presented in discontinued operations only when an entity has made a strategic shift in its operations. Thus, the goal of the FASB has been to create a definition of discontinued operations that precludes the sale of most single assets and groups of small assets from being classified as a discontinued operation.

The key objective of the discontinued operations project is to:

- Develop an improved definition of discontinued operations that also enhances convergence of U.S. GAAP and IFRS
- Reduce complexity on the current rules, and
- Enhance disclosures about discontinued operations including the disclosures and expanded presentation of the balance-sheet effects of discontinued operations.

In April 2013, the FASB issued an exposure draft entitled, *Presentation of Financial Statements (Topic 205): Reporting Discontinued Operations.* The FASB received 45 letters of comment to the exposure draft.

In April 2014, the FASB issued the final statement as ASU 2014-08.

The key changes made by ASU 2014-08 are as follows:

1. The ASU affects an entity that has either of the following:
   a. A component of an entity that either is disposed of, or is classified as held for sale, or
   b. A business or nonprofit activity that, on acquisition, is classified as held for sale.
2. There is a new definition of discontinued operations that limits discontinued operations reporting.
   a. The new definition provides that a disposal of a component (or group of components) of an entity is required to be reported in discontinued operations only if the disposal *represents a strategic shift* that has (or will have) a *major effect* on an entity's operations and financial results.

      Note: Under current U.S. GAAP, many disposals, some of which may be routine in nature and not a change in an entity's strategy, are reported in discontinued operations.
3. There are expanded disclosures about discontinued operations to provide users more information about assets, liabilities, revenues, and expenses of discontinued operations.
   a. The ASU requires an entity to disclose the pretax profit or loss (or change in net assets for a not-for-profit entity) of an individually significant component of an entity that does not qualify for discontinued operations reporting.

b. Within the disclosures, there are certain reconciliations and cash flow information required related to a discontinued operation.

4. There are several changes to the Accounting Standards Codification to improve the organization and readability of ASC 205-20, *Discontinued Operations*, and ASC 360-10, *Property, Plant, and Equipment—Overall*, including the addition of flowcharts to help stakeholders implement the disclosure requirements.

5. The ASU eliminates several transactions that were exempt from discontinued operations.

Under the amendments in ASU 2014-08, the definition of discontinued operations differs from current U.S. GAAP as follows:

1. Under the new rules, only those disposals of components of an entity that represent a *strategic shift* that has (or will have) a *major effect* on an entity's operations and financial results will be reported as discontinued operations in the financial statements.

   Currently, a component of an entity that is a reportable segment, an operating segment, a reporting unit, a subsidiary, or an asset group is eligible for discontinued operations presentation.

2. The current definition of discontinued operations has been removed, which requires that:

   a. The operations and cash flows of the component must have been (or will be) eliminated from the ongoing operations of the entity as a result of the disposal transaction, and

   b. The entity will not have any significant continuing involvement in the operations of the component after the disposal transaction.

3. A business or nonprofit activity that, on acquisition, meets the criteria to be classified as held for sale may now be reported in discontinued operations. Currently, U.S. GAAP does not include a business or nonprofit activity in the definition of discontinued operations.

4. A disposal of an equity method investment that meets the definition of discontinued operations may now be reported in discontinued operations. Currently, disposals of equity method investments are not in the scope of discontinued operations found in ASC 205-20.

The new definition of discontinued operations in ASU 2014-08 is now similar to the definition of discontinued operation in IFRS 5, *Noncurrent Assets Held for Sale and Discontinued Operations*. Part of the definition of discontinued operations in the ASU is based on the guidance in IFRS 5 indicating that a discontinued operation should represent a separate major line of business or geographical area of operations.

III. Definitions

ASU 2014-08 makes the following amendments to definitions found in the Master Glossary of ASC 360:

Disposal Group: A disposal group for a long-lived asset or assets to be disposed of by sale or otherwise, represents assets to be disposed of together as a group in a single transaction and liabilities directly associated with those assets that will be transferred in the transaction. A disposal group may include a discontinued operation along with other assets and liabilities that are not part of the discontinued operation.

Business: An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants.

Component of An Entity: 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.

Nonprofit Activity: An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing benefits, other than goods or services at a profit or profit equivalent, as a fulfillment of an entity's purpose or mission (for example, goods or services to beneficiaries, customers, or members). As with a not-for-profit entity, a nonprofit activity possesses characteristics that distinguish it from a business or a for-profit business entity.

Firm Purchase Commitment: A firm purchase commitment is an agreement with an unrelated party, binding on both parties and usually legally enforceable, that meets both of the following conditions:

a. It specifies all significant terms, including the price and timing of the transaction.
b. It includes a disincentive for nonperformance that is sufficiently large to make performance probable.

Not-for-Profit Entity: An entity that possesses the following characteristics, in varying degrees, that distinguish it from a business entity:

a. Contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return
b. Operating purposes other than to provide goods or services at a profit
c. Absence of ownership interests like those of business entities.

Entities that clearly fall outside this definition include the following:

a. All investor-owned entities
b. Entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants, such as mutual insurance entities, credit unions, farm and rural electric cooperatives, and employee benefit plans.

Probable: The future event or events are likely to occur.

Public Business Entity: A public business entity is a business entity meeting any one of the criteria below. Neither a not-for-profit entity nor an employee benefit plan is a business entity.

a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).
b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.
c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of, or for purposes of issuing securities that are not subject to contractual restrictions on transfer.
d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.
e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including footnotes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.

IV. Scope and Scope Exceptions

1. The scope of ASU 2014-08 applies to either of the following:

   a. A *component* or a group of components of an entity that is disposed of, or is classified as held for sale that has been disposed of, or alternatively, has been classified as held for sale, or

   b. A *business or nonprofit activity* that, on acquisition, is classified as held for sale.

2. The scope of the ASU *does not apply* to oil and gas properties that are accounted for using the full-cost method of accounting as prescribed by the U.S. Securities and Exchange Commission (SEC)[5]

   a. The list of activities excluded from discontinued operations has been reduced under ASU 2014-08 as noted in the following table:

Activities Excluded from Discontinued Operations	
Existing GAAP ASC 205-20 [Pre-ASU 2014-08]	**New GAAP ASU 2014-08**
• Goodwill	
• Intangible assets not amortized	
• Servicing assets	
• Financial instruments	
• Deferred policy acquisition costs	
• Deferred tax assets	
• Unproved oil and gas properties accounted for using the successful-efforts method of accounting	
• Oil and gas properties accounted for using the full-cost method	• Oil and gas properties accounted for using the full-cost method
• Certain other long-lived assets in specialized industries	

Observation: Prior to the effective date of ASU 2014-08, ASC 205-20 excludes certain types of assets from the scope of discontinued operations including goodwill, servicing assets, and unproved oil and gas properties that are accounted for using the full-cost method of accounting. In issuing ASU 2014-08, the FASB decided that all of the previous scope exceptions should be eliminated except for the scope exception for oil and gas properties that are accounted for using the full-cost method of accounting.

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[5] See Regulation S-X, Rule 4-10, *Financial Accounting and Reporting for Oil and Gas Producing Activities Pursuant to the Federal Securities Laws and the Energy Policy and Conservation Act of 1975*.

V. Rules in ASU 2014-08

1. ASU 2014-08 discusses the conditions under which a transaction is presented as a discontinued operation in an entity's financial statements.

2. 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.

   Note: If a component of an entity that either has been disposed of or is classified as held for sale does not meet the conditions to be reported in discontinued operations, ASC 360-10-45, *Property, Plant and Equipment, Overall, Other Presentation Matters*, provides guidance on presenting disposal gains and losses and impairment losses on assets classified as held for sale.

   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. Discontinued operation comprising a component or a group of components of an entity:

   a. 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 when any of the following occurs:

      1) The component of an entity or group of components of an entity meets the criteria to be classified as *held for sale*.

      2) The component of an entity or group of components of an entity is *disposed of* by:

         - Sale, or
         - Other than sale (e.g., disposal occurs by abandonment, exchange, spinoff, or in a distribution to owners).

b. 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

c. Definition of *major effect*:

1) The ASU does not define the threshold for "major effect."

2) 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.

4. Discontinued operation comprising a business or nonprofit activity:

a. A business or nonprofit activity that, on acquisition, meets the criteria to be classified as held for sale is a discontinued operation.

b. Below is a list of the criteria that must be satisfied to meet the held-for-sale threshold:

Criteria for Classification of Held for Sale

1. A component of an entity (or component) or a group of components of an entity (or component), or a business or nonprofit activity (the entity (or component) to be sold), shall be classified as *held for sale* in the period in which *all* of the following criteria are met:

   a. Management, having the authority to approve the action, commits to a plan to sell the entity (or component) to be sold.

   b. The entity (or component) to be sold is available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such entities to be sold.[6]

   c. An active program to locate a buyer or buyers and other actions required to complete the plan to sell the entity (or component) to be sold, have been initiated.

   d. The sale of the entity (or component) to be sold is *probable*, and transfer of the entity (or component) to be sold is expected to qualify for recognition as a completed sale, *within one year*, except as permitted by paragraph (3) below.

   e. The entity (or component) to be sold is being actively marketed for sale at a price that is reasonable in relation to its current fair value.

[6] Examples 5 through 7 [paragraphs 360- 10-55-37 through 55-42], *Property, Plant and Equipment*, provides illustrations of when this criterion would be met.

- The price at which an entity (or component) to be sold is being marketed is indicative of whether the entity (or component) currently has the intent and ability to sell the entity (or component) to be sold.

- A market price that is reasonable in relation to fair value indicates that the entity (or component) to be sold is available for immediate sale, whereas a market price in excess of fair value indicates that the entity (or component) to be sold is not available for immediate sale.

f. Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

2. If at any time the criteria in (a) through (f) above are no longer met (except as permitted by (3) below), an entity (or component) to be sold that is classified as held for sale shall be reclassified as held and used and measured in accordance with ASC 360-10-35-44, *Property, Plant and Equipment*.

3. Extension of the one-year rule: Events or circumstances beyond an entity (or component's) control may extend the period required to complete the sale of an entity (or component) to be sold beyond one year.

An exception to the one-year requirement in paragraph (1)(d) above shall apply in the following situations in which those events or circumstances arise:

a. If, at the date that an entity (or component) commits to a plan to sell an entity (or component) to be sold, the entity (or component) reasonably expects that others (not a buyer) will impose conditions on the transfer of the entity (or component) to be sold that will extend the period required to complete the sale and *both* of the following conditions are met:

- Actions necessary to respond to those conditions cannot be initiated until after a firm purchase commitment is obtained, and
- A firm purchase commitment is probable within one year.

b. If an entity (or component) obtains a firm purchase commitment and, as a result, a buyer or others unexpectedly impose conditions on the transfer of an entity (or component) to be sold previously classified as held for sale that will extend the period required to complete the sale and *both* of the following conditions are met:

- Actions necessary to respond to the conditions have been or will be timely initiated, and
- A favorable resolution of the delaying factors is expected.

c. If during the initial one-year period, circumstances arise that previously were considered unlikely and, as a result, an entity (or component) to be sold previously classified as held for sale is not sold by the end of that period and all of the following conditions are met:

- During the initial one-year period, the entity (or component) initiated actions necessary to respond to the change in circumstances
- The entity (or component) to be sold is being actively marketed at a price that is reasonable given the change in circumstances, and
- The criteria in paragraph (1) are met.

Note: Examples 8-11 in ARC 360-10-55-43 through 48, *Property, Plant and Equipment*, provide illustrations that address the application of the held for sale rules.

Observation: In choosing a definition of a discontinued operation, the FASB considered numerous elements. In the end, the FASB concluded that the nature of the disposal and its

effect on an entity's operations and financial results matter more than the composition of the transaction. Therefore, the FASB decided that a discontinued operation could include different parts of an entity other than an entire major line of business or a major geographical area of operations, as long as those parts together represent a strategic shift that has a major effect on an entity's operations and financial results.

The FASB also decided that strategic shifts reported in discontinued operations should include only those disposals of components of an entity that have (or will have) a major effect on an entity's operations and financial results.

Do the new rules permit the effects of a sale of a single asset to be presented as discontinued operations?

Under the current rules for discontinued operations, many companies have taken liberty to classify 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 the 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."

The author suggests the following transactions and his unofficial opinion on each:

	Strategic Shift?	Major Effect?	Discontinued Operation?
Sale of a major single asset that does not represent a shift of operations away from a particular geographic area or product line	No	Yes	No
Sale of a major single asset that represents a planned or strategic shift away from a particular geographic region or product line	Yes	Yes	Yes

In reviewing the previous chart, rarely will the sale of a single asset represent a "strategic shift" in an entity's operations even if such a sale meets the "major effect“ threshold. Thus, discontinued operations treatment for a single asset sale is unlikely under the new ASU 2014-08 definition. In order for that single sale to satisfy the "strategic shift" criterion, it must represent a shift away from a particular geographic region or product line. In particular, a one-off sale of an asset most likely does not represent a shift away from a geographic region or product line.

What is the threshold for determining whether a strategic shift has or will have a "major effect" on the entity's operations and financial results?

The ASU does not quantify how to determine whether a strategic shift has, or will have, a major effect. The FASB staff has indicated that the SEC has provided its own input and suggested that in order for a transaction to meet the "major effect" threshold, it must represent 15 to 20% of an entity's total assets, revenue or net income, although that threshold is not codified in any authoritative document. In fact, in the various examples given by the FASB in ASU 2014-08, those examples offer 15 to 20% thresholds.

Interestingly, the author is surprised that the FASB did not use a 10% threshold consistent with other GAAP (e.g., segment reporting, major customers, etc.). The fact that the SEC (and FASB) have a higher threshold of 15 to 20% illustrates the importance the discontinued operations changes have and the overall goal to minimize the volume of transactions that qualify for discontinued operations treatment. After all, the higher the percentage threshold, the fewer transactions that qualify to be classified as discontinued operations.

Example: Company X is a mall owner and owns 20 malls across the United States. X is concerned about the New England market and overall competition that market. As a result, X decides to divest of one of its malls located in Burlington, Massachusetts, and invest the net proceeds into other parts of the country in which growth is more likely. The mall represents about 18% of X's revenue, profitability and total assets. There is a loss on sale.

Should X present the loss on sale and the net rental income from the Burlington Mall in discontinued operations?

Response: Probably. The sale represents a *strategic shift* of its operations out of New England. Further, the sale will have a major effect on X's operations and financial results given the fact that the mall represents about 18% of its revenue, profitability and total assets.

Example: Company Y is a real estate rental company that owns and operates numerous residential and commercial real estate along the East Coast.

Y decides to sell on large commercial building in North Carolina because Y is offered an excellent price from a competitor. The sale is completed and yields a gain. The building represents about 20% of Y's revenue.

Should Y present the gain on sale and the net rental income from the commercial building in discontinued operations?

Response: Probably not. It is true that the sale will have a major effect on X's operations and financial results based on the fact that the building represents 20% of Y's revenue. However, there is *no evidence* that the sale of this one asset represents a *strategic shift* of its operations. Instead, the sale is a one-off and isolated sale that does not appear to be driven by a strategy to shift away from a geographic area or product line.

Thus, the gain on sale and the net rental income for the year of sale, should not be presented in discontinued operations. Instead, they should remain as part of income from continuing operations.

5. Statement of income reporting- discontinued operations:

   If a transaction qualifies as a discontinued operation, ASU 2014-08 requires the following be presented in the income statement:

   a. The income statement (or the statement of activities of a not-for-profit entity (NFP)) shall report the following in the period in which a discontinued operation either has been disposed of, or is classified as held for sale:

      - Results of operations of the discontinued operation, and
      - Any gain or loss recognized on the disposal, if any.

      Note: The results of operations and any gain or loss related to discontinued operations are presented *net of applicable income taxes or benefit*.

b. The results of all discontinued operations, less applicable income taxes (benefit), shall be reported as a separate component of income before extraordinary items (if applicable).

c. A gain or loss recognized on the disposal (or loss recognized on classification as held for sale) shall be disclosed either:

- Presented separately on the face of the income statement (parenthetically or otherwise), or
- Disclosed in the notes to financial statements.

Note: A gain or loss recognized on the disposal (or loss recognized on classification as held for sale) of a discontinued operation shall be calculated in accordance with other GAAP. For example, if a discontinued operation is within the scope of ASC 360, *Property, Plant, and Equipment*, an entity shall follow the guidance in paragraphs 360-10-35-37 through 35-45 and 360-10-40-5 for calculating the gain or loss recognized on the disposal (or loss on classification as held for sale) of the discontinued operation.

d. Adjustments to amounts previously reported in discontinued operations in a prior period shall be presented separately in the current period in the discontinued operations section of the statement where net income is reported.

Examples of circumstances in which those types of adjustments may arise include the following:

- The resolution of contingencies that arise pursuant to the terms of the disposal transaction, such as the resolution of purchase price adjustments and indemnification issues with the purchaser
- The resolution of contingencies that arise from and that are directly related to the operations of the discontinued operation before its disposal, such as environmental and product warranty obligations retained by the seller, and
- The settlement of employee benefit plan obligations (pension, postemployment benefits other than pensions, and other postemployment benefits), provided that the settlement is directly related to the disposal transaction.

  Note: A settlement is directly related to the disposal transaction if there is a demonstrated direct cause-and-effect relationship and the settlement occurs no later than one year following the disposal transaction, unless it is delayed by events or circumstances beyond an entity's control.

e. ASU 2014-08 carries over the existing rule found in ASU 205-20-45-3 that if a transaction is presented in discontinued operations in the current period income statement, the results of operations and gain or loss, if any, for that operations shall be reclassified into discontinued operations for the prior periods presented comparatively.

f. ASC 205-20-45, (paragraphs 6 through 9), provides rules for allocating interest and overhead to discontinued operations.

- Interest on debt to be assumed by the buyer and on debt required to be repaid due to the disposal is allocated to discontinued operations.
- Consolidated interest that is not directly attributable to other operations of the entity is permitted to be allocated to discontinued operations.
- Other consolidated interest that cannot be attributed to other operations is allocated based on the ratio of net assets to be sold less debt to be repaid, to the sum of total net assets of the consolidated entity plus consolidated debt other than certain identified debt.
- General corporate overall is not allocated to discontinued operations.

Following is an example of the presentation of discontinued operations on the income statement:

Income from continuing operations before income taxes	$XX	
Income taxes	(XX)	
Income from continuing operations		XX
Discontinued operations		
Loss from operations of discontinued Component X (including loss on disposal of $XX) (a)	***(XX)***	
Adjustment to previously reported discontinued operation (b)	***XX***	
Income tax benefit	***XX***	
Loss on discontinued operations		***(XX)***
Income before extraordinary gain		XX
Extraordinary gain (net of tax effect of $XX)		XX
Net income		$XX

(a) The ASU permits the loss from disposal to be presented on the face of the income statement (parenthetically or otherwise) or notes to financial statements.

(b) The ASU requires that any adjustments to amounts previously reported in discontinued operations in a prior period be presented separately in the current period.

6. Balance sheet reporting- discontinued operations:

a. In the period(s) in which a discontinued operation is classified as *held for sale* and for all prior periods presented, the assets and liabilities of the discontinued operation shall be presented separately in the asset and liability sections, respectively, of the statement of financial position.

   1) Those assets and liabilities shall not be offset and presented as a single amount.

   2) If a discontinued operation is part of a disposal group that includes other assets and liabilities that are not part of the discontinued operation, an entity may present the assets and liabilities of the disposal group separately in the asset and liability sections, respectively, of the statement of financial position.

   Note: The ASU requires that the prior years' balance sheets be reclassified to reflect the discontinued operations by reclassifying the assets and liabilities related to the discontinued operations in the prior years' balance sheets. The ASU states that the reclassification of the prior years' balance sheets is required when there is a discontinued operation that is classified as held for sale. It does not state that such a reclassification is required if there is an actual sale of an asset or asset group in the current period. (The author has addressed this issue with the FASB staff which has unofficially stated that the reclassification of the prior years' balance sheets is required if there is a current year discontinued operation from an actual disposal or a transaction held for sale. Apparently, there was an oversight within the language found in the ASU.)

b. If a discontinued operation is disposed of before meeting the criteria to be classified as held for sale, an entity shall present the assets and liabilities of the discontinued operation separately in the asset and liability sections, respectively, of the statement of financial position for the periods presented in the statement of financial position *before* the period that includes the disposal.

   Note: When an entity separately presents in prior periods the assets and liabilities of a discontinued operation, the entity *shall not apply* the guidance in ASC 360-10-35-43, *Property, Plant and Equipment*, as if those assets and liabilities were held for sale in those prior periods. Thus, the requirement found in ASC 360-10-35-43 that an asset held for sale be recorded at the lower of carrying amount or fair value less costs to sell, is ignored.

c. For any discontinued operation *initially classified* as held for sale in the current period, an entity shall either present on the face of the statement of financial position or disclose in the notes to financial statements, the major classes of assets and liabilities of the discontinued operation classified as held for sale for all periods presented in the statement of financial position.

1) Any loss recognized on a discontinued operation classified as held for sale in the income statement shall not be allocated to the major classes of assets and liabilities of the discontinued operation.

d. A long-lived asset classified as held for sale, *but not qualifying for presentation as a discontinued operation in the statement of financial position*, shall be presented separately in the statement of financial position of the current period.

Observation: Currently, U.S. GAAP requires that if in the current year there is a transaction that is classified as a discontinued operation, the income statement for the prior period presented should also be reclassified in discontinued operations.

Although GAAP requires that the income statement must be reclassified for the prior period, existing GAAP does not specify whether the balance sheet of a discontinued operation should be reclassified for prior periods. The FASB included a question in the proposed ASU asking whether U.S. GAAP should provide further guidance on reclassification of the balance sheet.

Some respondents suggested requiring reclassification of a discontinued operation's balance sheet for prior periods. Those respondents noted that reclassifying the prior year balance sheet is necessary to evaluate an entity's balance sheet in prior periods without the discontinued operation, which would promote comparability across reporting periods.

In the final ASU 2014-08, the FASB included language requiring reclassification of discontinued operations in the balance sheet for prior periods. The FASB noted that reclassifying prior periods in the balance sheet provides information about historical trends related to the entity's continuing operations and discontinued operations, including the ability to better analyze trends in return on assets and leverage. As to the income statement, the ASU does not change the current rules that require that the income statement for the prior periods presented also be reclassified to present the results of operations and gain or loss in the discontinued operations section of the prior periods' income statements that are presented comparatively.

Example: In 2015, Company X issues financial statements. In 2016, X decides to sell its widget product line and places the line on the market for sale. At the end of 2016, the product line has not been sold but satisfies the criteria to be held for sale and to be classified as discontinued operations.

Conclusion: For 2016, X must classify the assets and liabilities of the discontinued operation separately in the asset and liability sections of the 2016 balance sheet. Those assets and liabilities shall not be offset and presented as a single amount. Further, X

must reclassify the 2015 balance sheet by separating the assets and liabilities of the widget product line, for the discontinued operation on that 2015 balance sheet.

As to X's income statement, in 2016, the results of operations and loss from any writedown, if any, for the held for sale assets, is presented in discontinued operations in the income statement, net of the tax effect. Because the transaction is presented as a discontinued operations in 2016, X must reclassify its income statement for 2015 to present the results of operations of the widget product line in the discontinued operations section of the income statement for that year.

X's 2016 and 2015 balance sheets and income statements are presented below:

Company X
Balance Sheets
December 31, 2016 and 2015

Assets	2016	2015 (a)
Current assets:		
Cash	$XX	$XX
Trade receivables	XX	XX
Inventories	XX	XX
Assets held for sale	***XX***	***XX***
Total current assets	XX	XX
Property, plant and equipment, net:		
Cost	XX	XX
Less accumulated depreciation	XX	XX
Total property, plant, and equipment	XX	XX
	$XX	$XX
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	XX	XX
Accrued expenses	XX	XX
Debt related to assets held for sale	***XX***	***XX***
Current portion of long-term debt, all other debt	XX	XX
Total current liabilities	XX	XX
Long-term debt:	XX	XX
Stockholders' equity:		
Common stock	XX	XX
Retained earnings	XX	XX
Total stockholders' equity	XX	XX
	$XX	$XX

(a) ASU 2014-08 requires that the balance sheet for the prior year be reclassified to reflect the assets and liabilities of the transaction related to the 2016 discontinued operation. If the balance sheet is reclassified in the prior year, the assets are not revalued under the held for sale rules.

Company X
Statements of Income
For the Years Ended December 31, 2016 and 2015

	2016	2015 (c.)
Net sales	$XX	$XX
Cost of sales	XX	XX
Gross profit on sales	XX	XX
Operating expenses	XX	XX
Income from operations	XX	XX
Other income and expenses	XX	XX
Income from continuing operations before income taxes	XX	XX
Income taxes	(XX)	(XX)
Income from continuing operations	XX	XX
Discontinued operations		
Loss from operations of discontinued Component X (including loss on disposal of $XX) (a)	***(XX)***	***(XX)***
Adjustment to previously reported discontinued operation(b)	***XX***	***XX***
Income tax benefit	***XX***	***XX***
Loss on discontinued operations	***(XX)***	***(XX)***
Income before extraordinary gain	XX	XX
Extraordinary gain (net of tax effect of $xx)	XX	XX
Net income	$XX	$XX

(a) The ASU permits the loss from disposal to be presented on the face of the income statement (parenthetically or otherwise) or notes to financial statements.

(b) The ASU requires that any adjustments to amounts previously reported in discontinued operations in a prior period be presented separately in the current period.

(c.) Although the discontinued operation occurred in 2016, GAAP requires that the income statement for the prior year 2015 be reclassified to reflect the revenue and expenses and gain/loss of the transaction in discontinued operations for 2015.

How do the rules apply when a transaction is held for sale?

The discontinued operations rules apply to a disposal transaction, and a held-for-sale transaction. Under the held-for-sale rules, if a transaction satisfies certain criteria in the current year, the transaction is classified as held for sale. Under the discontinued operation rules, a held-for-sale transaction is treated the same as an actual disposal. The exception is that a held for sale transaction does not have a recognized gain or loss on disposal because the transaction has not been completed.

The ASU carries over a list of criteria from ASC 360, *Property, Plant and Equipment*, that determine whether a transaction should be classified as held for sale in the current period. Those criteria include:

1. Management commits to a plan to sell the components to be sold.

2. The components to be sold are available for immediate sale in their present condition subject only to terms that are usual and customary for such sales.

3. An active program to sell has been initiated.

4. The sale of the component(s) to be sold is *probable*, and transfer is expected to qualify for recognition as a completed sale, *within one year.*

5. The components to be sold are being actively marketed for sale at a price that is reasonable in relation to its current fair value.

6. Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

If an entity satisfies the above criteria, the transaction is classified as held for sale in the current period with the prior year financial statements reclassified, as well.

Once the above criteria are met, GAAP requires that the components (asset(s) and liabilities) to be sold be measured at the lower of carrying amount or fair value less costs to sell as follows:

Carrying amount (a)		$XX
Fair value less costs to sell (b)		XX
= Lower of (a) or (b)		$XX
Entry:	dr	cr
Unrealized loss	XX	
Assets held for sale		XX

Once the assets and liabilities have been written down to the lower of carrying amount or fair value (less costs to sell), a few rules apply to the balance sheet:

1. The asset(s) classified as held for sale:

   - Are *not depreciated* (or amortized) while it is classified as held for sale.

- Are *presented separately* in the balance sheet.

2. The assets and liabilities held for sale should be presented separately as current assets and liabilities unless the sale is not expected to be completed within one year or the operating cycle.

The next step is to determine whether the held-for-sale assets qualify as a discontinued operation using the ASU 2014-08 rules. That is, does the pending disposal represent a *"strategic shift that will have a major effect on an entity's operations and financial results?"* If so, the held-for-sale transaction is presented in discontinued operations in the current year with the prior year comparative income statement and balance sheet being reclassified to reflect the discontinued operation.

There is one key point worth noting. If a held-for-sale transaction is measured and presented in discontinued operations in the current year, the ASU requires that the prior year's balance sheet be reclassify by separately presenting the assets and liabilities of the transaction in the prior year's balance sheet. The ASU also states that although the prior year's assets and liabilities are reclassified, they are not revalued under the lower of carrying amount or fair value rules.

If the assets are held for sale, that means they have not been sold. Therefore, in the discontinued operations section of the income statement, the elements of the held for sale assets and liabilities reflect the following elements:

- Income or loss from operations, and

- Unrealized loss from writedown to lower of carrying amount and fair value (less costs to sell).

Following is an example of the format of the income statement presentation:

		2015		2014
Income from continuing operations		XX		XX
Discontinued operations				
Income from operations of discontinued Component X		***XX***		***XX***
Unrealized loss on writedown of assets held for sale	***(b)***	***(XX)***	***(a)***	***-***
Income tax benefit		***XX***		***XX***
Income (loss) on discontinued operations		***(XX)***		***(XX)***

(a) The prior year income statement (and balance sheet) should reflect the reclassification of the discontinued operations transaction. There is no writedown of the 2014 prior year's balance sheet to reflect the lower of carrying amount and fair value.

(b) Current year 2015 writedown of assets and liabilities held for sale to lower of carrying amount and fair value (less costs to sell).

VI. Disclosures

1. Disclosures required for all types of discontinued operations:

   The following shall be disclosed in the notes to financial statements that cover the period in which a discontinued operation either has been disposed of, or is classified as held for sale:

   a. A description of both of the following:

      1. The facts and circumstances leading to the disposal or expected disposal, and

      2. The expected manner and timing of that disposal.

   b. If not separately presented on the face of the income statement (or statement of activities for a not-for-profit entity) as part of discontinued operations, the gain or loss recognized on disposal (or loss on classification as held for sale) of a discontinued operation.

   c. If applicable, the segment(s) in which the discontinued operation reported under ASC 280, *Segment Reporting*.

2. Change to a plan of sale:

   In the period in which the decision is made to change the plan for selling the discontinued operation, an entity shall disclose in the notes to financial statements:

a. A description of the facts and circumstances leading to the decision to change, and

b. The change's effect on the results of operations for the period and any prior periods presented.

3. Adjustments to previously reported amounts:

An entity shall disclose the nature and amount of adjustments to amounts previously reported in discontinued operations that are directly related to the disposal of a discontinued operation in a prior period.

4. Continuing involvement:

An entity shall disclose information about its significant continuing involvement with a discontinued operation after the disposal date.

Examples of continuing involvement with a discontinued operation after the disposal date include:

- A supply and distribution agreement
- A financial guarantee
- An option to repurchase a discontinued operation, and
- An equity method investment in the discontinued operation.

An entity shall disclose the following in the notes to financial statements for each discontinued operation in which the entity retains significant continuing involvement after the disposal date:

a. A description of the nature of the activities that give rise to the continuing involvement.

b. The period of time during which the involvement is expected to continue.

c. For all periods presented, both of the following:

- The amount of any cash inflows or outflows from, or to the discontinued operation after the disposal transaction, and

- Revenues or expenses presented, if any, in continuing operations after the disposal transaction that before the disposal transaction were eliminated in the consolidated financial statements as intra-entity transactions.

d. For a discontinued operation in which an entity retains an equity method investment after the disposal (the investee), information that enables users of financial statements to compare the financial performance of the entity from period to period assuming that the entity held the same equity method investment in all periods presented in the statement where net income is reported (or statement of activities for a not-for-profit entity). The disclosure shall include all of the following until the discontinued operation is no longer reported separately in discontinued operations:

- For each period presented in the statement where net income is reported (or statement of activities for a not-for-profit entity) after the period in which the discontinued operation was disposed of, the pretax income of the investee in which the entity retains an equity method investment

- The entity's ownership interest in the discontinued operation before the disposal transaction

- The entity's ownership interest in the investee after the disposal transaction, and

- The entity's share of the income or loss of the investee in the period(s) after the disposal transaction and the line item in the statement where net income is reported (or statement of activities for a not-for-profit entity) that includes the income or loss.

Note: The previously noted disclosures are required until the results of operations of the discontinued operation in which an entity retains significant continuing involvement are no longer presented separately as discontinued operations in the statement where net income is reported (or statement of activities for a not-for-profit entity).

5. <u>Disclosures required for a discontinued operation comprising a component or group of components of an entity:</u>

An entity shall disclose, to the extent not presented on the face of the financial statements is part of discontinued operations, all of the following in the notes to financial statements:

a. The pretax profit or loss (or change in net assets for a not-for-profit entity) of the discontinued operation for the periods in which the results of operations of the discontinued operation are presented in the statement where net income is reported (or statement of activities for a not-for-profit entity).

b. The major classes of line items constituting the pretax profit or loss (or change in net assets for a not-for-profit entity) of the discontinued operation (for example, revenue, cost of sales, depreciation and amortization, and interest expense) for the periods in which the results of operations of the discontinued operation are presented in the statement where net income is reported (or statement of activities for a not-for-profit entity).

c. Cash flows information: Either of the following:

- The total operating and investing cash flows of the discontinued operation for the periods in which the results of operations of the discontinued operation are presented in the statement where net income is reported (or statement of activities for a not-for-profit entity), or

- The depreciation, amortization, capital expenditures, and significant operating and investing noncash items of the discontinued operation for the periods in which the results of operations of the discontinued operation are presented in the statement where net income is reported (or statement of activities for a not-for-profit entity).

d. If the discontinued operation includes a noncontrolling interest, the pretax profit or loss (or change in net assets for a not-for-profit entity) attributable to the parent for the periods in which the results of operations of the discontinued operation are presented in the statement where net income is reported (or statement of activities for a not-for-profit entity).

e. The carrying amount(s) of the major classes of assets and liabilities included as part of a discontinued operation classified as held for sale for the period in which the discontinued operation is classified as held for sale and all prior periods presented in the statement of financial position. Any loss recognized on the discontinued operation classified as held for sale shall not be allocated to the major classes of assets and liabilities of the discontinued operation.

f. Additional disclosures: If an entity provides the disclosures required by paragraph 5 (a), (b) and (e) in the notes to financial statements, the entity shall disclose the following:

1) For the initial period in which the disposal group is classified as held for sale and for all prior periods presented in the statement of financial position, a *reconciliation* of both of the following:

- The amounts disclosed in paragraph 5(e) above, and

- Total assets and total liabilities of the disposal group classified as held for sale that are presented separately on the face of the statement of financial position.

Note: If the disposal group includes assets and liabilities that are not part of the discontinued operation, an entity shall present those assets and liabilities in line items in the reconciliations that are separate from the assets and liabilities of the discontinued operation.

Sample Disclosure:

Reconciliation of the Carrying Amounts of Major Classes of Assets and Liabilities of the Discontinued Operation That Are Disclosed in the Notes to Financial Statements to Total Assets and Liabilities of the Disposal Group Classified as Held for Sale That Are Presented Separately in the Statement of Financial Position

	20X5	20X4
Carrying amounts of major classes of assets included as part of discontinued operations:		
Cash	$XX	$XX
Trade receivables	XX	XX
Inventories	XX	XX
Property, plant and equipment	XX	XX
Other classes of assets that are not major	XX	XX
Total major classes of assets of the discontinued operation	XX	XX
Other assets included in the disposal group classified as held for sale	XX	XX
Total assets of the disposal group classified as held for sale in the statement of financial position	$XX	$XX
Carrying amounts of major classes of assets included as part of discontinued operations:		
Trade payables	$XX	$XX
Short-term borrowings	XX	XX
Other classes of liabilities that are not major	XX	XX
Total major classes of liabilities of the discontinued operations	XX	XX
Other liabilities included in the disposal group classified as held for sale	XX	XX
Total liabilities of the disposal group classified as held for sale in the statement of financial position	$XX	$XX

2) For the periods in which the results of operations of the discontinued operation are reported in the income statement (or statement of activities for a not-for-profit entity), a *reconciliation* of both of the following:

a) The following amounts:

- The pretax profit or loss (or change in net assets for a not-for-profit entity) of the discontinued operation

- The major classes of line items constituting the pretax profit or loss (or change in net assets for a not-for-profit entity) of the discontinued operation such as revenue, cost of sales, depreciation and amortization, and interest expense, and

b) The after-tax profit or loss from discontinued operations presented on the face of the income statement (or statement of activities for a not-for-profit entity)

Note: For purposes of the reconciliation, an entity may aggregate the amounts that are not considered major and present them as one line item in the reconciliation.

Sample Disclosure:

Reconciliation of the Major Classes of Line Items Constituting Pretax Profit (Loss) of Discontinued Operations That Are Disclosed in the Notes to Financial Statements to the After-Tax Profit or Loss of Discontinued Operations That Are Presented in the Income Statement

Major classes of the items constituting pretax profit (loss) of discontinued operations:	20X5	20X4
Revenue	$XX	$XX
Cost of sales	(XX)	(XX)
Selling, general and administrative expenses	(XX)	(XX)
Interest expense	(XX)	(XX)
Other income (expense) items that are not major	(XX)	(XX)
Pretax profit or loss of discontinued operations related to major classes of pretax profit (loss)	XX	XX
Pretax gain or loss on the disposal of the discontinued operations	XX	XX
Total pretax gain or loss on discontinued operations	XX	XX
Income tax expense or benefit	(XX)	(XX)
Total profit or loss on discontinued operations that is presented in the statement of income	$XX	$XX

6. Disclosures required for a discontinued operation comprising an equity method investment:

   For an equity method investment disposal that meets the criteria to be classified as a discontinued operation, an entity shall disclose summarized information about the assets, liabilities, and results of operations of the investee if that information was disclosed in financial reporting periods before the disposal.

7. Disclosures for long-lived assets classified as held for sale or disposed of:

   For any period in which a long-lived asset (disposal group) either has been disposed of, or is classified as held for sale, an entity shall disclose *all* of the following in the notes to financial statements:

   a. A description of the facts and circumstances leading to the disposal or the expected disposal.

   b. The expected manner and timing of that disposal.

   c. The gain or loss recognized.

   d. If not separately presented on the face of the statement where net income is reported (or in the statement of activities for a not-for-profit entity), the caption in the statement where net income is reported (or in the statement of activities for a not-for-profit entity) that includes that gain or loss.

   e. If not separately presented on the face of the statement of financial position, the carrying amount(s) of the major classes of assets and liabilities included as part of a disposal group classified as held for sale. Any loss recognized in the disposal group classified as held for sale shall not be allocated to the major classes of assets and liabilities of the disposal group.

   f. If applicable, the segment in which the long-lived asset (disposal group) is reported under ASC 280**,** *Segment Reporting.*

8. In addition to the disclosures in paragraph 7(a) through (f) above, if a long-lived asset (disposal group) includes an *individually significant component* of an entity that either has been disposed of or is classified as held for sale, and *does not qualify for presentation and disclosure as a discontinued operation*, a public business entity (and a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market) shall disclose the information in (a).

a. *For a public business entity (and a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market*), disclose *both* of the following:

- The pretax profit or loss (or change in net assets for a not-for-profit entity) of the individually significant component of an entity for the period in which it is disposed of or is classified as held for sale, and for all prior periods that are presented in the income statement (or statement of activities for a not-for-profit entity) calculated in accordance with the rules found in ASC 205-20-45-6 through 45-9.

- If the individually significant component of an entity includes a noncontrolling interest, the pretax profit or loss (or change in net assets for a not-for-profit entity) attributable to the parent for the period in which it is disposed of or is classified as held for sale, and for all prior periods that are presented in the income statement (or statement of activities for a not-for-profit entity).

b. *For all other entities, (including non-public entities),* disclose *both* of the following:

- The pretax profit or loss (or change in net assets for a not-for-profit entity) of the individually significant component of an entity for the period in which it is disposed of, or is classified as held for sale calculated in accordance with the allocation rules found in ASC 205-20-45-6 through 45-9.

- If the individually significant component of an entity includes a noncontrolling interest, the pretax profit or loss (or change in net assets for a not-for-profit entity) attributable to the parent for the period in which it is disposed of or is classified as held for sale.

What about the statement of cash flows?

Existing GAAP does not require a separate disclosure of cash flows related to discontinued operations. In ASU 2014-08, the FASB added a new requirement to include disclosure of *either:*

- The total operating and investing cash flows of the discontinued operation, or

- The depreciation, amortization, capital expenditures, and significant operating and investing noncash items of the discontinued operation.

This requirement is a disclosure that is not required to be presented on the face of the statement of cash flows. The result is that the impact of a discontinued operation is not

segregated on the statement of cash flows. Instead, the transaction is accounted for on the statement of cash flows just like any other transaction. For example, the gain or loss from a disposal is an adjustment to net income using the indirect method, while any proceeds from the sale of the disposed asset(s) are presented as a cash inflow in the investing activities section of the statement of cash flows.

Finally, if there is a discontinued operations gain or loss on the income statement, in the statement of cash flows, the indirect method presentation of cash from operating activities starts with net income and not net income from continuing operations.

VII. Comparison of Key Provisions of ASU 2014-08 Versus Existing GAAP

The following chart summarizes the key provisions of ASU 2014-08 as compared with the rules found in existing GAAP in ASC 205, *Discontinued Operations*.

COMPARISON OF KEY PROVISIONS OF DISCONTINUED OPERATIONS EXISTING GAAP VERSUS NEW ASU 2014-08	
Existing GAAP	**New ASU 2014-08**
Definition of discontinued operation	
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: a. 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. b. The entity *will not have any significant continuing involvement* in the operations of the component after the disposal transaction.	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 when any of the following occurs: a. The component of an entity or group of components of an entity meets the criteria to be classified as held for sale. b. The component of an entity or group of components of an entity is disposed of by sale. c. The component of an entity or group of components of an entity is disposed of other than by sale (e.g., abandonment, exchange, spinoff or distribution).
Currently, a single component (asset) of an entity that is a reportable segment, an operating segment, a reporting unit, a subsidiary, or an asset group is eligible for discontinued operations presentation.	Under the new definition, a single component or asset of a segment, reporting unit, subsidiary, or asset group is not eligible for discontinued operations unless the disposal represents a "strategic shift" that has a "major effect" on the entity's operations and financial results.
Current definition requires that there be no significant continuing involvement in the component after the disposal.	Under the new definition, a disposal qualifies as a discontinued operation even if there is significant continuing involvement in the component after the disposal. If there is significant continuing involvement, additional disclosure is required.
Existing GAAP definition of a discontinued operation does not include: • A business or nonprofit activity in the definition of a discontinued operation. • Disposal of an equity method investment	A discontinued operation includes: • Business or nonprofit activity that, on acquisition, meets the criteria to be classified as held for sale

	• Disposal of an equity method investment that meets the definition of a discontinued operation.

Scope Exceptions	
Currently, ASC 205-20 excludes the following from discontinued operations: • Goodwill • Intangible assets not amortized • Servicing assets • Financial Instruments • Deferred policy acquisition costs • Deferred tax assets • Unproved oil and gas properties accounted for using the successful-efforts method of accounting • Oil and gas properties accounted for using the full-cost method • Certain other long-lived assets in specialized industries	The scope of ASU 2014-08 *does not apply:* • Oil and gas properties that are accounted for using the full-cost method of accounting All other exceptions are eliminated.
Definition of a Component	
Component of an entity: 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.	No change
Allocation of Interest and Overhead to Discontinued Operations	
Current GAAP has the following rules for allocating interest and overhead to discontinued operations: Interest: 1) Interest on debt that is to be assumed by the buyer and interest on debt that is required to be repaid as a result of a disposal transaction shall be allocated to discontinued operations. 2) The allocation to discontinued operations of other consolidated interest that is not directly attributable to, or related to other operations of the entity is permitted, but not required. 3) Other consolidated interest that cannot be attributed to other operations of the entity, is allocated based on the ratio of net assets to be sold or discontinued, less debt that is required to be paid as a result of the disposal transaction to the sum of total net assets of the	No change

consolidated entity plus consolidated debt other than the following: • Debt of the discontinued operation that will be assumed by the buyer • Debt that is required to be paid as a result of the disposal transaction • Debt that can be directly attributed to other operations of the entity. <u>Overhead</u>: 1) General corporate overhead shall not be allocated to discontinued operations.	
Income Statement Presentation	
• The results of all discontinued operations, less applicable income taxes (benefit), shall be reported as a separate component of income before extraordinary items (if applicable). • A gain or loss recognized on the disposal (or loss recognized on classification as held for sale) shall be disclosed either: Presented separately on the face of the income statement, or disclosed in the notes to financial statements	No change
Adjustments to amounts previously reported in discontinued operations that are directly related to the disposal of a component of an entity in a prior period shall be classified separately in the current period in discontinued operations.	Essentially the same with minor changes to language.
Presentation of Assets and Liabilities of Discontinued Operations	
<u>Current year</u> assets and liabilities that are held for sale are presented separately in the asset and liability sections of the statement of financial position.	No change
<u>Prior year presentation</u>: Current GAAP does not specify whether an entity should reclassify assets and liabilities as held for sale in the statement of financial position for periods before the reclassification.	<u>Prior year presentation:</u> The ASU requires that assets and liabilities for prior periods be reclassified to held for sale in the statement of financial position for prior periods presented.

Disclosures	
Various disclosures are required under existing GAAP.	Disclosures expanded to include: • Cash flows of the discontinued operations • Reconciliation of pretax profit or loss and major classes of line items of pretax profit or loss of the discontinued operation

VIII. Illustrations

The following examples are extracted from ASU 2014-08 and modified by the author.

First, let's do a quick review.

1. In order for a transaction to be classified as a discontinued operation, it must consist of 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. A component of an entity comprises operations and cash flows that can be *clearly distinguished, operationally and for financial reporting purposes*, from the rest of the entity.

3. A disposal of a component 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 when any of the following occurs:

    a. The component of an entity or group of components of an entity meets the criteria to be classified as *held for sale*.

    b. The component of an entity or group of components of an entity is *disposed of* by:

        - Sale
        - Other than sale (e.g., disposal occurs by abandonment, exchange, spinoff, or in a distribution to owners)

    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

Now let's look at the following examples:

Example 1: Consumer Products Manufacturer

Facts: Company X manufactures and sells consumer products that are grouped into five major product lines as follows:

- Discount cleaning products (DOG)
- Premium cleaning products (STAR)
- Candy and confectionery products
- Cereals
- Soups

Each product line includes several brands that comprise operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of X.

Therefore, for X, each major product line includes a group of components.

X has experienced high growth in its discount cleaning product line that has lower price points than its premium cleaning product line.

Total revenues from the discount cleaning product line are 15% of X's total revenues; however, the discount cleaning product line will require significant future investment to increase its profits. Therefore, X decides to shift its strategy of selling cleaning products at multiple price points and focus solely on selling cleaning products at a premium cleaning products line.

As a result, X sells the discount cleaning product line for a small gain.

Conclusion: First, the fact that each product line can be clearly distinguished, operationally and for financial reporting purposes, means that each product line meets the definition of a component.

Next, the question is whether the disposal of a component (discount cleaning product line) qualifies to be a discontinued operation.

The disposal represents a *strategic shift* in X's product lines by focusing on premium cleaning products instead of discount cleaning products. Further, the discount cleaning product line is one of five major product lines and its absence will have a *major effect* on X's operations and financial results. The "major effect" threshold is satisfied because total revenues from the disposed product line equal 15% of X's total revenues, which is the minimum percentage to achieve the "major effect."

Because the discount cleaning product line is a component, and its disposal represents a strategic shift with its absence having a major effect on X's operations and financial results, the disposal of the discount cleaning product line should be reported in discontinued operations. That means that the results of operations and the gain on sale should be classified into discontinued operations on the income statement, net of the applicable tax effect.

Example 2: Processed and Packaged Goods Manufacturer

Facts: Company Y manufactures and sells food products that are grouped into five major geographical areas as follows:

- Europe
- Asia
- Africa
- United States
- South America

Each major geographical area includes several brands that comprise operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of Y. Therefore, for Y, each major geographical area includes a group of components of the entity.

Y has experienced slower growth in its operations located in the South America, which account for 20% of Y’s total assets.

Therefore, Y decides to shift its strategy of selling food products in the South America geographical area and focus its resources on manufacturing and marketing food products in its other four higher growth geographical areas.

As a result, Y decides to sell its operations in South America and, at year end, classifies the components of the South America area as held for sale. In doing so, the net assets are written down to the lower of carrying amount or fair value less selling costs, and an unrealized loss is recorded.

Conclusion: The disposal of the South America operations should be reported in discontinued operations.

The reasons are as follows:

- Each of the five major geographic areas is a separate component in that each area's operations and cash flows can clearly be distinguished, operationally and for financial reporting purposes.

- The disposal represents a *strategic shift* in Y's operations from South America to the other four geographic areas.

- Y's operation in South America is one of five major geographical areas and its absence will have a *major effect* on Y's operations and financial results. The major effect threshold is satisfied based on the fact that the South America region's total assets represent 20% of Y's total assets.

The result is that Y should present the results of operations, and the unrealized loss on the writedown of the held-for-sale South American assets, in discontinued operations, net of taxes.

Example 3: General Merchandise Retailer

Facts: Company Z is a general merchandise retailer and operates 1,000 retail stores in two different store formats, all throughout the United States, as follows:

- Malls
- Supercenter stores

Z divides its stores into five major geographical regions:

- Northwest
- Southwest
- Midwest
- Northeast, and
- Southeast.

For Z, each retail store comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of Z. Therefore, for Z, each retail store is a component of Z.

Z has experienced declining net income at its 200 stores located in malls across all five major geographical regions.

Historically, net income from the 200 stores in malls has been in a range of 30 to 40% of Z's total net income.

Total net income from the 200 stores in malls is down to 15% of Z's total net income because of declining customer traffic in malls.

Therefore, Z decides to shift its strategy of selling products in malls and sells the 200 stores located in malls.

Conclusion: The disposal of the 200 stores should be reported in discontinued operations for the following reasons:

- The 200 stores represent a group of components in that each retail store comprises operations and cash flows can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity.
- The disposal of the 200 stores in malls and a focus solely on its supercenter stores represents a *strategic shift* in its product lines and geography of operations, and
- The disposal of the 200 stores located in malls will have a *major effect* on Z's operations and financial results given the fact that the 200 stores represent 15% of Z's total net income.

Example 4: Oil and Gas Entity

Facts: Company X produces oil and gas in two major geographical areas (Europe and Africa). Each area is divided into several regions. Each region comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of X.

Therefore, for X, each major geographical area (Europe and Africa) includes a group of components of X.

In its Africa operations, X operates through a joint venture with another entity that is accounted for by the reporting entity as an equity method investment. X's carrying amount of its investment in the joint venture is 20% of X's total assets.

Because of significant investments needed in its operations in Europe, X decides to shift its strategy away from operating in Africa to focus on its operations in Europe.

Thus, Company X sell its stake in the Africa joint venture.

Conclusion: The Africa disposal is reported in discontinued operations for the following reasons:

- Africa is a separate component of X that comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity.

- The disposal of a component of X (the Africa joint venture) represents a *strategic shift* in its geographic operations from Africa to a focus on Europe where it maintains full control.

- The disposal of the Africa joint venture will have a *major effect* on X's operations and financial results, based on the fact that the joint venture asset represents 20% of X's total assets.

Example 5: Sports Equipment Manufacturer

Facts: Company Y, a manufacturer and seller of sports equipment, has two product lines that serve the football and baseball markets.

Each product line includes several different brands that each comprise operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of Y. Therefore, for Y, each product line includes a group of components of Y.

Y decides to shift its strategy away from selling products to the baseball equipment market, which accounts for 40% of its revenues, and focus more effort on serving its customers in the football equipment market.

However, Y decides to retain some exposure to the baseball equipment market by selling only 80% of the group of components in its baseball market product line to another entity.

Y completes the sale of 80% of its baseball product line.

Conclusion: The disposal of 80% of Y's baseball line represents a discontinued operation for the following reasons:

- The baseball product line, with its several different brands, represents a group of components, each comprising operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of Y.

- The disposal represents a *strategic shift* from selling products to the baseball equipment market by selling 80% of the group of components in the baseball product line.

- The 80% baseball interest sold will have a *major effect* on X's operations and financial results. That conclusion is reached based on the fact that the baseball product line represents 40% of Y's total revenue. If 80% of the baseball product line is sold, X will lose 32% of its total revenue (40% x 80% = 32%).

The fact that Y has significant continuing involvement after the disposal date is not a factor in determining whether the transaction should be classified as discontinued operations. There are, however, additional disclosures that are required when there is significant continuing involvement after the disposal.

Example 6: Manufacturer of Two Plants

Facts: Company R is a manufacturer that has two plants, each of which is a major part of R's operations and financial results.

Each plant comprising operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity.

R decides to consolidate its operations by selling one of its plants and merging both operations into one plant. The plant that is disposed of represents 45% of R's total assets.

After the disposal, there will be no change in the products sold but profitability is expected to increase because of the consolidation of operations.

Conclusion: The disposal of the plant should *qualify* as a discontinued operation under the ASU 2014-08 rules.

The reasons are simple:

- First, the plant consists of a component of R in that its operations and cash flows can be clearly distinguished operations and for financial reporting purposes, from the rent of the entity.

- The disposal of the plant is a *strategic shift* in a major part of R's business for the purpose of consolidating operations.

- Lastly, the disposal will have a *major effect* on R's operations and financial results given the fact that the plant that is disposed of represents 45% of R's total assets.

Thus, the results of operations of the plant and any gain or loss on disposal, should be presented in discontinued operations, net of the tax effect.

Example 7: Distributor with a Sale of a Single Building

Facts: Company K is a distributor. K owns a separate commercial building that it rent to an unrelated party. The building is not related to its core business of being a distributor even though its asset value and cash flow are a major portion of K's overall assets (approximately 20% of the carrying value of K's assets).

The commercial building comprising operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of K.

K decides it wants to sell the building as the real estate market is hot. K places the property on the market for sale and at December 31, 2015, the real estate satisfies all of the requirements to be considered held for sale.

Conclusion: Although the real estate is held for sale, it does not qualify as a discontinued operation.

The reasons are as follows:

- First, the commercial real estate consists of a component of K in that its operations and cash flows can clearly be distinguished, operationally and for financial reporting purposes, from the rest of K.

- Although it is true that real estate is a major part of K's business and financial results (20% of total assets), the disposal of the real estate is *not a strategic shift* in K's business of distribution. Instead, the sale is a one-off transaction.

Thus, the net rental income for 2015 and any unrealized loss from the writedown of the held-for-sale asset, should not be presented as discontinued operations.

IX. Transition and Effective Date of ASU 2014-08

1. *A public business entity (and a not-for-profit entity that has issued, or is a conduit bond obligor for securities that are traded, listed, or quoted on an exchange or an over-the-counter market)*: shall apply the ASU prospectively to both of the following:

   a. All disposals (or classifications as held for sale) of components of an entity that occur within annual *periods beginning on or after December 15, 2014*, and interim periods within those years.

b. All businesses or nonprofit activities that, on acquisition, are classified as held for sale that occur within annual *periods beginning on or after December 15, 2014*, and interim periods within those years.

2. *All other entities (including non-public entities)*: shall apply the ASU prospectively to both of the following:

   a. All disposals (or classifications as held for sale) of components of an entity that occur within annual periods *beginning on or after December 15, 2014*, and interim periods within annual periods beginning on or after December 15, 2015.

   b. All businesses or nonprofit activities that, on acquisition, are classified as held for sale that occur within annual *periods beginning on or after December 15, 2014*, and interim periods within annual periods beginning on or after December 15, 2015.

3. An entity shall not apply the ASU to a component of an entity, or a business or nonprofit activity, that is classified as held for sale before the effective date even if the component of an entity, or business or nonprofit activity, is disposed of after the effective date.

4. Early adoption is permitted, but only for disposals (or classifications as held for sale) that have not been reported in financial statements previously issued or available for issuance.

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 the new discontinued operation rules found in ASU 2014-08, which of the following is an element that a disposal must have to qualify for discontinued operation classification:
   a. There must be a strategic shift
   b. The operations of the component must have been eliminated from operations
   c. The entity must not have any continued involvement in the operations of the component
   d. There must have been a sale of a component

2. Company Y is disposing of a component of its business. Which of the following thresholds might qualify the disposal as a discontinued operation classification:
   a. The component disposed of represents 10% of total assets
   b. The component disposed of has revenue of 19% of total entity revenue
   c. The net income of the component disposed of represents 12% of the entity's total assets
   d. The liabilities of the component represent 25% of the entity's total liabilities

3. Company Z, a wholesale company, is selling a single building and wants to classify the loss has part of discontinued operations. The building represents 24% of the entity's total assets but is not a key part of Z's core business. Which of the following is correct:
   a. Z satisfies the criteria to classify the transaction as a discontinued operation
   b. The transaction does not qualify as a discontinued operation because the transaction does not have a major effect on Z's operations
   c. The transaction does not qualify as a discontinued operation because the transaction does not represent a strategic shift in Z's business
   d. The transaction does not qualify as a discontinued operation because none of the criteria for discontinued operations treatment are satisfied

4. Company K is about to sell an asset and wants to determine whether the sale qualifies as a held-for-sale transaction under ASC 360. Which of the following is a criterion that

K should considered in determining whether the transaction should be classified as held for sale:

a. K is about to decide to sell the asset
b. The components to be sold by K will be actively marketed within the next six months
c. There are likely to be significant changes to K's plan to sell the asset
d. K's management commits to a plan to sell the components to be sold

5. Company B has certain depreciable assets that B has classified as held for sale. Which of the following is the correct treatment for B to follow in accounting for the assets under the held for sale rules:
   a. B should start depreciating the assets over the remaining useful lives up to the estimated date of sale
   b. B should write off the net assets to zero
   c. B should not depreciate the assets while classified as held for sale
   d. B should depreciate the assets over standard GAAP lives as if the assets are not being sold

6. Which of the following is *not* an example of an event in which an entity has continuing involvement with a discontinued operation after the disposal date:
   a. A financial guarantee
   b. An interest in possibly securing a future distribution agreement
   c. A supply agreement
   d. An option to repurchase a discontinued operation

7. Company J has a transaction properly classified as part of discontinued operations. How should J account for the transaction on the statement of cash flows:
   a. Disclose total financing cash flows in the notes
   b. Disclose total operating and investing cash flows of the discontinued operations
   c. Disclose on the face of the statement of cash flows total operating and investing cash flows of the discontinued operations
   d. Disclose nothing separate from all other transactions

SUGGESTED SOLUTIONS

1. Under the new discontinued operation rules found in ASU 2014-08, which of the following is an element that a disposal must have to qualify for discontinued operation classification:
   a. Correct. One requirement is that the disposal must represent a strategic shift in the entity's operations.
   b. Incorrect. The pre-ASU 2014-08 rules require that the operations of the component must have been eliminated from operations. The new definition in ASU 2014-08 no longer has that requirement making the answer incorrect.
   c. Incorrect. Under the pre-2014-08 rules, in order to qualify for discontinued operations treatment, the entity must not have any continued involvement in the operations of the component after the disposal. That requirement was eliminated by ASU 2014-08 making the answer incorrect.
   d. Incorrect. There must be a disposal which is not limited to a sale. The disposal can include a held-for-sale transaction whereby the sale has yet to occur. Thus, the answer is incorrect.

2. Company Y is disposing of a component of its business. Which of the following thresholds might qualify the disposal as a discontinued operation classification:
   a. Incorrect. In order for a component to qualify for discontinued operations classification, the component must have a major effect on the entity. The term major effect can mean 15-20% of total assets which is higher than the 10% threshold of the component. Thus, the disposed of component does not have a "major effect" on Company Y and therefore, does not qualify for discontinued operations based on its total assets.
   b. Correct. A disposal must have a major effect on the entity's operations which can be measured several ways. One way is that the component disposed of must have revenue of at least 15-20% of the entity's total revenue. At 19% of revenue, the component appears to satisfy the major effect threshold.
   c. Incorrect. Unless net income of the component is at least 15% of total entity income, the disposal is not deemed to have a major effect on the entity and therefore, does not qualify for discontinued operations treatment.
   d. Incorrect. The disposal must have a major effect on the entity's operations. The component's liabilities representing 25% of the entity's total liabilities is generally not a benchmark for measuring "major effect." Instead, major effect is measured using total assets, revenue, or net income.

3. Company Z, a wholesale company, is selling a single building and wants to classify the loss has part of discontinued operations. The building represents 24% of the entity's total assets but is not a key part of Z's core business. Which of the following is correct:
   a. Incorrect. Although the transaction has a major effect on Z's operations (24% of total assets are disposed of), the transaction is not a strategic shift in Z's business, making the answer incorrect.
   b. Incorrect. Because the building represents 24% of total assets, the transaction does have a major effect on Z's operations. In general, the disposal of at least 15% of total assets, revenue, or net income is considered to have a major effect. Thus, the answer is incorrect.
   c. Correct. Under the new ASU 2014-08 rules, a discontinued operation must represent a strategic shift in the entity's operations. In this example, Z's core business is wholesale, not real estate. Thus, the sale of a single piece of real estate is not likely to represent a strategic shift in Z's business.
   d. Incorrect. The transaction does satisfy the "major effect" criterion, although it does not satisfy the "strategic shift" criterion. The fact that it meets one of the two criteria makes the answer incorrect.

4. Company K is about to sell an asset and wants to determine whether the sale qualifies as a held for sale transaction under ASC 360. Which of the following is a criterion that K should considered in determining whether the transaction should be classified as held for sale:
   a. Incorrect. One of the criteria is that an active program to sell the asset has been initiated by K, and not that K is about to decide to sell the asset.
   b. Incorrect. One criterion is that the components to be sold by K are being actively marketed for sale at a price that is reasonable, and not that it will be actively marketed within the next six months.
   c. Incorrect. One of the criteria is that that it is unlikely (not likely) that significant changes to K's plan to sell will be made or the plan will be withdrawn. Thus the answer is incorrect.
   d. Correct. ASC 360 states that a criterion to consider as to whether the transaction qualifies as held for sale is that K's management commits to a plan to sell the components to be sold.

5. Company B has certain depreciable assets that B has classified as held for sale. Which of the following is the correct treatment for B to follow in accounting for the assets under the held for sale rules:
   a. Incorrect. The held-for-sale rules do not provide for B depreciating the assets over the remaining useful lives up to the estimated date of sale. In fact, the assets are not depreciated making the answer incorrect.
   b. Incorrect. Because the assets are held for sale, those assets have already been written down to lower of carrying amount or fair value (less costs to sell). Thus, writing off those assets to zero is inappropriate and not authorized under GAAP.
   c. Correct. Under GAAP, B should not depreciate the assets while classified as held for sale. The reason is because the assets are being sold and are not providing utility to the company.
   d. Incorrect. GAAP does not provide for depreciating the assets over standard GAAP lives because those assets will not offer utility to the company over such longer useful lives, making the answer incorrect.

6. Which of the following is *not* an example of an event in which an entity has continuing involvement with a discontinued operation after the disposal date:
   a. Incorrect. A financial guarantee is an example because, through giving the guarantee, the entity stays involved after the discontinued operation.
   b. Correct. Although an actual distribution agreement would result in continuing involvement, an interest in possibly securing a future distribution agreement would not because the entity is not bound by a mere interest.
   c. Incorrect. Having a supply agreement in place means the entity is bound by and involved in the operation after the disposal date.
   d. Incorrect. Having an option to repurchase a discontinued operation means the entity is still involved in the discontinued operation.

7. Company J has a transaction properly classified as part of discontinued operations. How should J account for the transaction on the statement of cash flows:
   a. Incorrect. There is no disclosure requirement related to financing cash flows in the notes, making the answer incorrect.
   b. Correct. ASU 2014-08 provides a choice of disclosures related to cash flows. One is to disclose total operating and investing cash flows of the discontinued operations.
   c. Incorrect. Although disclosure of total operating and investing cash flows of the discontinued operations is one of two options for disclosures, there is no requirement that it be presented on the face of the income statement, making the answer incorrect.
   d. Incorrect. ASU 2014-08 adds new disclosures about cash flows related to discontinued operations, making the answer incorrect.

ASU 2015-01: Income Statement—Extraordinary and Unusual Items (Subtopic 225-20) Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items

Issued: January 2015

Effective date: ASU 2014-08 is effective as follows:

Effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. A reporting entity may apply the amendments prospectively. A reporting entity also may apply the amendments retrospectively to all prior periods presented in the financial statements. Early adoption is permitted provided that the guidance is applied from the beginning of the fiscal year of adoption. The effective date is the same for both public business entities and all other entities.

I. Objective

The objective of ASU 2015-01 is to eliminate the extraordinary item classification in the income statement. The ASU is part of the FASB's project 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 the users of financial statements.

II. Background

Under existing GAAP, an event or transaction is presumed to be an ordinary and usual activity of the reporting entity unless evidence clearly supports its classification as an extraordinary item.

Under existing ASC 225-20-45-2, *Income Statement-Extraordinary and Unusual Items*, a transaction is classified as extraordinary if it contains *both* of the following criteria:

> *Unusual nature:* The underlying event or transaction should possess a high degree of 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.

If an event or transaction meets both of the criteria for extraordinary classification, an entity is required to:

- Segregate the extraordinary item from the results of ordinary operations and show the item separately in the income statement, net of tax, after income from continuing operations, and

- Disclose applicable income taxes and either present or disclose earnings-per-share data applicable to the extraordinary item.

Following is an illustration of the income statement presentation of discontinued operations and extraordinary items under existing GAAP:

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

Over decades, the FASB (and its predecessor, Accounting Principles Board (APB)), carved out certain transactions that were automatically deemed to satisfy the infrequent and unusual criteria, such as the tax benefits of using a net operating loss carryforward, and the gain or loss from early extinguishment of debt. Gradually over time, the FASB has reversed its early trend by eliminated these specific transactions from automatic extraordinary item treatment.

More specifically, over the past two decades, 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 Hurricane Katrina and acts of God
- Gains and losses related to 9/11 and Boston Marathon 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 from the income statement, altogether.

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 eliminates extraordinary items from GAAP

Even though the FASB had made it more difficult to qualify a transaction as extraordinary, nevertheless the concept of extraordinary still existed thereby requiring companies to evaluate certain nonrecurring transactions for extraordinary treatment.

Users of financial statements have consistently commented that the concept of extraordinary is outdated and may not be meaningful as follows:

- The concept of extraordinary causes uncertainty and is costly because it is unclear when an item should be considered both unusual and infrequent.
- Users do not find the extraordinary item classification and presentation necessary to identify those events and transactions that are unusual and infrequent.
- It is extremely rare in current practice for a transaction or event to meet the requirements to be presented as an extraordinary item.

Based on the feedback from users, the FASB chose to add a project to its agenda to eliminate extraordinary treatment from GAAP. In January 2015, that project culminated with the issuance of 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 was issued as part of the FASB's Simplification Initiative which has as a goal 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 the users of financial statements.

ASU 2015-01 does the following:

- Its eliminates from GAAP the concept of extraordinary items found in ASC 225-20, *Income Statement—Extraordinary and Unusual Items,* effective for fiscal years, and interim periods within those fiscal years, *beginning after December 15, 2015*.

  Effective for years beginning after 2015, no transactions will qualify for extraordinary item classification on the income statement.

- It reduces costs for financial statement preparers because they will not have to assess whether a particular event or transaction event is extraordinary (even if they ultimately would conclude it is not).

- It alleviates uncertainty for preparers, auditors, and regulators because auditors and regulators no longer will need to evaluate whether a preparer treated an unusual and/or infrequent item appropriately.

Although the amendments in ASU 2015-01 eliminate the requirements for entities to consider whether an underlying event or transaction is extraordinary, the presentation and disclosure guidance for items that are unusual in nature or occur infrequently are retained and are expanded to include items that are both unusual in nature and infrequently occurring.

Finally, the changes made by ASU 2015-01 align more closely the GAAP income statement presentation guidance with IAS 1, *Presentation of Financial Statements,* which prohibits the presentation and disclosure of extraordinary items.

III. Rules in ASU 2015-01

1. ASU 2015-01 amends ASC 225-20, *Income Statement- Extraordinary and Unusual Items* to remove all references to extraordinary items.

a. Transactions are no longer classified as extraordinary on the income statement regardless of whether they satisfy the unusual nature and infrequency of occurrence criteria.

b. Upon the effective date of ASU 2015-01, the title of ASC 225-20 will change to *Income Statement-Unusual or Infrequently Occurring Items.*

2. The ASU retains the definitions of *unusual nature* and *infrequency of occurrence* for presentation and disclosure purposes only, as follows:

   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.

3. A material event or transaction that an entity considers to be of an *unusual nature* or of a type that indicates *infrequency of occurrence* or *both* shall be reported as a separate component of income from continuing operations.

   a. The nature and financial effects of each event or transaction shall be presented as a *separate component of income from continuing operations* or, alternatively, disclosed in notes to financial statements.

   b. Gains or losses of a similar nature that are *not individually material shall be aggregated* and shall not be reported on the face of the income statement net of income taxes. Similarly, the EPS effects of those items shall not be presented on the face of the income statement.

   c. The ASU provides a list of illustrative events or transactions that are *either unusual nature* or *infrequency of occurrence.*

      - A large portion of a tobacco manufacturer's crops are destroyed by a hail storm. Severe damage from hail storms in the locality where the manufacturer grows tobacco is rare.
      - A steel fabricating entity sells the only land it owns. The land was acquired 10 years ago for future expansion, but shortly thereafter the entity abandoned all plans for expansion and held the land for appreciation.

- An earthquake destroys one of the oil refineries owned by a large multinational oil entity.

Example 1: Company X has a sale of an asset that satisfies *both* the unusual nature criterion and infrequency of occurrence criteria.

Conclusion: Because the sale satisfies both the unusual nature and infrequency of occurrence criteria. any gain or loss should be reported as a *separate component of income from continuing operations.*

Following is an example:

Net operating income	$XX
Other income:	
Gain on sale of asset (1)	***XX***
Income from continuing operations before income taxes	$XX
Income taxes	XX
Income from continuing operations	XX
Discontinued operations (net of taxes of $XX)	(XX)
Net income	$XX

(1) Satisfies both unusual nature and infrequency of occurrence criteria that were required under the pre-ASU 2015-01 extraordinary item rules.

What if only one of the two criteria is satisfied?

The presentation noted above would not change.

ASU 2015-01 states that a material event or transaction that an entity considers to be of *an unusual nature* or of a type that indicates *infrequency of occurrence*, or *both* shall be reported as a separate component of income from continuing operations.

Moreover, the nature and financial effects of each event or transaction shall be presented as a separate component of income from continuing operations or, alternatively, disclosed in notes to financial statements.

Thus, under the new rules found in ASU 2015-01, if either or both of the two criteria are satisfied, that transaction is presented on the income statement as part of continued operations.

Under the pre-2015-01 rules, a transaction that satisfies both criteria (unusual nature and infrequence of occurrence) would be treated as an extraordinary item. Under the 2015-01 rules, it is treated as part of income from continuing operations. If the transaction satisfied one, but not both of the criteria, under the pre-2015-01 rules, the transaction would be presented as part of continued operations, the same as the way it is treated under the new ASU 2015-01 rules.

Comparison of Presentation of Transactions- Existing Pre-ASU 2015-01 Rules Versus ASU 2015-01 Rules		
Criterion Satisfied	**Existing Pre-ASU 2015-01 rules**	**New ASU 2015-01 Rules**
Unusual nature criterion	Continued operations	Continued operations
Infrequency of occurrence criterion	Continued operations	Continued operations
Both unusual nature and infrequency of occurrence criteria	**Extraordinary item**	**Continued operations**

Notice in the previous chart that the key change made by ASU 2015-01 is that a transaction that satisfies *both* the unusual nature and infrequency of occurrence criteria, is now presented as part of continued operations. Extraordinary item treatment no longer exists. However, if the transaction satisfies one, but not both, of the two criteria that were required to qualify for extraordinary treatment, the new ASU 2015-01 rules carry over the same treatment that has existed in the pre-ASU 2015-01 rules. That is, the transaction is presented as a separate item in continued operations.

IV. Transition Related to ASU 2015-01

1. The changes made by ASU 2015-01 are effective for fiscal years, and interim periods within those fiscal years, *beginning after December 15, 2015*.

   a. Early adoption is permitted provided that the guidance is applied from the beginning of the fiscal year of adoption.

2. An entity may elect to apply the ASU *prospectively* to events or transactions occurring after the date of adoption as well as to any items included in previously classified and presented financial statements before the date of adoption.

   a. If an entity applies the ASU prospectively, it shall disclose, if applicable, both the nature and the amount of an item included in income from continuing operations after adoption that adjusts an extraordinary item previously classified and presented before the date of adoption.

3. An entity may elect to apply the ASU retrospectively to all prior periods presented in the financial statements.

    a. If an entity applies the ASU retrospectively, it shall provide the disclosures in ASC Subtopic 250-10-50-1 through 50-2, *Accounting Changes and Corrections*, in the period the entity adopts ASU 2015-01.

REVIEW QUESTIONS

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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 a comment that users of financial statements have made about the concept of extraordinary items within GAAP:
   a. Users want more information on extraordinary items
   b. Too many transactions are being classified as extraordinary in practice
   c. GAAP should improve and expand the use of extraordinary treatment because international standards permit its use
   d. The concept of extraordinary has caused uncertainly and is costly

2. In order to satisfy the *unusual nature* criterion, which of the following must a transaction possession:
   a. It must have a high degree of abnormality
   b. It must clearly related to the ordinary activities of the entity
   c. It must be recurring
   d. It must clearly be related to the typical activities of the entity

3. Company M has a material transaction that M considers to be of an *unusual nature*. How should M present the transaction on the income statement under ASU 2015-01:
   a. As part of extraordinary items, net of the applicable income tax or benefit
   b. As a separate component of income from continued operations
   c. As part of cost of goods sold
   d. As a separate item through retained earnings

4. How should a transaction that satisfies both unusual nature and infrequency of occurrence criteria be presented on the income statement under ASU 2015-01:
   a. As part of continuing operations
   b. As a separate item within operating income
   c. Disclosed only
   d. As a separate footnote on the face of the income statement

SUGGESTED SOLUTIONS

1. Which of the following is a comment that users of financial statements have made about the concept of extraordinary items within GAAP:
   a. Incorrect. Users do not find the classification and presentation of extraordinary items as being necessary, making the answer incorrect.
   b. Incorrect. Users noted that it is rare in practice for transactions to be presented as extraordinary, making the answer incorrect.
   c. Incorrect. International standards do not permit the use of extraordinary treatment and there is no evidence that users want to improve and expand use of extraordinary items, making the answer incorrect.
   d. Correct. Users have commented that the use of extraordinary items has caused uncertainty and has been costly due to the fact that it is unclear when an item satisfies both the unusual nature and infrequency of occurrence criteria.

2. In order to satisfy the unusual nature criterion, which of the following must a transaction possession:
   a. Correct. The definition of "unusual nature" requires that the event or transaction should possess a high degree of abnormality.
   b. Incorrect. It must be clearly unrelated to (not related to) the ordinary activities of the entity, making the answer incorrect.
   c. Incorrect. The definition does not require that the transaction be recurring, making the answer incorrect.
   d. Incorrect. The definition states it must clearly be unrelated to (rather than related to) the typical activities of the entity.

3. Company M has a material transaction that M considers to be of an *unusual nature*. How should M present the transaction on the income statement under ASU 2015-01:
   a. Incorrect. The rules in ASU 2015-01 eliminate the classification of a transaction as an extraordinary item, making the answer incorrect.
   b. Correct. If a transaction is unusual in nature, ASU 2015-01 requires that the transaction be presented as a separate component of income from continuing operations. Alternatively, it can be disclosed in the notes.
   c. Incorrect. Nothing in GAAP provides for presenting the transaction as part of cost of goods sold, making the answer incorrect.
   d. Incorrect. Such a transaction must flow through the income statement so that presenting it as part of retained earnings would be inappropriate.

4. How should a transaction that satisfies both unusual nature and infrequency of occurrence criteria be presented on the income statement under ASU 2015-01:
   a. Correct. Under the new rules, a transaction that satisfies the two criteria that previously qualified for extraordinary item treatment, is now presented as part of continued operations.

b. Incorrect. There is no requirement in ASU 2015-01 that such a transaction be presented as a separate item within operating income. All that is required is that it be presented within continuing operations.
c. Incorrect. Although it may have to be disclosed, it also must be presented separately on the income statement as part of continuing operations, making the answer incorrect.
d. Incorrect. The ASU does not provide any requirement that the transaction be presented as a separate footnote on the face of the income statement.

Glossary

Business: An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants.

Component of An Entity: 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.

Discontinued operation: A disposal of a component of an entity or a group of components of an entity that represents a strategic shift that has (or will have) a major effect on an entity's operations and financial results.

Disposal Group: A disposal group for a long-lived asset or assets to be disposed of by sale or otherwise, represents assets to be disposed of together as a group in a single transaction and liabilities directly associated with those assets that will be transferred in the transaction. A disposal group may include a discontinued operation along with other assets and liabilities that are not part of the discontinued operation.

Firm Purchase Commitment: An agreement with an unrelated party, binding on both parties and usually legally enforceable, that meets both of the following conditions: a) It specifies all significant terms, including the price and timing of the transaction, and b) It includes a disincentive for nonperformance that is sufficiently large to make performance probable.

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.

Nonprofit Activity: An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing benefits, other than goods or services at a profit or profit equivalent, as a fulfillment of an entity's purpose or mission (for example, goods or services to beneficiaries, customers, or members). As with a not-for-profit entity, a nonprofit activity possesses characteristics that distinguish it from a business or a for-profit business entity.

Not-for-Profit Entity: An entity that possesses the following characteristics, in varying degrees, that distinguish it from a business entity: a) Contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return, b) Operating purposes other than to provide goods or services at a profit, and c) Absence of ownership interests like those of business entities.

Probable: The future event or events are likely to occur.

Unusual nature: The underlying event or transaction should possess a high degree of ordinary and typical activities of the entity, taking into account the environment in which the entity operates.

Chapter 5: ASU 2014-18: Business Combinations (Topic 805) Accounting for Identifiable Intangible Assets in a Business Combination

Issued: December 2014

Effective date:

The decision to adopt ASU 2014-18 must be made upon the occurrence of the *first transaction that is identified* in fiscal years *beginning after December 15, 2015*, and the timing of that first transaction determines the effective date.

If the first transaction occurs in the first fiscal year beginning after December 15, 2015, the ASU will be effective for that fiscal year's annual financial reporting and all interim and annual periods thereafter.

If the first transaction occurs in fiscal years beginning after December 15, 2016, the ASU will be effective in the interim period that includes the date of the transaction and subsequent interim and annual periods thereafter.

I. Objective

The objective of ASU 2014-18 is to provide an accounting alternative for a private company to measure certain identifiable intangible assets acquired in a business combination.

II. Background

ASU 2014-18 represents the fourth accounting standards update (ASU) issued by the FASB's Private Company Council (PCC).

The PCC, was established in 2012 to provide exemptions and modifications to existing GAAP for non-public (private) entities.

To date, the PCC has approved and the FASB has endorsed three ASUs in addition to ASU 2014-18, as follows:

- ASU 2014-03: *Derivatives and Hedging (Topic 815) Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps—Simplified Hedge Accounting Approach*

- ASU 2014-02: *An Amendment of the FASB Accounting Standards Codification® Intangibles—Goodwill and Other (Topic 350) Accounting for Goodwill*

- ASU 2014-07: *Consolidation (Topic 810)- Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements*

In accordance with ASC 805, *Business Combinations*, in a business combination, an acquirer recognizes assets acquired and liabilities assumed at their fair values on the acquisition date. Those assets include all intangible assets that are identifiable.

ASC 805 states that an asset is considered *identifiable* if it meets either of the following *two criteria*:

a. It is separable and capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability, regardless of whether the entity intends to do so (referred to as the separability criterion), or

b. It arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations (referred to as the contractual-legal criterion).

According to the PCC, private company stakeholders have noted the following:

- The costs exceed the benefits of following the ASC 805 acquisition model with respect to accounting for identifiable intangible assets separate from goodwill.

- The recognition and measurement of certain identifiable intangible assets separately from goodwill in a business combination does not always provide decision-useful information.

- Many private companies consider intangible assets that currently are recognized separately as not being any different than goodwill.

- The relevance of separately recognized intangible assets diminishes in periods after a business combination because the carrying amounts of the intangible assets no longer represent their fair values.

- The cost and complexity of estimating the fair value of certain identifiable intangible assets is too high.

- Intangible assets that are most relevant to be accounted for separately are those that are a) legally protected, b) generate separate and reliable cash flows (such as technology), and c) can be sold in liquidation.

Based on the feedback from private companies, in February 2013, the PCC added the identifiable intangibles project to its agenda.

In December 2014, the PCC issued ASU 2014-18, which amends ASC 805 with respect to certain private companies that make an election to apply an exception found in ASU 2014-18.

The ASC does the following:

a. It applies 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®*.

b. It applies when an entity within the scope of the 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):

   - Applying the acquisition method under ASC 805 on business combinations
   - 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 ASC 323 on investments—equity method and joint ventures
   - Adopting fresh-start reporting under ASC 852 on reorganizations.

c. An entity within the scope of the ASU that elects to apply the provisions in the ASU is subject to all of the recognition requirements within the *accounting alternative*.

d. The accounting alternative, when elected, should be applied to all in-scope transactions entered into after the effective date.

e. An entity within the scope of the ASU that elects the accounting alternative to recognize or otherwise consider the fair value of intangible assets as a result of any in-scope transactions should no longer recognize separately from goodwill, two types of intangible assets:

   1) Customer-related intangible assets unless they are capable of being sold or licensed independently from the other assets of the business, and

   2) Noncompetition agreements.

f. Intangible assets other than customer-related intangible assets (that are not capable of being sold or licensed independently from the other assets of a business) and noncompetition agreements will continue to be recognized separately from goodwill.

g. An entity that elects the accounting alternative in the ASU must also adopt the private company alternative to amortize goodwill over a maximum of 10 years, under ASU 2014-02, *Intangibles—Goodwill and Other (Topic 350): Accounting for Goodwill*. However, an entity that elects the accounting alternative in ASU 2014-02 is not required to adopt the amendments in this Update.

For entities electing this alternative, the amendments generally will result in those entities separately recognizing fewer intangible assets in a business combination when compared to entities that do not elect, or are not eligible, for this alternative.

The decision to adopt the accounting alternative in ASU 2014-18 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.

III. Definitions

The ASU adds or modifies certain terms that are now part of ASC 805-20, *Business Combinations- Identifiable Assets and Liabilities, and Any Noncontrolling Interest,* as follows:

Contract Asset: An entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (for example, the entity's future performance).

Available to Be Issued: Financial statements are considered available to be issued when they are complete in a form and format that complies with GAAP and all approvals necessary for issuance have been obtained, for example, from management, the board of directors, and/or significant shareholders. The process involved in creating and distributing the financial statements will vary depending on an entity's management and corporate governance structure as well as statutory and regulatory requirements.

Lease: An agreement conveying the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time.

Private Company: An entity other than a public business entity, a not-for-profit entity, or an employee benefit plan within the scope of ASC 960 through 965 on plan accounting.

Public Business Entity: A public business entity is a business entity meeting any one of the following criteria. Neither a not-for-profit entity nor an employee benefit plan is a business entity.

a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).

b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.

c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for the purpose of issuing securities that are not subject to contractual restrictions on transfer.

d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including footnotes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.

IV. Rules

ASU 2014-18 amends ASC 805, *Business Combinations*, as follows:

1. A *private company* may make an accounting policy election to apply an accounting alternative in ASU 2014-18.

2. The guidance applies when a private company is required to recognize or otherwise consider the fair value of intangible assets as a result of *any one of the following transactions*:

   a. Applying the acquisition method as described by ASC 805, *Business Combinations.*

1) The acquisition method requires the acquirer, at the acquisition date, to recognize separate from goodwill, identified assets acquired and liabilities assumed, and any noncontrolling interest. Fair value is used to measure assets and liabilities.

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 of accounting in accordance with ASC 323, *Investments- Equity Method and Joint Ventures*, or

c. Adopting fresh-start reporting in accordance with ASC 852, *Reorganizations*.

3. A private entity that elects the accounting alternative under ASU 2014-18 shall apply it to:

a. *All* of the related recognition requirements upon election.

b. *All future transactions* that are identified in 2(a) through (c) above.

4. An entity that elects this accounting alternative must also adopt the accounting alternative for amortizing goodwill in ASU 2014-02: *An Amendment of the FASB Accounting Standards Codification® Intangibles—Goodwill and Other (Topic 350) Accounting for Goodwill* which is now part of ASC 350-20, *Intangibles—Goodwill and Other*.

a. ASC 350-20 provides an accounting alternative under which private companies may elect to amortize goodwill over a maximum of 10 years on a straight-line basis (or less than 10 years if the entity can demonstrate that another life is more appropriate).

The accounting alternative to amortize goodwill is not available for an SEC company so that such an SEC entity does not amortize goodwill and tests it annually for impairment.

b. If the accounting alternative for amortizing goodwill under ASC 350-20 was not adopted previously, it should be adopted on a prospective basis as of the adoption date of ASU 2014-18.

c. An entity that elects the accounting alternative to amortize goodwill is not required to adopt the accounting alternative in this ASC 350-20.

Example 1: Company X elects the accounting alternative under ASU 2014-18 effective January 1, 2016.

Conclusion: X must also elect the accounting alternative under ASC 350-20 to amortize goodwill over 10 years on a straight-line basis. The election to amortize goodwill is made prospectively starting January 1, 2016.

Example 2: Company X has elected the accounting alternative to amortize goodwill effective January 1, 2015.

Conclusion: The fact that X has elected to amortize goodwill does not mean that X is required to elect the accounting alternative in this ASU 2014-18 with respect to identifiable intangibles.

Note: The primary reason for linking the ASU 2014-18 (identifiable intangibles) and ASU 2014-02 (goodwill amortization) is that the adoption of ASU 2014-18 would result in intangible assets that are wasting in nature being absorbed into goodwill. The PCC and the FASB concluded that it would not be appropriate to absorb finite-lived intangible assets into goodwill unless goodwill is amortized. Further, the adoption of ASU 2014-18 likely will result in a higher goodwill balance than would result under current GAAP. Therefore, entities will be exposed to a higher risk of goodwill impairment. By linking the adoption of ASU 2014-18 to the goodwill amortization accounting alternative in ASU 2014-02, a private company will reduce its risk for goodwill impairment by amortizing goodwill (which would include intangible assets that are not recognized separately).

5. General rule

a. As of the acquisition date, the acquirer shall recognize, separately from goodwill, the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree.

1) An *identifiable intangible asset* is one that meets either the *separability criterion* or the *contractual-legal criterion*.

Separability criterion: An acquired intangible asset is capable of being separated or divided from the acquiree and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability.

Contractual-legal criterion: An acquired asset arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

6. Accounting alternative for private companies

a. A private entity (the acquirer) may elect to apply the *accounting alternative* for the recognition of *identifiable intangible assets acquired in a business combination*.

b. Under the accounting alternative, an acquirer *shall not recognize separately from goodwill* the following *two types of intangible assets:*

   1) *Customer-related intangible assets:* unless they are capable of being sold or licensed independently from other assets of a business, and

   2) *Noncompetition agreements*

7. Customer-related intangible assets

a. Customer-related intangible assets include the following:
   - Customer lists
   - Order or production backlog
   - Customer contracts and related customer relationships
   - Noncontractual customer relationships

b. Customer-related intangible assets that must be recognized: Customer-related intangible assets that would be recognized separate from goodwill under ASU 2014-18 are those that are *capable of being sold or licensed independently* from the other assets of a business.

   Customer-related intangible assets that are capable of being sold or licensed independently of other business assets, and that may meet that criterion for recognition *separate from goodwill* include, but are not limited to:
   - Mortgage servicing rights
   - Commodity supply contracts
   - Core deposits
   - Customer information (such as names and contact information).

c. An additional list of customer-related intangible assets (CRIs) that are capable of being *recognized separate from goodwill* consists of the following contract-based intangible assets:
   - Licensing, royalty, standstill agreements
   - Advertising, construction, management, service or supply contracts
   - Lease agreements
   - Construction permits
   - Franchise agreements
   - Operating and broadcast rights
   - Servicing contracts such as mortgage servicing contracts

- Employment contracts
- Use rights such as drilling, water, air, timber cutting, and route authorities.

Observation: ASU 2014-18 provides that customer-related intangible assets are not allocated separately from goodwill unless they are capable of being sold or licensed independently from other assets of a business. In general, most (but no all) of the intangibles found in the above two lists in 7(b) and 7(c.) consist of those intangibles that most likely are capable of being sold or licensed independent of the other assets of the entity. Thus, a private company would not be able to use the accounting alternative in ASU 2014-18 to include their value as part of goodwill. However, there are instances in which some of the above-noted intangibles are not capable of being sold or licensed individually such as customer information and lists. (Further on in this chapter the author addresses these types of assets.)

The examples of customer-related intangible assets that may meet the criterion for recognition separate from goodwill (e.g., they are capable of being sold or licensed independently) consists of mortgage servicing rights, commodity supply contracts, core deposits, and customer information. These assets typically represent relationships and information that often can be sold to third parties without input or approval from the customer or their agreement to the transfer.

If the transfer of a customer relationship is dependent on the decisions of a customer, it would be clear that a reporting entity is not capable of selling that customer-related intangible asset separately from the other assets of the business. Furthermore, the PCC and the FASB noted that private companies generally are aware of whether their customer-related intangible assets can be sold and transferred to another entity even if the private company has no intention of selling the customer-related intangible assets.

d. Customer-related intangible assets *exclude* the following:

Contract assets, as used in ASC 606 on revenue from contracts with customers, are not considered to be customer-related intangible assets for purposes of applying this accounting alternative. Therefore, contract assets are not eligible to be subsumed into goodwill and shall be recognized separately.

Leases, are not considered to be a customer-related intangible asset for purposes of applying the accounting alternative in ASU 2014-18. Therefore, favorable and unfavorable leases are not eligible to be subsumed into goodwill and shall be recognized separately.

Observation: The PCC and FASB decided that contract assets as used in ASC 606, *Revenue from Contracts with Customers*, are not considered intangible assets

eligible to be part of goodwill and therefore are not within the scope of ASU 2014-18. In certain situations, an entity satisfies a performance obligation but does not have an unconditional right to consideration, for example, because it first needs to satisfy another performance obligation in the contract. That leads to recognition of a contract asset. Once an entity has an unconditional right to consideration, it should present that right as a receivable separately from the contract asset and account for it in accordance with other guidance (such as ASC 310, Receivables). Consequently, the PCC and FASB concluded that it is inappropriate to classify a contract asset as a customer-related intangible asset at the acquisition date when the contract asset will eventually be reclassified as a receivable.

8. Non-competition agreements

a. Under the accounting alternative in ASU 2014-18, *all non-competition agreements* are combined as part of goodwill regardless of whether they could be sold or licensed separately from other assets of the business.

Observation: The PCC and the FASB note that they chose not to require an assessment of whether a noncompetition agreement is capable of being sold or licensed separately from the other assets of a business because, in their view, noncompetition agreements will seldom, if ever, meet the criteria for recognition.

How do you determine which intangible assets are not recognized separate from goodwill under the private company accounting alternative?

ASU 2014-18 provides that in a business combination, a private company may elect not to allocate fair value to certain *identifiable intangible assets*, separate from goodwill.

Identifiable intangible assets are those intangibles that meet either the *separability criterion* or the *contractual-legal criterion* as follows:

Separability criterion: An acquired intangible asset is capable of being separated or divided from the acquiree and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability.

Contractual-legal criterion: An acquired asset arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

The ASU states that a private company may elect not to allocate any fair value from an acquisition to two specific types of identifiable intangible assets, as follows:

a. *Customer-related intangible assets:* unless they are capable of being sold or licensed independently from other assets of a business, and

b. *Noncompetition agreements*

As to the first category of intangibles, customer-related intangible assets (CRIs) include the following:

- Customer lists
- Order or production backlog
- Customer contracts and related customer relationships
- Noncontractual customer relationships

As to customer-related intangible assets (CRIs), a private company that elects the accounting alternative assigns *no value* to the CRIs unless they are capable of being sold or licensed independently from other assets of the business. That means that a private company must evaluate CRIs to determine those assets that can and cannot be sold or licensed separate from other assets of the business.

Those CRIs that cannot be sold or licensed independently from other business assets are not assigned a separate value at acquisition date. Instead, the asset value is part of goodwill.

Those CRIs that are capable of being sold or licensed independently from other business assets are assigned at acquisition date, a value separate from goodwill.

Thus, customer-related intangible assets (CRIs) are separated into two types:

Type of Customer-Related Intangible Asset (CRI)	**Treatment under Private Company Accounting Alternative (ASU 2014-18)**
CRIs- that are *capable* of being sold or licensed independently from other assets	Must be assigned a value separate from goodwill
CRIs that are *not capable* of being sold or licensed independently from other assets	Are not assigned a value separate from goodwill

So, the next question is which CRIs are *"capable of being sold or licensed independently*" from other assets of the business?

Customer-related intangible assets (CRIs) that may be *capable of being sold or licensed independently of other business assets*, and that are likely to be recognized separate from goodwill include but are not limited to:

- Mortgage servicing rights
- Commodity supply contracts
- Core deposits
- Customer information (such as names and contact information).

Although the first three items on the list (mortgage servicing rights, commodity supply contracts, and core deposits) most likely are capable of being sold or licensed independently of other business assets, the last one (customer information) may have restrictions that preclude it from being sold without customer approval. In such situations, the customer list is *not capable of being sold independently of other assets* and, therefore, is not measured separately from goodwill under the private company accounting alternative election per ASU 2014-18.

The key issue is in determining whether a customer-related intangible asset (CRI) is measured separately from goodwill under the private company alternative is this:

Can that asset be sold or licensed independently from other business assets?

The entity must be able to sell or license the intangible asset *on its own* without selling or licensing any other assets of the business. Under this narrow requirement, many intangible assets that are saleable as part of the sale of an asset group, may not be saleable individually.

For example, an entity might be able to sell a customer list as part of an overall business sale, but may not be able to sell it independent of other business assets. After all, the entity acquiring the list might be reluctant to purchase it without a noncompete agreement or purchase of the entity name.

Factors that may restrict the sale of a CRI are:

1. A reluctance of a buyer to acquire an asset without other assets of the business being acquired.

   Example: A buyer might not be willing to acquire a customer list or other customer information unless the buyer can ensure that the seller will not compete for those customers after the sale of the list.

2. A customer list or other information requires customer approve prior to sale, under law or contract.

3. A customer contract has a restriction on assignability or a confidentiality provision.

4. A website list or other information was obtained with a representation that the list would not be distributed or sold without offering customers the ability to opt out if their information is sold or transferred to another party.

5. A company acquires an order backlog that cannot be fulfilled without having special know how or equipment.

What are the requirements for a private company not to allocate value to a non-compete agreement?

As previously discussed, ASU 2014-18 states that a private company may elect not to allocate any fair value at the acquisition date to two specific types of identifiable intangible assets:

a. *Customer-related intangible assets (CRIs):* unless they are capable of being sold or licensed independently from other assets of a business, and

b. *Noncompetition agreements*

In the previous section, the author discussed that a private company may elect not to allocate value at the acquisition date to customer-related intangible assets (CRIs) that are *not capable of being sold or licensed independently* from other assets of the business. CRIs that are capable of being sold or licensed independently from other assets of the business, must have a value assigned to them that is separate from goodwill.

When it comes to noncompete agreements, there is no differentiation required between those agreements that qualify and those that do not qualify under the private company election. ASU 2014-18 simply states that *all noncompete agreements qualify for exclusion* under ASU 2014-18. That is, if a private company acquires a noncompete agreement as part of a business combination, and that private company makes the accounting alternative election under ASU 2014-18, the private company is not required to allocate any of the acquisition-date purchase price to the noncompete agreement. Instead, the value would have been assigned to the noncompete agreement, is allocated to goodwill.

If a private company elects the accounting alternative in ASU 2014-18, must the company include disclosures about the intangible assets to which no allocation was made?

ASU 2014-18 does not require additional disclosures beyond those required by existing GAAP.

An entity is required to include disclosures that are required by other GAAP. For example, assume a private company makes the accounting alternative election in ASU 2014-18 and, as a result, does not allocate any of the acquisition price to noncompete agreements. In disclosing the allocation of the fair value at acquisition, the entity would not have any portion of the value allocated to the noncompete agreements. However, the entity would have to disclose the terms and conditions of the noncomplete agreements that were executed as part of the business combination.

V. Transition into ASU 2014-18

1. ASU 2014-18 provides the following guidance into implementing the accounting alternative:

   a. The decision to adopt the accounting alternative found in ASU 2014-18 must be made upon the occurrence of the *first transaction that occurs in fiscal years beginning after December 15, 2015*, and the timing of that first transaction determines the effective date of the ASU.

   b. If the first transaction occurs in the first fiscal year beginning after December 15, 2015, the ASU will be effective for that fiscal year's annual financial reporting and all interim and annual periods thereafter.

   c. If the first transaction occurs in fiscal years beginning after December 15, 2016, the ASU will be effective in the interim period that includes the date of the transaction and subsequent interim and annual periods thereafter.

   d. Customer-related intangible assets and noncompetition agreements that *exist as of the beginning of the period of adoption* shall continue to be sequently measured in accordance with ASC 350, *Intangibles—Goodwill and Other*. That is, existing customer-related intangible assets and noncompetition agreements should not be subsumed (absorbed) into goodwill upon adoption of ASU 2014-18.

   e. Early application of ASU 2014-18 is permitted for any interim and annual period before which an entity's financial statements are available to be issued.

   Observation: Under ASU 2014-18, an entity should continue to recognize and measure customer-related intangible assets and noncompetition agreements that exist as of the beginning of the period of adoption in accordance with ASC 350, *Intangibles—Goodwill and Other*. The PCC and FASB stated that they considered requiring any

intangible asset that exists as of the beginning of the period of adoption to no longer be separately recognized and, therefore, to be absorbed into goodwill. However, the PCC and the FASB concluded that because the cost of initially measuring the fair value of those customer-related intangible assets and noncompetition agreements has already been incurred, continuing to recognize and measure them separately will not result in significant additional costs.

VI. Disclosures

1. If a private company elects the accounting alternative in ASU 2014-18, additional disclosures are not required.

   Note: The PCC and FASB decided that the current disclosure requirements in ASC 805, *Business Combinations*, offer sufficient disclosures about intangible assets that do not require separate recognition. This includes a qualitative description of intangible assets that do not qualify for separate recognition.

Example: Application of ASU 2014-18

Facts: On January 1, 20X1, Company X, a non-public (private) entity, acquired 100% of the assets of Company Y for $10 million.

X has no goodwill from other transactions.

X elects the accounting alternative in ASU 2014-18 to not allocate the fair value to the identifiable intangible assets.

Assets acquired consist of the following at the fair value at the January 1, 20X1 acquisition date:

Inventory	$2,000,000
Property and equipment	3,000,000
Agreement not to compete	1,000,000
Supply contract	500,000
Customer list	TBD
Goodwill	TBD

- The $1,000,000 agreement not to compete consists of a three-year agreement with key officers of the Company Y, payable over a three-year period.

- The supply contract consists of a favorable contract to purchase commodities, valued at approximately $500,000 fair value. X believes the supply contract *could be sold* independently from other X assets because it pertains to an oil commodity which is easily separable and saleable from the rest of X's business.

- The customer list consists of customer names and other customer information for Y's 4,000 customers. X believes it is *not capable of selling or licensing* the customer list and information independently from the other assets of X because a prospective buyer would require X to guarantee not to compete for those same customers after a sale.

Conclusion: By making the accounting alternative election, X must evaluate the identifiable intangible assets to determine whether a portion of the $10 million purchase price should be allocated to them or not.

Intangibles that qualify for the private company accounting alternative election are:

- *Customer-related intangible assets (CRIs):* unless they are capable of being sold or licensed independently from other assets of a business, and

- *Noncompetition agreements*

X has the following identifiable intangible assets:

Identifiable Intangible Asset	**Is it Capable of Being Sold or Licensed Independently of X's Other Assets?**	**Treatment per ASU 2014-18**
Customer-related intangible assets: • Supply contract	Yes. Capable of being sold independently of other X assets	Value *assigned separate from goodwill* per ASU 2014-18 election
• Customer list	No. Not capable of being sold independently of other X assets	Value *not assigned separate from goodwill* per ASU 2014-18 election
Noncompetition agreement: • Agreement not to compete	NA- automatically qualifies for exclusion per ASU 2014-18	Value not assigned separate from goodwill per ASU 2014-18 election

Based on X's analysis, X should allocate a value to the supply contract because that contract represents a customer-related intangible asset that is capable of being sold or licensed independently from X's other assets.

The customer list should not have a separate value assigned. Instead any value is included as part of goodwill in accordance with ASU 2014-18. The reason is because the customer list represents a customer-related intangible asset that is not capable of being sold or licensed independently from X's other assets.

No value should be assigned to the agreement not to compete. Instead, the $1,000,000 value is part of goodwill. Under ASU 2014-18, an agreement not to compete has no value assigned to it if a private company makes the accounting alternative election.

Based on the above analysis, $10 million purchase price is allocated to assets acquired at the date of acquisition as follows:

As of January 1, 20X1
($000s)

	Fair value
Inventory	$2,000,000
Property and equipment	3,000,000
Agreement not to compete (a)	0
Supply contract	500,000
Customer list (a)	0
Goodwill (plug)	**4,500,000**
Total assets acquired	$10,000,000

(a) The values of the agreement not to complete and the customer list are allocated to goodwill under the ASU 2014-18 election.

-end of example-

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. Company Y is a private company and wants to elect the accounting alternative with respect to identifiable intangible assets. To which of the following transactions is Y permitted to apply the accounting alternative under ASU 2014-18:
   a. The purchase of equipment
   b. An acquisition under the acquisition method
   c. A reorganization
   d. The sale of a business

2. Company D elects the accounting alternative in ASU 2014-18. Which of the following is correct:
   a. D must also ensure that it does not use the accounting alternative for goodwill
   b. D must also elect the accounting alternative for variable interest entities
   c. D must also elect the accounting alternative to amortize goodwill
   d. D must also ensure that it does not use the accounting alternative for variable interest entities

3. Company K, a private company, elects the accounting alternative under ASU 2014-18. Which of the following assets is K permitted *not* to recognize separately from goodwill:
   a. A customer-related intangible that K is able to sell separate from other assets
   b. Property and equipment
   c. Inventory
   d. Noncompetition agreement

4. Which of the following is an example of a customer-related intangible asset to which the accounting alternative under ASU 2014-18 applies:
   a. Contract assets under ASC 606
   b. Lease
   c. Backlog that cannot be sold separate from other company assets
   d. Tradename

5. Company M is a private company that elects the accounting alternative for identifiable intangibles under ASU 2014-18. M wants to determine whether a customer-related intangible asset (a customer list) is an asset that can be excluded from allocation under the ASU. Which of the following would result in the customer list qualifying for exclusion under the accounting alternative:
   a. The list can be sold under law or contract
   b. A buyer can acquire the list without other assets of the business being acquired
   c. The list can be sold without customer approval
   d. The list is a website list that can be sold only after offering customers the ability to opt out of the list

SUGGESTED SOLUTIONS

1. Company Y is a private company and wants to elect the accounting alternative with respect to identifiable intangible assets. To which of the following transactions is Y permitted to apply the accounting alternative under ASU 2014-18:
   a. Incorrect. The purchase of equipment is not one of the transactions to which the ASU 2014-18 alternative applies. In particular, the purchase of a single asset is not a business so that acquisition method accounting does not apply to the purchase of assets that are not a business.
   b. Correct. An acquisition under the acquisition method per ASC 805 is one example of a transaction to which an eligible entity may elect ASU 2014-18's accounting alternative.
   c. Incorrect. Although one of the three types of transactions to which ASU 2014-18's accounting alternative can apply is fresh start reporting. However, it does not apply to a reorganization.
   d. Incorrect. The alternative applies to a purchase, and not a sale, so that the answer is incorrect.

2. Company D elects the accounting alternative in ASU 2014-18. Which of the following is correct:
   a. Incorrect. The ASU actually states that D must ensure that it uses the accounting alternative for goodwill, making the answer incorrect.
   b. Incorrect. Use of the accounting alternative for variable interest entities has no correlation or importance to use of ASU 2014-18's alternative for identifiable intangible assets.
   c. Correct. ASU 2014-18 states that if the accounting alternative is elected with respect to identifiable intangible assets in a business combination, an entity must also elect the accounting alternative to amortize goodwill per ASU 2014-02.
   d. Incorrect. The accounting alternative for variable interest entities has nothing to do with ASU 2014-18, making the answer incorrect.

3. Company K, a private company, elects the accounting alternative under ASU 2014-18. Which of the following assets is K permitted *not* to recognize separately from goodwill:
   a. Incorrect. K is permitted not to recognize separately from goodwill a customer-related intangible, but only if that intangible is not capable of being sold or licensed independently from other assets of the business.
   b. Incorrect. The ASU pertains to identifiable intangible assets, not property and equipment, making the answer incorrect.
   c. Incorrect. ASU 2014-18 does not cover inventory. Instead, the election relates to intangible assets that are recognized separately from goodwill.
   d. Correct. One of the assets to which the accounting alternative found in ASU 2014-18 applies is a noncompetition agreement which is not recognized separately from goodwill.

4. Which of the following is an example of a customer-related intangible asset to which to which the accounting alternative under ASU 2014-18 applies:
   a. Incorrect. The ASU specifically states that contracts with customers are not considered to be customer-related intangible assets in applying the ASU's alternative.
   b. Incorrect. ASU 2014-18 states that a lease is not considered to be a customer-related intangible asset in applying the ASU's accounting alternative. That applies to both favorable and unfavorable leases.
   c. Correct. An order backlog is a customer-related intangible asset to which the ASU applies provided the asset cannot be sold or licensed separate from other company assets.
   d. Incorrect. Although a tradename is an intangible, it is not a customer-related intangible asset to which the ASU applies.

5. Company M is a private company and elects the accounting alternative under ASU 2014-18. M wants to determine whether a customer-related intangible asset (a customer list) is an asset that can be excluded from allocation under the ASU. Which of the following would result in the customer list qualifying for exclusion under the accounting alternative:
   a. Incorrect. If the list can be sold or licensed by law or contract, it is capable of being sold or licensed independent of the other assets of M. Thus, the list is not a customer-related intangible asset that qualifies for exclusion under ASU 2014-18. Instead, a portion of the acquisition price must be allocated to the customer list.
   b. Incorrect. If a buyer acquires the list without other assets of the business being acquired, that means the list can be sold or licensed independent of other assets of M. An intangible that is capable of being sold or licensed independent of other assets does not qualify for exclusion under ASU 2014-18's accounting alternative.
   c. Incorrect. If the list can be sold without customer approval, that means the list is capable of being sold or licensed independent of other assets of M. Such an asset is not subject to the scope of the ASU.
   d. Correct. If the list can be sold only after offering customers the ability to opt out of the list, the list is not capable of being sold or licensed independent of other assets of M. Thus, the list qualifies as an asset that can be excluded from allocation under ASU 2014-18's accounting alternative.

Glossary

Contract Asset: An entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time.

Available to Be Issued: Financial statements are considered available to be issued when they are complete in a form and format that complies with GAAP and all approvals necessary for issuance have been obtained, for example, from management, the board of directors, and/or significant shareholders. The process involved in creating and distributing the financial statements will vary depending on an entity's management and corporate governance structure as well as statutory and regulatory requirements.

Contractual-legal criterion: An acquired asset arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

Identifiable intangible asset: An asset that meets either the separability criterion or the contractual-legal criterion described in the definition of identifiable.

Lease: An agreement conveying the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time.

Private Company: An entity other than a public business entity, a not-for-profit entity, or an employee benefit plan within the scope of ASC 960 through 965 on plan accounting.

Public Business Entity: A public business entity is a business entity meeting any one of the criteria below. Neither a not-for-profit entity nor an employee benefit plan is a business entity.

- It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).

- It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.

- It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for the purpose of issuing securities that are not subject to contractual restrictions on transfer.

- It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including footnotes) and make them publicly available on a periodic basis. An entity must meet both of these conditions to meet this criterion.

Separability criterion: An acquired intangible asset is capable of being separated or divided from the acquiree and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability.

Chapter 6: ASU 2014-17: Business Combinations (Topic 805) – Pushdown Accounting – A consensus of the FASB Emerging Issues Task Force, and

ASU 2015-08: Business Combinations (Topic 805) – Pushdown Accounting Amendments to SEC Paragraphs Pursuant to Staff Accounting Bulletin No. 115

Issued: November 2014 and March 2015.

Effective date: ASU 2014-07 is effective on November 18, 2014 (the issue date).

After the effective date, an acquired entity can make an election to apply the ASU guidance to future change-in-control events or to its most recent change-in-control event. 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 ASU would be a change in accounting principle.

I. Objective

The objective of ASU 2014-17 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.

II. Background

There has been limited U.S. GAAP guidance for determining when, if ever, an acquiring entity's cost of acquiring another entity should be used to establish a new accounting and reporting basis (pushdown) in the acquired entity's standalone financial statements.

Pushdown accounting refers to establishing a new accounting basis for an acquired entity (acquiree) in its separate standalone financial statements. Use of pushdown accounting is triggered when an acquirer obtains control of an acquiree in a business combination.

Example: Company A (acquirer) purchases 100% of the voting stock of Company B (acquiree) from an unrelated third party for $30 million.

Company B's net book value of its equity was $4 million immediately prior to the acquisition and Company B will continue to issue its own separate standalone financial statements after the acquisition.

Conclusion: If pushdown accounting were applied, Company B would establish a new basis for its net assets equal to $30 million in its own separate standalone financial statements. That is, B would revalue its balance sheet to reflect the $30 million of net asset value as if the transaction had been an asset purchase, not a stock purchase.

Existing GAAP

Existing GAAP does not require nonpublic companies to use pushdown accounting.

Conversely, SEC companies have been required by SEC rules to use pushdown accounting in certain cases. Thus, existing GAAP has provided no requirement or guidance as to when, if ever, a nonpublic entity should or may use pushdown accounting.

The authority for SEC companies to use pushdown accounting has been found in the following guidance was codified into FASB ASC 805-50-S99-1 through 4, applicable to SEC companies only, as follows:

- SEC Staff Accounting Bulletin Topic No. 5.J, *New Basis of Accounting Required in Certain Circumstances*

- EITF Topic No. D-97, *Pushdown Accounting*

- Other comments made by the SEC Observer at EITF meetings

SEC guidance on pushdown accounting:

Prior to the issuance of ASU 2014-17, SEC guidance has followed certain rules in applying pushdown accounting to an SEC registrant.

1. If a purchase transaction results in an entity becoming *substantially wholly owned*, its standalone financial statements should be adjusted to reflect the new basis of accounting of the acquiring entity.

2. Pushdown accounting is:

   - Required when 95 percent or more of an entity is acquired
   - Permitted when 80 to 95 percent is acquired, and
   - Prohibited when less than 80 percent ownership is acquired.

Note: Pushdown accounting assumes that due to the purchase transaction, the acquired entity (acquiree) is within the control of the acquiring entity (acquirer). Other interests, such as outstanding public debt, preferred stock, or a significant non-controlling interest,

however, may impact the acquired entity's ability to adjust its standalone financial statements to reflect the acquiring entity's basis of accounting.

The SEC staff's guidance also indicates that holdings of investors, who both mutually promote the acquisition and collaborate on the subsequent control of the acquired entity, should be aggregated for the purposes of determining whether the acquired entity has become substantially wholly owned.

1. When applying pushdown accounting to an SEC company, there have been a few nonauthoritative rules that have been followed:

    - The assets and liabilities of the target should be grossed up to fair value.
    - Acquisition debt is pushed down to the target in certain cases where the target assumes the debt or the target pledges its assets as collateral for the debt, among other situations.
    - The buyer's equity accounts should not be pushed down to the target subsidiary.
    - The target's common stock account should reflect the par value of its issued shares, and its additional paid-in capital account should represent the difference between the recorded net assets and the sum of the par value of its issued shares and the amount of any preferred stock outstanding.
    - In the financial statements and footnotes, periods prior to the application of pushdown accounting should be separated from the periods after the application of pushdown accounting.
    - Acquisition costs incurred by the buyer should not be pushed down to the target's standalone financial statements.
    - Any gain from a bargain purchase recorded by the buyer when applying the acquisition method is not pushed down to the target's standalone income statement.

Because the SEC staff’s guidance has applied only to SEC registrants, no guidance has existed for the application of pushdown accounting to entities that are not SEC registrants. Thus, for example, a nonpublic entity has had no guidance as to how and when to apply pushdown accounting.

In the absence of relevant GAAP guidance, non-SEC registrants have had to look to the SEC staff guidance to determine whether and at what threshold they should apply pushdown accounting in their separate financial statements.

The history of pushdown accounting and nonpublic entities:

Historically, nonpublic (non-SEC) entities have not been required to follow the SEC staff's pushdown accounting guidance. While there has been no authoritative guidance on pushdown accounting for non-SEC registrants, nothing in GAAP has precluded a nonpublic entity from following SEC guidance on pushdown accounting. Thus, a non-SEC

company could choose to apply pushdown accounting if the related SEC requirements were met.

The issue of whether pushdown accounting should apply to nonpublic entities has been around for decades, but has not resulted in the issuance of any authoritative guidance.

Some GAAP documents have addressed pushdown accounting but a consensus has been reached in limited cases as follows:

- EITF Issue No. 86-9, *IRC Section 338 and Pushdown Accounting*, and
- EITF Issue No. 87-21, *Change of Accounting Basis in Master Limited Partnership Transactions*

Both of the previously noted EITF Issues are currently codified in ASC Subtopic 805-50, *Business Combinations: Related Issues.*

Going as far back as 1979, the AICPA Task Force on Consolidation Problems discussed pushdown accounting in its October 30, 1979 non-authoritative Issues Paper, *Pushdown Accounting*. The Issues Paper developed some advisory conclusions but no authoritative guidance was issued.

In addition, the FASB considered the issue in its Discussion Memorandum, *New Basis Accounting*, published on December 18, 1991. The Discussion Memorandum was issued as part of the FASB's broader project on consolidations but no further decisions were reached by the FASB on pushdown accounting after its issuance.

Since the SEC staff's guidance has only been mandatory for SEC registrants, variation in practice has existed on the application of pushdown accounting to nonpublic entities.

The issue that the FASB EITF decided to address is whether an acquired entity (acquiree) should establish a new accounting basis in its standalone financial statements due to a change in its ownership as a result of a transaction accounted for as a business combination by the acquiring entity. If so, what would be the level of ownership at which the new accounting basis should be required?

New ASU 2014-17 adds pushdown accounting guidance to all entities

As a result of the limited overall guidance in using pushdown accounting, particularly for non-SEC entities, i**n April 2014, the FASB issued an exposure draft entitled, *Business Combinations (Topic 805) Pushdown Accounting,* a consensus of the FASB Emerging Issues Task Force.**

In November 2014, the exposure draft was issued as a final statement as ASU 2014-17, *Business Combinations (Topic 805) Pushdown Accounting*.

ASU 2014-17 does the following:

- It amends ASC 805, *Business Combinations*, and provides specific guidance on using pushdown accounting for *all entities*, SEC and non-SEC, alike.

- It applies to the separate financial statements of an acquired entity and its subsidiaries that are a business or nonprofit activity (either public or nonpublic).

- It provides an option under which an acquired entity may elect to apply pushdown accounting in its separate financial statements upon a *change-in-control event* in which an acquirer (individual or entity) obtains control of the acquired entity.

- The change-in-control threshold used in the ASU is consistent with the threshold for change-in-control events found in ASC 805, *Business Combinations*, and ASC 810, *Consolidation.*

In May 2015, the FASB issued ASU 2015-08, *Business Combinations (Topic 805) Pushdown Accounting Amendments to SEC Paragraphs Pursuant to Staff Accounting Bulletin No. 115.* ASU 2015-08 amends ASC 805 to reflect the SEC's rescission of its previous guidance on pushdown accounting found in SEC Topic 5-J. The SEC's rescission of SEC Topic 5-J is discussed further on in this section.

III. Definitions

1. The ASU amends ASC 805 to reflect the following definitions:

   Acquiree: The business or businesses that the acquirer obtains control of in a business combination. This term also includes a nonprofit activity or business that a not-for-profit acquirer obtains control of in an acquisition by a not-for-profit entity.

   Acquirer: The entity that obtains control of the acquiree. However, in a business combination in which a variable interest entity (VIE) is acquired, the primary beneficiary of that entity always is the acquirer.

   Acquisition Date: The date on which the acquirer obtains control of the acquiree.

   Business: An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants.

Business combination: A transaction or other event in which an acquirer obtains control of one or more businesses.

Control: The same as the meaning of *controlling financial interest* in ASC 810-10-15-8, which is ownership of a majority voting interest, directly or indirectly. The power to control may also exist with a lesser percentage of ownership, by contract, lease, agreement with other stockholders, or by court decree.

Nonprofit Activity: An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing benefits, other than goods or services at a profit or profit equivalent, as a fulfillment of an entity's purpose or mission (for example, goods or services to beneficiaries, customers, or members). As with a not-for-profit entity, a nonprofit activity possesses characteristics that distinguish it from a **business** or a for-profit business entity.

Pushdown Accounting: Use of the acquirer's basis in the preparation of the acquiree's separate financial statements.

IV. Scope of ASU 2014-17

1. The rules for pushdown accounting found in ASU 2014-17 apply to the separate financial statements of:

- An acquiree, and
- Any subsidiaries of an acquiree

a. An acquiree (or its subsidiaries) must be either a *business or a non-profit activity*.

b. An acquiree (and its subsidiaries) can be an SEC, non-SEC or nonprofit entity.

2. The guidance of pushdown accounting *does not apply* to certain transactions identified in ASC 805-10-15-4 as follows:

a. The formation of a joint venture

b. The acquisition of an asset or group of assets that does not constitute a business or non-profit activity

c. A combination between entities, businesses, or nonprofit activities under *common control*

d. An acquisition by a not-for-profit entity for which the acquisition date is before December 31, 2009, or a merger of not-for-profit entities, and

e. A transaction or other event in which a not-for-profit entity obtains control of a not-for-profit entity but does not consolidate that entity.

3. SEC SAB 115 Rescission of SEC Topic 5.J

a. SEC rescinds SEC Topic 5.J so that pushdown accounting is no longer required for SEC registrants.

b. SEC registrants are permitted, but not required, to elect pushdown accounting using the guidance found in ASU 2014-17, not SEC Topic 5.J.

c. The 80% to 95% thresholds for using pushdown accounting for SEC registrants is gone.

d. In May 2015, the FASB issued ASU 2015-08, *Business Combinations (Topic 805) Pushdown Accounting Amendments to SEC Paragraphs Pursuant to Staff Accounting Bulletin No. 115.* ASU 2015-08 amends ASC 805 to reflect the SEC's rescission of its previous guidance on pushdown accounting found in SEC Topic 5-J.

Observation: On November 18, 2014, the SEC issued Staff Accounting Bulletin (SAB) 115 which rescinds the SEC guidance previously issued for SEC registrants in SEC Topic 5.J. That previous guidance permitted SEC registrants to use of pushdown accounting when there is ownership of 80 percent of more of an acquiree. At 95% or more ownership, pushdown accounting was required. With the elimination of SEC Topic 5.J and the 80% or greater threshold, SEC registrants now have the option (not requirement) to use pushdown accounting when there is a change-in-control event. That change in control may occur when an entity (acquirer) acquires more than 50% of the voting shares of an acquiree. Thus, ASU 2014-17's threshold for using pushdown accounting (more than 50% of the voting interest) is far lower that the 80% or greater threshold previously found in SEC Topic 5.J.

V. Rules of ASU 2014-17

1. An acquiree (or its subsidiaries) shall have the option to apply pushdown accounting in its separate financial statements when an acquirer **(**an entity or individual acquirer) *obtains control* of the acquiree (e.g., there is a *change-in-control event*).

a. The activity of obtaining control is referred to as a *"change-in-activity"* event.

b. Any subsidiary of an acquiree also is eligible to make an election to apply pushdown accounting to its separate financial statements regardless of whether the acquiree elects to apply pushdown accounting.

Example: Company S owns subsidiaries S1 and S2. Company P acquires 100% of the voting interest of Company S. Company S chooses not to elect pushdown accounting.

Conclusion: Although S does not elect pushdown accounting, either or both of S's subsidiaries, S1 and S2, can make an independent election to apply pushdown accounting.

2. An acquirer might obtain control (change-in-control event) of an acquiree in several ways which include any of the following:[7]

   a. By transferring cash or other assets
   b. By incurring liabilities
   c. By issuing equity interests
   d. By providing more than one type of consideration
   e. *Without transferring consideration*, including by contract alone

   Note: ASC 805-10-25-11 provides the following examples of situations in which control occurs *without transferring consideration*:

   - The acquiree repurchases a sufficient number of its own shares for an existing investor (the acquirer) to obtain control

   - Minority veto rights lapse that previously kept the acquirer from controlling an acquiree in which the acquirer held the majority voting interest, or

   - The acquirer and acquiree agree to combine their businesses by contract alone and the acquirer transfers no consideration in exchange for control of an acquiree and holds no equity interests in the acquiree, either on the acquisition date or previously. Examples including bringing two businesses together in a stapling arrangement or forming a dual-listed corporation.

3. Definition of control for purposes of determining change in control

   a. Control exists if an acquirer obtains a *"controlling financial interest"* in an acquiree, as defined in ASC 810-10-15-8 which includes obtaining:

[7] If there is a transaction in which one party loses control without another party gaining control, such a transaction is not considered a change-in-control event to which pushdown accounting would apply.

1) Ownership of a majority (more than 50%) voting interest in the acquiree, or

2) Power to control the acquiree through contract, lease, agreement with other shareholders, or by court decree

   Note: A primary beneficiary has a controlling financial interest in a variable interest entity (VIE)

How do you determine the acquirer and acquiree in business combinations involving more than two entities?

The ASU provides some limited guidance in determining which entity is the acquiree and which is the acquirer in certain cases.

The ASU states that the guidance in ASC Subtopic 810-10, *Consolidation-Overall*, related to determining the existence of a controlling financial interest, shall be used to identify the acquirer.

If a business combination has occurred but it is not clear which of the combining entities is the acquirer, the ASU 2014-07 references certain factors found that shall be considered in identifying the acquirer.

Those factors include the following:

- The acquirer usually is the entity that transfers the cash or other assets or incurs the liabilities, in instances where the business combination is effected primarily by transferring cash or other assets or by incurring liabilities.

- The acquirer usually is the entity that issues its equity interests if the business combination is effected primarily by exchanging equity interests.

- The acquirer usually is the combining entity whose relative size is significantly larger than that of the other combining entity or entities, measured in assets, revenue or earnings.

- In a business combination involving more than two entities, consideration should be given to factors such as which of the entities initiated the combination, and the relative size of the combining entities.

As to the acquiree, if the acquiree is a variable interest entity (VIE), the primary beneficiary of the acquiree always is the acquirer. The determination of which party, if

any, is the primary beneficiary of a VIE shall be made in accordance with the guidance in ASC Subtopic 810-10, *Consolidation-Overall.*

4. The acquiree's option to apply pushdown accounting may be elected each time there is a change-in-control event in which an acquirer obtains control of the acquiree.

   a. An acquiree shall make an election to apply pushdown accounting for the reporting period in which the change-in-control occurred as follows:

      For an SEC filer and a conduit bond obligor: Before the financial statements are issued, or

      For all other entities: Before the financial statements are available to be issued.

5. If the acquiree elects the option to apply pushdown accounting, it must apply it as of the *acquisition date* of the change-in-control event.

6. If the acquiree *does not elect* to apply pushdown accounting upon a change-in-control event, it can elect to apply pushdown accounting to its most recent change-in-control event in a subsequent reporting period as a change in accounting principle in accordance with ASC 250, *Accounting Changes and Error Corrections.*

7. Any subsidiary of an acquiree is eligible to make an election to apply pushdown accounting to its separate financial statements irrespective of whether the acquiree elects to apply pushdown accounting.

8. The decision to apply pushdown accounting to a specific change-in-control event if elected by an acquiree is irrevocable.

   Note: Because the elect is irrevocable, a reduction the equity held by a controlling party to a non-controlling level would not result in the acquiree stopping use of pushdown accounting.

9. If an acquiree *elects the pushdown accounting option*, the acquiree applies the following rules:

   a. The acquiree reflects in its separate financial statements the *new basis of accounting* established by the acquirer for its individual assets and liabilities by applying the *acquisition method* rules found in ASC 805, *Business Combinations*.

      1) Under the acquisition method, identified assets and acquired liabilities of the acquirer are recorded at *fair value at the acquisition date*.

b. An acquiree shall recognize goodwill that arises because of the application of pushdown accounting in its separate financial statements.

c. Bargain purchase gains recognized by the acquirer, if any, shall not be recognized (pushed down) in the acquiree's income statement.

   1) The acquiree shall recognize the bargain purchase gains recognized by the acquirer as an *adjustment to additional paid-in capital* (or net assets of a not-for-profit acquiree).

d. An acquiree shall recognize in its separate financial statements any *acquisition-related liability incurred* by the acquirer *only if the liability represents an obligation of the acquiree* in accordance with other applicable ASC Topics.

   1) Acquisition costs of the acquirer would generally not be pushed down to the acquiree unless the acquiree is an obligor of those costs.

   Note: ASU 2014-17 states that any acquisition-related liability incurred by the acquirer should be recognized in the acquired entity's separate financial statements only if the acquired entity is required to recognize a liability in accordance with other applicable GAAP (for example, an acquiree might be required to record a joint and several liability arrangements under ASC 405-40, *Liabilities-Obligations Resulting from Joint and Several Liability Arrangements.* The FASB EITF referred to the definition of a liability in FASB Concepts Statement No. 6, *Elements of Financial Statements*, which states that "liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events."

e. Deferred income taxes measured and recorded by the acquirer related to the business combination would also be pushed down to the acquiree's balance sheet.

f. If the acquirer did not establish a new basis of accounting for the individual assets and liabilities of the acquiree because it was not required to record the assets and liabilities at fair value under ASC 805, the acquiree shall still reflect the new basis of accounting in its separate financial statements *as if* the acquirer had valued the acquired assets and liabilities at fair value under ASC 805.

   Examples where the acquirer is not required to record the assets and liabilities at fair value include:

   - Acquirer is an individual
   - Acquirer is an investment company following the guidance in ASC 946

Example 1: John Smith acquires 100% of the voting shares of Company X for $5 million. Because John (the acquirer) is an individual, John does not record the assets and liabilities at fair value.

Conclusion: Although John does not record the assets and liabilities acquired at fair value, Company X (acquiree) can elect pushdown accounting and revalue its assets and liabilities at $5 million.

g. Once pushdown accounting is elected, the decision is *irrevocable* and cannot be reversed.

10. A new basis of accounting is not appropriate for any of the following transactions that create a master limited partnership:

a. A rollup in which the general partner of the new master limited partnership was also the general partner in some or all of the predecessor limited partnerships and no cash is involved in the transaction. Transaction costs in a rollup shall be charged to expense.

b. A dropdown in which the sponsor receives 1% of the units in the master limited partnership as the general partner and 24% of the units as a limited partner, the remaining 75% of the units are sold to the public, and a two-thirds vote of the limited partners is required to replace the general partner.

c. A rollout, or

d. A reorganization.

11. Subsequent Measurement

a. An acquiree shall follow the subsequent measurement guidance in other Subtopics of ASC 805 and other applicable Topics to subsequently measure and account for its assets, liabilities, and equity instruments, as applicable.

12. Common Control Transactions

a. ASU 2014-17 states that the pushdown accounting guidance *does not apply* to certain transactions, one of which is a combination between entities, businesses, or nonprofit activities under *common control.*

b. Examples of transactions between entities under common control, found in ASC 805-50-15-6, *Business Combinations- Related Issues,* follow:

1) An entity charters a newly formed entity and then transfers some or all of its net assets to that newly chartered entity

2) There is a change in legal organization but not a change in the reporting entity such as:

   - A parent transfers the net assets of a wholly owned subsidiary into the parent and liquidates the subsidiary, or

   - A parent transfers its controlling interest in several partially owned subsidiaries to a new wholly owned subsidiary.

3) A parent exchanges its ownership interests or the net assets of a wholly owned subsidiary for additional shares issued by the parent's less-than-wholly owned subsidiary, thereby increasing the parent's percentage of ownership in the less-than-wholly-owned subsidiary but leaving all of the existing noncontrolling interest outstanding.

4) A parent's less-than-wholly owned subsidiary issues its shares in exchange for shares of another subsidiary previously owned by the same parent, and the noncontrolling shareholders are not party to the exchange.

5) A limited liability company is formed by combining entities under common control, or

6) Two or more not-for-profit entities that are effectively controlled by the same board members transfer their net assets to a new entity, dissolve the former entities, and appoint the same board members to the newly combined entity.

Is an acquiree required to record an acquisition debt incurred by the acquirer to consummate the acquisition of the acquiree?

It depends on whether the acquiree is required to record that liability under other GAAP.

More specifically, ASU 2014-17 states that under the pushdown accounting rules, any acquisition-related liability incurred by the acquirer should be recognized in the acquiree's separate financial statements *only if the acquiree is required to recognize the liability in accordance with other GAAP* .

The ASU also states that the definition of a liability is based on the one found in FASB Concepts Statement No. 6, *Elements of Financial* statements which defines a liability as a *"probable future sacrifices of economic benefits arising from present obligations of a*

particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events."

That means that acquisition debt incurred by the acquirer will be "pushed down" to the acquiree if the acquiree is jointly obligated for that debt as a co-borrower and not as a guarantor.

More specifically, ASC Subtopic 405-40, *Liabilities-Obligations Resulting from Joint and Several Liability Arrangements*, addresses the recognition, measurement and disclosure of obligations resulting from joint and several liability arrangements. One example of a joint and several liability arrangement is where two entities are co-borrowers such as when an acquirer and acquiree are *borrowers on the same acquisition debt*.

Under ASC 405-40:

1. An entity (such an acquiree) 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 (acquiree, in this case) 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*.

Using the rules found in ASC 450-40, an acquiree who is a co-borrower of debt along with the acquirer, would be required to "pushdown" that debt to its new basis balance sheet under pushdown accounting. The reason is because ASC 450-40 requires the acquiree to record the debt as a GAAP liability because the acquiree is a co-obligor of that debt under a joint and several arrangement.

If, instead, the acquiree is merely a guarantor of the acquisition debt and the acquirer is the sole borrower, the acquiree would not pushdown that acquisition debt to its balance sheet.

Why? ASC 450-40 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*, which states:

a. At the inception of a guarantee, the guarantor shall recognize in its statement of financial position *a liability for that guarantee at the fair value* of the guarantee.

b. ASC 460 *does not apply to related party guarantees*. Therefore, if an entity guarantees the debt of a related party, the guarantor (acquiree in this case) is not required to record a liability.

Therefore, if an acquiree guarantees the acquisition debt of the acquirer in a business combination, the acquiree does not pushdown that debt to the acquiree's new basis balance sheet. The reason is because GAAP does not require the acquiree to record a liability for a related party guarantee.

Example 1: Company P (acquirer) acquires 100% of the voting equity of Company S (acquiree) for $20 million. P had no ownership in S prior to this acquisition.

As part of that acquisition, P borrows $15 million of bank financing. The financing is secured by the assets of S, but S is not a borrower.

The acquisition is a change-in-control event in that P is obtaining control of S through the transaction.

S elects pushdown accounting for the $20 million acquisition of P.

Conclusion: S will revalue its balance sheet by pushing down the $20 million of P's acquisition value. In doing so, the net assets and liabilities of S are revalued at fair value to reflect the $20 million value.

S *will not* pushdown the $15 million of P's acquisition debt. The reason is because S is only a guarantor of that debt and not a borrower. Thus, under GAAP, S does not record a liability for the guarantee of related party debt under ASC 460's rules.

Example 2: Same facts as Example 1 except that S is a co-borrower of the $15 million bank loan.

Conclusion: As part of implementing pushdown accounting, S should record the $15 million of acquisition debt because S is jointly and severally liable for that debt as a co-borrower.

Is an acquiree permitted to change from pushdown accounting once it is elected?

No. Paragraph 805-50-25-9 of the ASU states that "*the decision to apply pushdown accounting to a specific change-in-control event, if elected, by an acquiree is irrevocable*."

This means that if an acquiree elects to use pushdown accounting for a change-in-control event, once elected, the acquiree is not permitted to stop using pushdown accounting.

What if the change-in-control event occurs that results in a loss of control by the acquirer?

Is the acquiree required to stop using pushdown accounting?

The ASU is quite clear that once pushdown accounting is elected, it is irrevocable. Therefore, a subsequent loss in a control (controlling financial interest) by an acquirer of an acquiree should have no effect on the acquiree's use of pushdown accounting.

Is each change-in-control event evaluated separately in terms of whether an acquiree may elect pushdown accounting?

Paragraph BC17 of ASU 2014-17 states that an acquired entity (acquiree) should evaluate separately the option to apply pushdown accounting at *each change-in-control event* and that the guidance should not be treated as a one-time accounting policy election.

Every change-in-control event is a distinct event and, therefore, an acquiree should make its pushdown accounting election on the basis of the facts and circumstances and the needs of its users for each distinct change-in-control event.

Moreover, in the final ASU, the FASB clarified that the option to elect pushdown accounting can be made before the financial statements of the reporting period in which the change-in-control event occurred are issued or are available to be issued.

What happens if control shifts from one party to another?

Does that fact mean there is a change-in-control event?

No. If there is a transaction in which one party loses control of an acquiree without another party gaining control, such a transaction is not considered a change-in-control event to which pushdown accounting would apply.

However, if one majority owner sells its equity to a new majority owner, that sale is a change- in-control event for which the subsidiary may apply pushdown accounting to the transaction.

Example: Company P acquires 100 percent of the equity of Company S. S applies pushdown accounting on the acquisition date.

Two years later, Company P sells its 100 percent interest to Company P1.

Conclusion: The sale of the equity from P to P1 is a change-in-control event for which S may once again elect to apply pushdown accounting.

If there are multiple acquirees, is only one acquiree permitted to use pushdown accounting?

No. Although there is only one acquirer in a business combination, there can be several acquirees. ASU 2014-17 defines an acquiree as *"the business or businesses that the acquirer obtains control of in a business combination."*

Thus, if an acquirer obtains control of several entities in a business combination, each of those entities is an acquiree. Each acquiree may make its own election to apply pushdown accounting.

If the acquiree elects not to apply pushdown accounting, are its subsidiaries permitted to make the election?

Yes. Paragraph BC18 of ASU 2014-17 clarifies that the option to apply pushdown accounting should be *evaluated separately by each acquiree* in a change-in-control transaction.

Each acquiree's evaluation should be made independent of the election made by other entities in the group of entities controlled by the acquirer.

For example, if one acquiree elects not to apply pushdown accounting, one or more of its subsidiaries can elect to apply pushdown accounting to its separate financial statements.

If the acquiree elects not to apply pushdown accounting to a change-in-control event, is that acquiree permitted to apply it in the future?

Yes. Paragraph 805-50-25-7 of the ASU states that if the acquiree *does not elect to apply pushdown accounting upon a change-in-control event*, it can elect to apply pushdown accounting to the *most recent change-in-control event* in a subsequent reporting period. In doing so, the change is treated as a change in accounting principle in accordance with ASC 250, *Accounting Changes and Error Corrections.*

Example 1: On January 1, 2015, Company P acquires 100% of the voting common stock of Company S for $30 million. January 1, 2015 is the acquisition date.

On January 1, 2015, a change-in-control event date, S does not elect to apply pushdown accounting to its financial statements.

On January 1, 2016, S decides to elect pushdown accounting going back to the most recent change-in-control event, which is January 1, 2015.

Conclusion: Even though S did not elect pushdown accounting on the acquisition date of January 1, 2015, S may make the election on January 1, 2016. In doing so, S makes a change in accounting principle under ASC 250, *Accounting Changes and Error Corrections*, and applies the change retrospectively back to the most recent change-in-control event, which was the January 1, 2015 acquisition date.

The result is that S revalues its balance sheet as of the January 1, 2015 acquisition date, and restates the 2015 financial statements based on the new valuation. For example, because the 2015 financial statements would be restated to reflect the pushdown valuation as of January 1, 2015, depreciation and amortization would be changed for 2015. Both 2015 and 2016 financial statements would be presented under the new pushdown valuation that was made as of January 1, 2015.

Change the facts: Assume the same facts as Example 1 except that on September 1, 2015, there is a second change-in-control event under which a new parent acquires 100% of the equity of Company S. On January 1, 2016, S wants to make the election for pushdown accounting.

Conclusion: S can apply pushdown accounting to the most recent change-in-control event, which is now September 1, 2015. Thus, S can revalue its balance sheet as of September 1, 2015 and apply pushdown accounting prospectively from September 1, 2015 forward into 2016. Depreciation and amortization would be adjusted for the new bases from September 1, 2015 forward. Because there was a second and most recent change-in-control event on September 1, 2015, S can no longer go back and apply pushdown accounting to the first acquisition date of January 1, 2015.

Observation: In paragraph BC20 of the ASU's *Background and Conclusions Reached*, the FASB EITF addresses its reasoning for permitting an acquiree to elect to apply pushdown accounting in a period subsequent to a change-in-control event.

The EITF explains that in a subsequent period, there may be instances in which an entity's circumstances change that may make the use of pushdown accounting more relevant. One example given by the EITF is where there is a significant change in the investor mix such that pushdown accounting would be more relevant to the current investors. In such a situation, the EITF notes that the acquired entity should not be prohibited from applying pushdown accounting to a change-in-control event (change in mix of equity holders) for which it previously had elected not to apply pushdown accounting as long as that event is the acquired entity’s most recent change-in-control event.

How does an acquiree that elects pushdown accounting handle depreciation and amortization?

If the acquiree elects to revalue its balance sheet using pushdown accounting, the acquiree must recalculate depreciation and amortization using the new values. If the revaluation is done in the middle of the year, there would be two calculations, one for depreciation and amortization prior to the pushdown revaluation, and a second calculation based on the new values.

If pushdown accounting is elected and applied for the current year, how should the prior year be shown if presented for comparative purposes?

The ASU does not address the issue of what to do with the prior year's financial statements. If pushdown accounting is applies for the current year, that means the current year balance sheet will be revalued while the prior year will remain at the older values. If comparative financial statements are presented, there would be a mismatch of balance sheets; one with new values and one with old values. Alternatively, the acquiree could elect to present single-year current year financial statements only. Another option would be to present "black lined" financial statements under which both years are presented but there is a line clearly delineating the two years.

What is the impact of ASU 2014-17 on SEC companies?

Previously, SEC companies were required to use pushdown accounting at 95% or greater ownership, under SEC Topic 5.J. With the issuance of ASU 2014-17, the SEC has rescinded SEC Topic 5.J. That means that an SEC company follows the guidance in ASU 2014-17 only, and is not required to apply pushdown accounting in any instance given that ASU 2014-17 is optional.

VI. Disclosures

a. If an acquiree elects the option to apply pushdown accounting in its separate financial statements, it shall disclose information in the period in which the pushdown accounting was applied (or in the current reporting period if the acquiree recognizes adjustments that relate to pushdown accounting) that enables users of financial statements to *evaluate the effect of pushdown accounting*.

   Examples of disclosures of such information to evaluate the effect of pushdown accounting may include the following:

   1) The name and a description of the acquirer and a description of how the acquirer obtained control of the acquiree.

2) The acquisition date.

3) The acquisition-date fair value of the total consideration transferred by the acquirer.

4) The amounts recognized by the acquiree as of the acquisition date for each major class of assets and liabilities as a result of applying pushdown accounting. If the initial accounting for pushdown accounting is incomplete for any amounts recognized by the acquiree, the reasons why the initial accounting is incomplete.

5) A qualitative description of the factors that make up the goodwill recognized, such as expected synergies from combining operations of the acquiree and the acquirer, or intangible assets that do not qualify for separate recognition, or other factors. In a bargain purchase, the amount of the bargain purchase recognized in additional paid-in capital (or net assets of a not-for- profit acquiree) and a description of the reasons why the transaction resulted in a gain.

6) Information to evaluate the financial effects of adjustments recognized in the current reporting period that relate to pushdown accounting that occurred in the current or previous reporting periods (including those adjustments made as a result of the initial accounting for pushdown accounting being incomplete.)

Note: The ASU states that the list of disclosures noted above is not an exhaustive list of disclosure requirements. The acquiree shall disclose whatever additional information is necessary to meet the disclosure objective of enabling *users of financial statements to evaluate the effect of pushdown accounting.*

VII. Transition and Effective Date of ASU 2014-17

a. The ASU is effective *as of November 18, 2014*.

b. The provisions of the ASU shall be applied by an acquiree as of the acquisition date of a change-in-control event in which an acquirer obtained control of the acquiree to *both* of the following events:

1) A change-in-control event with an acquisition date after November 18, 2014

2) A change-in-control event with an acquisition date before November 18, 2014, when the financial statements of the reporting period that contains the acquisition date have not been issued (a Securities and Exchange Commission (SEC) filer or a conduit bond obligor as discussed in ASC 855, *Subsequent Events*) or made available to be issued (all other entities as discussed in ASC 855, *Subsequent Events*).

c. The changes made by ASU 2014-17 shall be applied by an acquiree as of the acquisition date of its most recent change-in-control event in which an acquirer obtained control of the acquiree that meets *both of the following conditions* as a change in accounting principle in accordance with ASC 250, *Accounting Changes and Error Corrections.*

   1) The acquisition date of the change-in-control event is before November 18, 2014.

   2) The financial statements of the reporting period that contains the acquisition date have been issued (an SEC filer or a conduit bond obligor as discussed in ASC 855) or made available to be issued (all other entities as discussed in ASC 855).

d. Pushdown accounting applied by an acquiree before the November 18, 2014 effective date is irrevocable.

Example- Application of Pushdown Accounting

Company S (acquiree) has the following balance sheet at December 31, 20X1:

Company S
Balance Sheet
December 31, 20X1

Current assets	$400,000
Property and equipment	550,000
Goodwill	0
Total assets	$950,000
Current liabilities	$100,000
Long-term debt	600,000
Retained earnings	200,000
Common stock	50,000
	$950,000

On December 31, 20X1, Company P (acquirer) purchases 100% of the common stock of Company S (acquiree) for $3,000,000. Company P pays for the purchase by borrowing $2,000,000 of acquisition debt, secured by the assets of Company S, and paying cash of $1,000,000.

S is a co-borrower with P on the $2,000,000 of acquisition debt.

The fair value of the underlying assets of Company S is as follows:

Fair value of underlying assets of S:

Current assets	$400,000
Property and equipment	2,800,000
Current liabilities	(100,000)
Long-term debt	(600,000)
Total	2,500,000
Goodwill (plug)	500,000
Fair value of the net assets acquired	$3,000,000

Breakout:

Fair value: Assets	$3,700,000
Liabilities	(700,000)
	$3,000,000

S (acquiree) elects pushdown accounting for the change in control by Company P.

Conclusion:

At the acquisition date of December 31, 20X1, S elects pushdown accounting. In doing so, it revalues its balance sheet at fair value consisting of $3,700,000 fair value of assets, less $700,000 of liabilities, for a net fair value of $3,000,000. In addition, $2,000,000 of P's acquisition debt is pushed down to S because the $2,000,000 is a liability of S under GAAP. The reason is because S is jointly and severally obligated for the debt as a co-borrower with Company P.

Following is a worksheet that illustrates the new basis of accounting analysis at the acquisition date:

Pushdown Worksheet
Acquisition to the Individual Assets and Liabilities of S
December 31, 20X1

	Company P	Company S (existing Balance Sheet)	Pushdown adjustment on S	Company S Revised Balance Sheet (Pushdown)
Current assets		$400,000		$400,000
Property and equipment		550,000	2,250,000	2,800,000
Goodwill		0	500,000	500,000
Investment in S	3,000,000			
Total assets	$3,000,000	$950,000		$3,700,000
Current liabilities		$100,000		$100,000
Long-term debt		600,000		600,000
Acquisition debt	2,000,000		2,000,000	2,000,000 (1)
Retained earnings		200,000	(200,000)	0
Common stock	1,000,000	50,000	0	50,000
APIC (plug)			950,000	950,000
Total L and SE	$3,000,000	$950,000	$ 0	$3,700,000

(1): Acquisition debt of P is pushed down to S because the debt is collateralized by the assets of S. If the debt was not collateralized by the assets of S, none of the debt would have been pushed down to S and the offset would be a credit to APIC of $2,950,000 instead of $950,000.

Entry: Company S's books: 12-31-X1:

	dr	cr
Property and equipment	2,250,000	
Goodwill	500,000	
Acquisition debt		2,000,000
Retained earnings	200,000	
Additional paid-in capital (APIC)		950,000

To pushdown acquisition of S to the underlying assets and liabilities.

Company S
Balance Sheet
December 31, 20X1
(After Pushdown Accounting)

ASSETS	
Current assets	$400,000
Property and equipment	2,800,000
Goodwill	500,000
Total assets	$3,700,000
LIABILILITIES AND STOCKHOLDER'S EQUITY	
Current liabilities	$100,000
Long-term debt	600,000
Acquisition debt	2,000,000
Retained earnings	0
Common stock	50,000
Additional paid-in capital	950,000
Total liabilities and stockholder's equity	$3,700,000

Observations: Starting on January 1, 20X2, Company S would start recording depreciation and amortization using the new revalued asset values.

VIII. Reasons for Using Pushdown Accounting

Why would an acquiree want to use pushdown accounting in the first place?

Now that pushdown accounting is permitted for use by all types of acquirees, a larger issue is whether is behooves an acquiree to use it. An acquiree must weigh the advantages and disadvantages of using pushdown accounting before making the election.

As ASU 2014-17 makes perfectly clear, once pushdown accounting is elected, it is irrevocable.

Although not all-inclusive, following are some of the advantages and disadvantages of using pushdown accounting:

Advantages:

1. The acquiree will typically have higher net assets due to the assets and liabilities being stepped up to fair value and goodwill being recognized.

2. Assets reflect fair value (minimal effect on liabilities).

3. Any negative book value deficiency from showing undervalued net assets, may be eliminated making borrowing easier.

Disadvantages:

1. Pushdown accounting typically results in lower net income.

   a. Higher stepped up assets and goodwill will result in higher depreciation and amortization, and impairment charges.

      Note: EBITDA and operating cash flows should be neutral as both are not impacted by higher depreciation and amortization expense.

Observation: Although some companies may choose to use pushdown accounting, others will not. In particular, those entities that have pressure to drive earnings, such as private equity companies, may not wish to use pushdown accounting due to the higher depreciation and amortization that will result from its use. Similarly, subsidiaries of SEC companies may choose not to use pushdown accounting. Its use is no longer required now that the SEC rescinded SEC Topic 5.J.

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. Company X, a public company, acquires 70% of the common stock of Company Y. Which of the following is correct with respect to whether Y can use pushdown accounting to account for the acquisition of Y's common stock under SEC rules in effect prior to the effective date of ASU 2014-17:
   a. Y is required to use pushdown accounting
   b. Y is permitted to use pushdown accounting
   c. Y is prohibited from using pushdown accounting
   d. There is no authority to address the issue

2. Company P acquires 80% of Company S. As a result of the transaction, P obtains control of S. Company S has two subsidiaries, Company X and Y. Company S does not elect pushdown accounting. Which of the following is correct as it relates to use of pushdown accounting:
   a. P may use pushdown accounting
   b. Even though S elects not to use pushdown accounting, that election is not available to S anyway
   c. X may not use pushdown accounting unless S make the pushdown accounting election
   d. Y may use pushdown accounting

3. Company P acquires some of the voting interest in Company S. Which of the following is a situation in which Company P (the acquirer) *does not obtain control* of Company S (the acquiree) in a business combination:
   a. If P obtains a total of 20-50% of the voting interest in S
   b. If P obtains 80% of the voting interest in S
   c. If P has the power to control S through a contract
   d. If P is the primary beneficiary of S and S is a variable interest entity (VIE)

4. Company P (the acquirer) acquires 100% of the voting interest in Company S (the acquiree). Which of the following is correct if S elects to use pushdown accounting:
   a. S is not permitted to recognize goodwill in applying pushdown accounting
   b. S is permitted to recognize any bargain purchase gains recognized by the acquirer
   c. S should use the book value method in applying pushdown accounting
   d. S should use the acquisition method in applying pushdown accounting

5. Company X acquires a controlling financial interest in Company Y. Company Y elects to apply pushdown accounting and does so in Year 1, the year in which the change-in-control event occurs. Which of the following is correct:
   a. Y may reverse its use of pushdown accounting in Year 2
   b. Y may not reverse its use of pushdown accounting in Year 2
   c. Y may reverse its use of pushdown accounting only after five years of its use
   d. Y may reverse its use of pushdown accounting in a subsequent year in which X loses it controlling financial interest in Y

SUGGESTED SOLUTIONS

1. Company X, a public company, acquires 70% of the common stock of Company Y. Which of the following is correct with respect to whether Y can use pushdown accounting to account for the acquisition of Y's common stock under SEC rules in effect prior to the effective date of ASU 2014-17.
   a. Incorrect. Under the SEC rules in effect prior to ASU 2014-17, the SEC requires use of pushown accounting when 95% or more of the entity is acquired, not 70%.
   b. Incorrect. Under the pre-ASU 2014-17 SEC rules, X is permitted to use pushdown accounting when there is 80 to 95% ownership acquired, not 70%.
   c. Correct. At less than 80%, the SEC rules have prohibited Y from using pushdown accounting.
   d. Incorrect. The SEC has provided authority on pushdown accounting for SEC companies, making the answer incorrect.

2. Company P acquires 80% of Company S. As a result of the transaction, P obtains control of S. Company S has two subsidiaries, Company X and Y. Company S does not elect pushdown accounting. Which of the following is correct as it relates to use of pushdown accounting:
   a. Incorrect. Pushdown accounting applies to an acquiree, and not an acquirer. P, as the party who obtains control to the business combination, is the acquirer so that pushdown accounting does not apply to P.
   b. Incorrect. Company S is an acquiree in a business combination through which an acquirer (Company P) obtains control. ASU 2014-17 permits such an acquiree to use pushdown accounting. Thus, even though S elected not to use pushdown accounting, S could have made that election, making the answer incorrect.
   c. Incorrect. ASU 2014-17 permits the subsidiary of an acquiree (Company X in this case) to use pushdown accounting even if the acquiree (Company S) elects not to use pushdown accounting. Thus, the answer is incorrect.
   d. Correct. The election to use pushdown accounting is available to an acquiree and any of the acquiree's subsidiaries, provided a business combination results in an acquirer obtaining control over the acquiree. In this case, as a subsidiary of S, Company Y is permitted to make its own election to use pushdown accounting.Thus, the answer is correct.

3. Company P acquires some of the voting interest in Company S. Which of the following is a situation in which Company P (the acquirer) does not obtain control of Company S (the acquiree) in a business combination:
   a. Correct. Under the definition of control found in ASC 810, control exists if P obtains a controlling financial interest in S. A controlling financial interest is deemed to occur if there is ownership of more than 50% of the voting interest in S. At 20% to 50%, P's interest falls short of the more than 50% mark.

b. Incorrect. At 80% of the voting interest in S, P has more than 50% which is considered a controlling financial interest. Control exists if the acquirer obtains a controlling financial interest.
c. Incorrect. ASC 810 states that P may have control if it has the power to control Company S through a contract. Ownership is not necessarily required. Thus, control does exist making the answer incorrect.
d. Incorrect. ASC 810 states that if P is the primary beneficiary of S and S is a variable interest entity (VIE), the primary beneficiary is deemed to have a controlling financial interest. Thus, the answer is incorrect.

4. Company P (the acquirer) acquires 100% of the voting interest in Company S (the acquiree). Which of the following is correct if S elects to use pushdown accounting:
   a. Incorrect. ASU 2014-17 states that the acquiree shall recognize goodwill that arises due to using pushdown accounting, making the answer incorrect.
   b. Incorrect. ASU 2014-17 provides that any bargain purchase gains recognized by the acquirer shall not be recognized in the acquiree's income statement, making the answer incorrect.
   c. Incorrect. ASU 2014-17 does not state that the book value method should be used in applying pushdown accounting, making the answer incorrect.
   d. Correct. If the pushdown accounting is used, the acquiree (Company S) presents in its separate financial statements, its assets and liabilities using the acquisition method. That method records assets and liabilities at fair value.

5. Company X acquires a controlling financial interest in Company Y. Company Y elects to apply pushdown accounting and does so in Year 1, the year in which the change-in-control event occurs. Which of the following is correct:
   a. Incorrect. ASU 2014-17 states that the election to use pushdown accounting is irrevocable, making the answer incorrect.
   b. Correct. Once Y elects to use pushdown accounting for a specific change-in-control event, Y may not reverse its use subsequently based on the rules found in ASU 2014-17.
   c. Incorrect. There is no five-year provision found in ASU 2014-17 making the answer incorrect.
   d. Incorrect. ASU 2014-17 states that the election is irrevocable and may not be reversed for any reason. Thus, the fact that X loses its controlling financial interest in a subsequent year does not mean that Y is permitted to reverse its use of pushdown accounting.

Glossary

Acquiree: The business or businesses that the acquirer obtains control of in a business combination. This term also includes a nonprofit activity or business that a not-for-profit acquirer obtains control of in an acquisition by a not-for-profit entity.

Acquirer: The entity that obtains control of the acquiree. However, in a business combination in which a variable interest entity (VIE) is acquired, the primary beneficiary of that entity always is the acquirer.

Acquisition date: The date on which the acquirer obtains control of the acquiree.

Business: An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants.

Business combination: A transaction or other event in which an acquirer obtains control of one or more businesses.

Control: The same as the meaning of controlling financial interest in ASC 810-10-15-8, which is ownership of a majority voting interest, directly or indirectly. The power to control may also exist with a lesser percentage of ownership, by contract, lease, agreement with other stockholders, or by court decree.

Nonprofit Activity: An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing benefits, other than goods or services at a profit or profit equivalent, as a fulfillment of an entity's purpose or mission (for example, goods or services to beneficiaries, customers, or members). As with a not-for-profit entity, a nonprofit activity possesses characteristics that distinguish it from a business or a for-profit business entity.

Pushdown Accounting: Use of the acquirer's basis in the preparation of the acquiree's separate financial statements.

Final Exam

1. With respect to FIFO inventory, ASU 2015-11 replaces the concept of "market" with which of the following:
   a. Replacement cost
   b. Fair value
   c. Normal profit
   d. Net realizable value

2. Company K uses LIFO to value its inventory. At the end of the year, how should K measure its inventory under ASU 2015-11:
   a. Net realizable value
   b. Lower of cost and net realizable value
   c. Lower of cost or market
   d. Cost

3. Company L wrote down its inventory to lower of cost and net realizable value last year. This year, it appears that there is a recovery of the write-down. Which of the following is true with respect to U.S. GAAP:
   a. L is permitted to reverse the previous year's write-down
   b. L cannot reverse the previous year's write-down under U.S. GAAP
   c. L is permitted to reverse the previous year's write-down above original cost
   d. If L were using international standards (IFRS), L would still not be permitted to reverse the prior year's write-down

4 A company is performing a lower of cost and net realizable value test on its year-end inventory. The company's inventory has about 1,000 individual items and two major categories of products. Which of the following *would not* be an appropriate approach to perform the test:
   a. Directly on each of the 1,000 individual items
   b. To the total inventory in each of the two major categories
   c. To the total inventory
   d. Perform the test on only 5 percent of the total inventory

5. Company Q is implementing ASU 2015-11. How should Q apply the changes in the ASU:
   a. Retroactively
   b. Retrospectively
   c. Prospectively
   d. As a change in estimate

6. Company Z has a deferred tax asset that relates to a temporary difference that is presented as current on the balance sheet. How should the deferred tax asset be presented on the balance sheet under new ASU 2015-17:
   a. Current
   b. Long-term
   c. Split current and long-term
   d. The asset is not recorded but is disclosed only

7. Company C presents an unclassified balance sheet so that assets and liabilities are not classified as current and long-term. Which of the following is true:
   a. The changes made by ASU 2015-17 do not apply to C because it does not have a classified balance sheet
   b. C must convert its unclassified balance sheet to a classified one to comply with the new ASU 2015-17 rules
   c. ASU 2015-17 requires C to make changes to C's deferred tax asset and liability
   d. ASU 2015-17 applies to unclassified balance sheets and not to classified balance sheets.

8. Company K is adopting ASU 2015-17 for deferred taxes effective in 2018 and will present a comparative balance sheet for 2017. If X adopts the ASU retrospectively, what should K do to the comparative 2017 balance sheet presentation of the deferred tax asset or liability:
   a. X should not restate the 2017 balance sheet
   b. X should reverse off the 2017 liability
   c. X must restate the 2017 balance sheet
   d. X should gross up the asset and liability for 2017

9. Company J is adopting ASU 2015-17 and applying it prospectively. Which of the following should J disclose in the first annual period of adoption:
   a. The computation of the deferred tax amount
   b. A reconciliation of the effective tax rate to the statutory rate
   c. The nature of and reason for the change in accounting principle
   d. Quantitative information about the effects of the accounting change on the three prior periods.

10. If a physician practice management entity (PPME) has a controlling financial interest in a physician practice, how should the PPME account for the physician practice:
    a. Consolidate it
    b. Record it at equity method
    c. Record it at cost
    d. Make no entry

11. In accordance with ASC Subtopic 810-20 and the rules in effective prior to the changes made by ASU 2015-02, there is a presumption that a general partner _____ a limited partnership regardless of the extent of the general partners' ownership interest in the limited partnership:
    a. Manages
    b. Controls
    c. Has significant influence in
    d. Materially participates in

12. A key aspect of a variable interest entity (VIE) is that it:
    a. Is not self-supportive
    b. Can finance its activities without additional financial support
    c. Is not required to be consolidated
    d. Controls a subsidiary

13. An example of where combined financial statements may be useful is:
    a. A group of unconsolidated entities
    b. Tax planning strategies
    c. When one entity wishes to augment its balance sheet
    d. Where there is a group of unrelated parties that wish to join forces

14. If combined financial statements are presented, combining is treated essentially in the same manner as a consolidation with:
    a. All intercompany transactions eliminated
    b. No intercompany transactions eliminated
    c. Selected intercompany transactions eliminated
    d. Only equity accounts consolidated with eliminations made

15. In accordance with ASU 2015-02, under the voting interest entity model for limited partnerships, a limited partnership has a controlling financial interest in a limited partnership if it has more than 50 percent of the limited partnership's _____.
    a. Kick-out rights
    b. Participation rights
    c. Subscription rights
    d. Controlling rights

16. Which of the following does ASU 2015-02 change with respect to a general partner and a limited partnership:
    a. Eliminates the presumption that a general partner should consolidate a limited partnership
    b. Now requires that a general partner consolidate a limited partnership in all instances
    c. Now precludes a general partner from consolidating a limited partnership in all instances
    d. Adds a rule that a general partner consolidate a limited partnership if the general partner holds more than 80% of the voting interest in the limited partnership

17. Company X is a noncontrolling limited partner in a limited partnership. X has noncontrolling rights that allow it to block partnership actions. Such rights are called _____:
    a. Participation rights
    b. Kick-out rights
    c. Blocking rights
    d. Protective rights

18. Company J has several rights in an investee. J wants to determine whether they are noncontrolling. Which of the following rights of J is considered noncontrolling:
    a. Name of investee
    b. Selection of board members
    c. Selection of senior management
    d. Right to sell the entity

19. One key change made by ASU 2015-02 is that some fees paid to a decision maker _____:
    a. Are excluded from the evaluation of whether the decision maker is the primary beneficiary of a VIE
    b. Are included in the test as to whether an entity is a VIE
    c. Are used in the computation of whether debt is nonrecourse under the VIE rules
    d. Are considered equity for purposes of determining if there is a controlling financial interest

20. _____ is defined as an underlying event or transaction that would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the entity operates:
    a. Infrequency of occurrence
    b. Unusual nature
    c. Not likely to occur
    d. Not probable

21. Company X is trying to shift a loss to discontinued operations. By making the shift in loss, which of the following is a key measurement that X can increase that could drive X's stock price or value:
    a. Operating income
    b. Revenue
    c. Net income
    d. Cost of goods sold

22. One reason why a company might be motivated to shift a loss from continuing operations to discontinued operations is that _____:
    a. There is no settling up in the future for past earnings management
    b. The effect of the shift reverses in a future period
    c. Net income increases
    d. Disclosures are reduced

23. Which of the following is a reason noted by the author as to why there has been an expansion in classification shifting to discontinued operations:
    a. The SEC and FASB have not been paying attention
    b. FASB No. 144 (now ASC 360) broadened the definition of discontinued operations
    c. The SEC issued a directive authorizing a large percentage of operating expenses to be allocated to discontinued operations
    d. There have been numerous calamities in recent years that qualify for discontinued operations treatment

24. One of the criticisms of the current definition of discontinued operations noted by investors is that it has resulted in which of the following:
    a. There has been a lack of disposals of small groups of assets classified as discontinued operations
    b. Not enough disposals of property transactions have been classified as continued operations
    c. Too many disposals of single transactions have been classified as discontinued operations
    d. Too many traditional revenue transactions have been classified as part of discontinued operations

25. Company X has numerous disposals and is trying to sort out which of them qualifies for discontinued operations classification under ASU 2014-08. Which of the following activities represents an activity that is *excluded* from discontinued operations under ASU 2014-08:
    a. Goodwill
    b. Servicing assets
    c. Oil and gas properties accounted for using the full-cost method
    d. Deferred tax assets

26. In order for a disposal to qualify as a discontinued operations under ASU 2014-08, the disposal must _____:
    a. Be material to the operations of the entity
    b. Have a major effect on an entity's operations
    c. Be an integral part of the business
    d. Be easily severable from the operations

27. Company Z has numerous operations all over the world. A disposal of which of the following would *not likely* be considered a *strategic shift* in Z's operations for purposes of meeting the discontinued operations definition:
    a. Sale of a single building
    b. Sale of a major group of retail stores in New England
    c. Sale of a major retail product line
    d. Sale of 85% of an equity method investment

28. How should the results of operations and any gain or loss related to discontinued operations be presented on the income statement:
    a. Net of applicable income taxes, but not benefit
    b. Net of applicable income taxes or benefit
    c. Gross without allocation of income taxes or benefit
    d. With income taxes allocated to the results of operations but not any allocation of income taxes to the gain or loss

29. If an entity has a discontinued operation that is classified as held for sale, how should the assets and liabilities of that transaction be classified on the balance sheet:
    a. Shall be combined with other assets and liabilities
    b. Shall be presented separately in the asset and liability sections
    c. Shall be commingled on the balance sheet with separate breakouts in the notes
    d. Shall be netted into one single line item called "net held for sale assets"

30. Company X classifies certain assets and liabilities as held for sale. How should those assets and liabilities be measured once the classification to held for sale is made:
    a. Amortized cost
    b. Fair value
    c. Lower of carrying amount or fair value less costs to sell
    d. Net realizable value

31. Which of the following is an example of a transaction type that the FASB has eliminated from extraordinary treatment over the past decade:
    a. Sale of fixed assets
    b. Gain on sale of certain utility equipment
    c. Tax benefit of a net operating loss carryforward
    d. Recoveries from previous trade receivable writeoffs

32. Which of the following is a change made to the extraordinary item rules by ASU 2015-01:
    a. Transactions are no longer classified as extraordinary on the income statement
    b. The rules to qualify a transaction for extraordinary treatment are more stringent
    c. FASB has liberalized the extraordinary item rules so that more transactions qualify for extraordinary item treatment
    d. ASU 2015-01 establishes a new sub-classification for extraordinary items

33. Company P has a material transaction that P considers to meet the *infrequency of occurrence* criterion. How should P present the transaction on the income statement under ASU 2015-01:
    a. As part of extraordinary items, net of the applicable income tax or benefit
    b. As part of cost of goods sold
    c. As a separate item through retained earnings
    d. As a separate component of income from continued operations

34. In implementing ASU 2015-01 for extraordinary items, which of the following are the choices an entity may use:
    a. Apply the ASU prospectively only
    b. Apply the ASU retrospectively only
    c. Apply the ASU either prospectively or retrospectively
    d. Neither prospective nor retrospective treatment would be appropriate

35. Which of the following entities is permitted to elect the accounting alternative under ASU 2014-18 with respect to identifiable intangible assets:
    a. A private company
    b. An SEC registrant
    c. A non-profit entity
    d. A pension plan

36. Company X elects the accounting alternative under ASU 2014-18. Which of the following is true:
    a. X is permitted to apply it to selected provisions of ASU 2014-18
    b. X is required to delay implementation for at least two years after making the election
    c. X must apply it to all of the related recognition requirements upon election
    d. X must apply it to three special provisions within ASU 2014-18 with the remainder being optional

37. Company Z is a private entity that wishes to elect the accounting alternative with respect to goodwill under ASU 2014-2: Under that alternative, how should Z account for goodwill:
    a. Amortize goodwill over a maximum of 10 years
    b. Not amortize it but test it annually for impairment
    c. Amortize goodwill over a maximum of 5 years and perform an annual impairment test
    d. Write off goodwill in the first year

38. Which of the following is a criterion of an identifiable intangible asset:
    a. Amortization criterion
    b. Separability criterion
    c. Impairment criterion
    d. Vendor-specific criterion

39. Which of the following is an example of a customer-related intangible asset:
    a. Noncompete agreement
    b. Customer list
    c. Patent
    d. Trademark

40. Company P acquires 100 percent of the voting shares of Company S in a business combination. As a result of the transaction, P obtains control of S. In this transaction, S is a (an) _____:
    a. Acquirer
    b. Acquiree
    c. Seller
    d. Buyer

41. Company X is an acquiree in a business combination in which the acquirer obtains control of the acquiree. In which of the following situations, are the pushdown accounting rules *not available* to X:
    a. If X is an SEC entity
    b. If X is a non-SEC entity
    c. If X is not a business
    d. If X is a nonprofit entity

42. Company S is an acquiree in a business combination and wishes to elect to apply pushdown accounting. As of which of the following dates must S apply the pushdown accounting:
    a. The acquisition date of the change-in-control event
    b. The date on which the financial statements are issued
    c. The date on which the financial statements are available to be issued
    d. The first date on which the acquiree and acquirer engaged in any financial transaction

43. Which of the following should an acquiree recognize in its separate financial statements if the acquiree elects to use pushdown accounting:
    a. Acquisition costs of the acquirer
    b. Acquisition-related liability which represents an obligation of the acquiree
    c. Liability of the acquirer for which the acquiree has no obligation
    d. The assets and liabilities of all related-party entities

44. Company S, an acquiree, is contemplating electing use of pushdown accounting for its separate financial statements. In making the decision, which of the following is an advantage that use of pushdown accounting might have to S:
    a. Net income is likely to be higher
    b. EBITDA is likely to be higher
    c. Net assets are likely to be higher
    d. Operating cash flow is likely to be higher