FASB's Simplification Initiative and New GAAP Changes

7 CPE Hours

IMPORTANT NOTE: In order to search this document, 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.
FASB'S Simplification Initiative and New GAAP Changes

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<td>Level of knowledge:</td>
<td>Overview</td>
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<td>Prerequisite:</td>
<td>Basic understanding of U.S. GAAP</td>
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<td>Advanced Preparation:</td>
<td>None</td>
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<td>7</td>
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<td>Course qualification:</td>
<td>Qualifies for both NASB QAS and Registry CPE credit based on a 50-minute per CPE hour measurement</td>
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<td>NASBA Registry Sponsor Number: 138298</td>
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LEARNING ASSIGNMENTS and OBJECTIVES

As a result of studying this assignment, you should be able to meet the objectives listed below.

1. Review the materials.
2. Study the Review Questions and Suggested Solutions from the course
3. Answer the Review Questions and compare your answers to the Suggested Solutions

After reading Chapter 1 **FASB’S Simplification Initiative**, you will be able to:

- Recognize how to amortize debt issuance costs under ASU 2015-03
- Recall selected items that must be disclosed under ASU 2015-03
- Identify how to implement ASU 2015-03 with respect to debt issuance costs
- Recognize an example of a cloud computing arrangement
- Recall how to account for internal-use software
- Identify criteria that must be met to treat software as internal-use software

After reading Chapter 2 **Significant GAAP Changes in 2016 and Beyond**, you will be able to:

- Recognize some of the implications that might occur if there is a drastic change in the format of financial statements
- Identify a reason why U.S. convergence with international standards has not occurred
- Recognize a financial statement element that is eliminated by ASU 2016-01
- Identify a key change made by the lease standard
- Recall how to recognize a lease liability under the lease standard
- Identify how a lease asset is recognized under the lease standard
- Recognize how existing leases are accounted for under the lease standard
- Identify one of the challenges a company may have with using the AICPA’s FRF for SMEs
- Recognize a key difference IFRS and IFRS for SMEs
- Identify the period of time for which an entity’s management must perform its evaluation of going concern under ASU 2014-15
- Recognize how a nonpublic entity with no uncertain tax positions liability should handle the disclosure of the number of years open for examination
Chapter 1: FASB’S Simplification Initiative

I. Background

In 2014, the FASB added to its agenda a project to simplify many of the existing accounting standards. The project, referred to as the Simplification Initiative, represents a narrowly focused initiative to simplify and improve accounting standards by issuing a series of new accounting standards. A – a

According to the FASB, the intent is to improve or maintain the usefulness of the information that is reported to third parties while also reducing the cost and complexity of applying the standards.

To date, the scope of the projects found in the Simplification Initiative follows:

**Status of Projects Under FASB's Simplification Initiative**

<table>
<thead>
<tr>
<th>Project</th>
<th>Description</th>
<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>Development stage entities</td>
<td>Removes the requirement for specific disclosures related to a development stage entity.</td>
<td>Completed in June 2014 with issuance of ASU 2014-10, Development Stage Entities (Topic 915): Elimination of Certain Financial Reporting Requirements, Including an Amendments to Variable Interest Entities Guidance in Topic 810, Consolidation</td>
</tr>
<tr>
<td>Extraordinary items</td>
<td>Eliminates the presentation of extraordinary items in GAAP.</td>
<td>Completed in January 2016 with 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</td>
</tr>
<tr>
<td>Simplification of measurement of inventory</td>
<td>Simplifies the measurement of inventory.</td>
<td>Completed in July 2015 with the issuance of ASU 2015-11: Inventory (Topic 330) Simplifying the Measurement of Inventory</td>
</tr>
<tr>
<td></td>
<td>Inventory is measured at the lower of cost and net realizable value (estimated selling price less reasonably costs of completion, disposal and transportation).</td>
<td></td>
</tr>
<tr>
<td></td>
<td>The requirement to consider replacement cost and lower of cost or market is eliminated for</td>
<td></td>
</tr>
<tr>
<td>Topic</td>
<td>Description</td>
<td>Completed by</td>
</tr>
<tr>
<td>----------------------------------------------------------------------</td>
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<td>-----------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td><strong>Presentation of debt issuance costs</strong></td>
<td>Requires debt issuance costs to be presented on the balance sheet as a reduction of the debt balance and not as an asset.</td>
<td>Completed in April 2015 with issuance of ASU 2015-03. <strong>Interest-Imputation of Interest</strong> (Subtopic 835-30): <strong>Simplifying the Presentation of Debt Issuance Costs</strong></td>
</tr>
<tr>
<td><strong>Fees paid in a cloud computing arrangement</strong></td>
<td>Clarifies whether fees paid in a cloud computing arrangement represent a software license or a service contract.</td>
<td>Completed in April 2015 with issuance of ASU 2015-05. <strong>Intangibles-Goodwill and Other-Internal-Use Software</strong> (Subtopic 350-40): <strong>Customer’s Accounting for Fees Paid in a Cloud Computing Arrangement</strong></td>
</tr>
<tr>
<td><strong>Measurement date of defined benefit pension plan assets</strong></td>
<td>Aligns the measurement date of defined benefit plan assets with the date that valuation information is provided by third-party service providers.</td>
<td>Completed in April 2015 with issuance of ASU 2015-04. <strong>Compensation-Retirement Benefits</strong> (Topic 715): <strong>Practical Expedient for the Measurement Date of an Employer’s Defined Benefit Obligation and Plan Assets</strong></td>
</tr>
<tr>
<td><strong>Accounting for income taxes</strong></td>
<td>Balance Sheet Classification of Deferred Taxes: Classifies all deferred tax assets and liabilities as noncurrent on the balance sheet.</td>
<td>Completed in November 2015 with the issuance of ASU 2015-17. <strong>Income Taxes</strong> (Topic 740) <strong>Balance Sheet Classification of Deferred Taxes</strong></td>
</tr>
<tr>
<td><strong>Business combinations</strong></td>
<td>Requires that an acquirer recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined.</td>
<td>Completed in September 2015 with the issuance of ASU 2015- <strong>Business Combinations</strong> (Topic 805) <strong>Simplifying the Accounting for Measurement-Period Adjustments</strong></td>
</tr>
<tr>
<td>Provisional amounts, calculated as if the accounting had been completed at the acquisition date.</td>
<td>Pending</td>
<td></td>
</tr>
<tr>
<td>---</td>
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</tr>
<tr>
<td><strong>Balance sheet classification of debt</strong></td>
<td>Would simplifies the presentation of debt on the balance sheet as current or long-term based on the contractual terms of the debt arrangement and an organization's current compliance with debt covenants.</td>
<td></td>
</tr>
<tr>
<td><strong>Accounting for income taxes</strong></td>
<td><strong>Intra-Entity Asset Transfers:</strong> Would eliminate the prohibition on the recognition of income taxes for transfers of assets from one jurisdiction to another.</td>
<td></td>
</tr>
<tr>
<td><strong>Stock-based compensation</strong></td>
<td>Would make some narrow simplifications and improvements to the accounting for stock compensation to employees.</td>
<td></td>
</tr>
<tr>
<td><strong>Equity method</strong></td>
<td>Would eliminate the requirement that an entity account for the difference between the cost of an investment and the amount of the underlying equity in net assets of an investor as if the investee were a consolidated subsidiary and related disclosures.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Would eliminate the requirement that an entity retroactively adopt the equity method if an investment that was previously accounted for on a method other than equity method becomes qualified to use the equity method due to an increase in the percentage ownership.</td>
<td></td>
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</tbody>
</table>
ASU 2015-03: Interest—Imputation of Interest (Subtopic 835-30)
Simplifying the Presentation of Debt Issuance Costs

Issued: April 2015

Effective date: ASU 2015-03 is effective as follows:

1. For public business entities, for financial statements issued for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years

2. For all other entities, for financial statements issued for fiscal years beginning after December 15, 2016. Early application is permitted for the financial statements that have not been previously issued.

I. Objective

The ASU is being issued as part of the FASB’s Simplification Initiative. The objective of the Simplification Initiative is to identify, evaluate, and improve areas of generally accepted accounting principles (GAAP) for which cost and complexity can be reduced while maintaining or improving the usefulness of the information provided to users of financial statements.

II. Background

Existing GAAP

Debt issuance costs are generally considered to be specific third-party incremental costs that are directly attributable to issuing a debt instrument, either in the form of:

- Issuing bonds
- Closing a bank or private loan

Such costs may include:

- Legal fees
- Commissions or financing fees
- Appraisal costs
- Accounting and auditing fees
- Points
- Title insurance
- Any other costs incurred in order to complete specific financing
Debt issuance costs generally *exclude* internal general and administrative costs and overhead of the borrowing entity.

Under existing GAAP prior to the effective date of ASU 2015-03, debt issuance costs are:

- Capitalized as an asset on the balance sheet, and
- Amortized to interest expense using the effective interest method.

**Note:** Although GAAP requires amortizing debt issuance costs using the effective interest method, most companies amortize these costs on a straight-line basis because the difference is not usually material.

Existing GAAP treats debt discounts and premiums as a direct reduction in the carrying amount of the underlying debt, while premiums are direct increases in that debt.

Thus, under existing GAAP, debt issuance costs are treated differently than debt discounts and premiums.

For years, there has been criticism about the accounting treatment of debt issuance costs. Some critics have stated that such costs should not be capitalized as an asset because the costs provide no future economic benefit to the entity.

Going back as far as 1985, the FASB agreed that the recording of debt issuance costs as an asset was flawed and should be changed.

In 1985, the FASB noted in paragraph 237 of Concept Statement No. 2:

> "Debt issue cost is *not an asset* for the same reason that debt discount is not—it provides no future economic benefit. Debt issue cost in effect reduces the proceeds of borrowing and increases the effective interest rate and thus may be accounted for the same as debt discount. However, debt issue cost may also be considered to be an expense of the period."

Now, thirty years later, the FASB has decided to take action to rectify the balance sheet classification of debt issuance costs.

**FASB makes a change**

In August 2014, the FASB added to its agenda a project with the objective of simplifying the presentation of debt issuance costs. At a meeting, the FASB tentatively decided to require that debt issuance costs be presented in the balance sheet as a direct deduction from the debt liability.

In October 2014, the FASB issued a proposed ASU entitled, *Interest—Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Cost.*
In April 2015, the FASB issued a final statement as ASU 2015-03.

In leading up to the issuance of ASU 2015-03, the FASB had received comments that companies have different balance sheet presentations for debt issuance costs and debt discount and premium which creates unnecessary complexity in practice. Most companies, however, present debt issuance costs as a separate asset named deferred charges. Such a presentation has caused challenges in practice for several reasons:

- Presenting a deferred charge differs from International Financial Reporting Standards (IFRS), which require that transaction costs be deducted from the carrying value of the financial liability and not recorded as separate assets.

- The requirement to recognize debt issuance costs as deferred charges conflicts with the guidance in FASB Concepts Statement No. 6, *Elements of Financial Statements*, which states that debt issuance costs are similar to debt discounts and in effect reduce the proceeds of borrowing, thereby increasing the effective interest rate. Concepts Statement 6 further states that debt issuance costs cannot be an asset because they provide no future economic benefit.

As a result, to simplify presentation of debt issuance costs, ASU 2015-03 changes current practice as follows:

a. Debt issuance costs related to a recognized debt liability must now be presented in the balance sheet as a *direct deduction from the carrying amount of that debt liability*, consistent with debt discounts. Presenting the costs as an asset is no longer permitted.

b. Amortization of debt issuance costs using the effective interest method and report the amortization as part of interest expense.

The recognition and measurement guidance for debt issuance costs is not affected by ASU 2015-03.

### III. Definitions

ASU 2015-03 provides the following definition that is used throughout the ASU.

**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 purposes 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 (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

1. ASU 2015-03 does not apply to the following:
   a. The amortization of premium and discount of assets and liabilities that are reported at fair value, and
   b. The debt issuance costs of liabilities that are reported at fair value.

2. The following elements shall be reported in the balance sheet as a direct deduction from the face amount of a note:
   a. The discount or premium resulting from the determination of present value in cash or noncash transactions, and
   b. Debt issuance costs related to a note (NEW)

   Note: The ASU states that similar to a discount or premium resulting from the determination of present value in cash or noncash transactions, debt issuance costs are not an asset or liability separable from the note that gives rise to it.

3. The discount, premium, or debt issuance costs shall not be classified on the balance sheet as a deferred charge or deferred credit.

4. Amortization of discount or premium and debt issuance costs shall be reported as follows on the income statement:
a. Amortization of discount or premium: As *interest expense* in the case of liabilities or as *interest income* in the case of assets.

b. Amortization of debt issuance costs: As *interest expense*.

5. An entity shall disclose the following on the financial statements or in the notes to the statements:

a. A description of a note (receivable or payable) which shall include the *effective interest rate*.

b. The face amount of the note.

**Observation:** According to the FASB, to simplify the presentation of debt issuance costs, the amendments in the ASU require that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from that debt liability, consistent with the presentation of a debt discount. This presentation is consistent with the guidance in Concepts Statement 6, which states that debt issuance costs are similar to a debt discount and in effect reduce the proceeds of borrowing, thereby *increasing the effective interest rate*.

Concepts Statement 6 further states that debt issuance costs are *not assets* because they provide no future economic benefit.

The presentation required by ASU 2015-03 is now consistency with IFRS, which requires that transaction costs be deducted from the carrying value of the financial liability and not recorded as separate assets.

The FASB also notes that it considered requiring that debt issuance costs be recognized as an expense in the period of borrowing, which is one of the options to account for those costs in Concepts Statement 6. The other option considered was to account for those costs as a valuation account presented as a deduction from the face amount of debt, which is the same as the guidance in ASU 2015-03. The FASB rejected the alternative to expense debt issuance costs in the period of the borrowing. Instead, it chose to treat such costs as a reduction in the debt balance, with increases the effective interest rate on the debt.

*How should costs incurred before funding of the note be accounted for?*

Debt issuance costs consist of specific third-party incremental costs that are directly attributable to issuing a debt instrument, whether a bank loan or a bond issuance.

Those costs usually include legal fees, commissions, points, appraisal costs, title insurance, and other costs required to obtain the funding.
Such costs *exclude* internal general and administrative costs and overhead of the borrowing entity.

A key element of debt issuance costs is that such costs are directly incurred *as part of the issuing of financing*. For a traditional bank loan, most of those costs are typically presented on the settlement statement, but may expand to include the borrower's attorney's fees and other professional fees incurred to obtain the specific financing.

The question is whether debt issuance costs include costs incurred *before* the debt is closed and recorded such as legal and accounting costs, and other fees incurred to search for financing among several alternatives.

**Example 1:** Company X is looking for a $2 million bank loan. X hires its lawyers and several brokers to search for financing alternatives and gets several proposals. X incurs $25,000 in fees for the search. None of proposals result in financing.

Several months later, X finally obtains financing from a source unrelated to the payment of the $25,000 in fees.

*Should X capitalize the $25,000 as part of the $2 million financing as a debt issuance cost, or should X expense the $25,000 as period costs?*

In ASU 2015-03, the FASB notes that the ASU guidance is limited to debt issuance costs which are costs incurred with *third parties directly related to* the closing on specific debt.

The FASB observed that costs may be incurred *before* an associated debt liability is recorded on the financial statements (for example, the costs are incurred before the proceeds are received on a debt liability or costs incurred in association with undrawn line of credit). In ASU 2015-03, the FASB did not provide explicit guidance in circumstances in which costs are incurred and the proceeds have not yet been received such as legal fees incurred to search out banks for financing alternatives.

The FASB also stated that the recognition and measurement guidance in other Codification Topics that require debt issuance costs to be accounted for differently from debt discount has a different underlying basis. The guidance in the amendments in ASU 2015-03 is limited to clarifying whether the debt issuance costs are the debtor’s assets.

ASU 340-10-S99-1, references SEC guidance found in SAB Topic 5.A. *Expenses of Offering*, and does provide some guidance as to how to account for expenses incurred prior to a debt funding or the search for funding.

The SAB offers the following facts:

**Facts:** Prior to the effective date of an offering of equity securities, Company Y incurs certain expenses related to the offering.
**Question:** Should such costs be deferred?

**Interpretative Response:** Specific incremental costs directly attributable to a proposed or actual offering of securities may properly be deferred and charged against the gross proceeds of the offering. However, management, salaries or other general and administrative expenses may not be allocated as costs of the offering and deferred costs of an aborted offering may not be deferred and charged against proceeds of a subsequent offering. A short postponement (up to 90 days) does not represent an aborted offering.

Although the SAB does focus on costs incurred with respect to an equity transaction, its application does parallel the issue as to how to account for costs incurred to obtain financing prior to funding, such as costs to search for such financing that does not come to fruition.

What the SAB does state is that costs incurred for aborted funding should not be deferred so that such costs must be expensed as incurred. Thus, costs incurred to search for financing among alternatives should be expensed if one chooses to follow the SAB guidance.

Going back to Example 1, because the $25,000 of fees relate the search for funding that did not occur, those costs should be expensed and should not be included as part of debt issuance costs related to the ultimate receipt of $2 million of funding.

**How should debt issuance costs be amortized under ASU 2015-03?**

ASU 2015-03 does not change the way in which debt issuance costs are amortized. All it does is address how it is presented on the balance sheet.

Thus, companies will continue to amortize debt acquisition costs using the *effective interest method*, with any amortization recorded as part of interest expense.

**Entry:**

<table>
<thead>
<tr>
<th></th>
<th>dr</th>
<th>cr</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt issuance costs</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Interest expense</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Note payable (principal)</td>
<td>XX</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td>XX</td>
</tr>
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</table>
Presentation of ASU 2015-03:

<table>
<thead>
<tr>
<th>Current liabilities:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current portion of long-term debt</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Long-term debt:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Note payable</td>
</tr>
<tr>
<td><strong>Less debt issuance costs</strong></td>
</tr>
<tr>
<td>Long-term debt, less debt issuance costs</td>
</tr>
</tbody>
</table>

**Is a company permitted to amortize debt issuance costs on a straight-line basis?**

GAAP requires that the effective interest method should be used to amortize debt issuance costs to interest expense. Yet, many companies choose to amortize such costs on a straight-line basis for simplicity, arguing that there is not a material difference between interest expense computed on a straight-line versus effective interest method.

Is the straight-line method appropriate?

ASC 835-30-35-4, *Interest, Imputation of Interest, Subsequent Measurement*, states the following:

"Other methods of amortization may be used if the results obtained are not materially different from those that would result from the interest method."

Thus, entities may use the straight-line method as long as the resulting amortization charged to interest is not materially different from the result that would be obtained if the effective interest method were used. For most companies, particularly nonpublic entities, debt issuance costs are not significant relative to financing obtained. In such instances, use of the straight-line method should be acceptable.

**How does an entity amortize debt issuance costs related to a line of credit or demand loan?**

ASC 470-50-40-21 addresses financing costs when there is a modification to or exchange of a line of credit or revolving debt arrangement.

If the borrowing capacity of a new arrangement is greater than or equal to the borrowing capacity of the old arrangement, the following rules apply:

- Any fees paid to the creditor, any unamortized deferred costs from the previous arrangement, and any third-party costs incurred are combined and treated as being new debt issuance costs associated with the new line of credit.
Those new debt issuance costs are amortized over the term of the new arrangement. Typically, a line of credit is extended for one year at a time. That means that for a one-year line of credit, any debt issuance costs should be amortized over the one year term.

**How does ASU 2015-03 impact the disclosure of the effective interest rate?**

Many practitioners may not be aware that existing GAAP requires disclosure of the effective interest rate on debt.

ASC 835-30-45-2 state the following:

"**The description of the note shall include the effective interest rate.**"

For most entities, unless they have non-interest bearing debt, the nominal contract rate is the same or similar to the effective interest rate. Thus, disclosure of the nominal rate generally suffices the satisfy disclosure of the effective interest rate.

That conclusion changes under ASU 2015-03. With the presentation of debt issuance costs as a reduction in the loan balance, the effective interest rate increases.

Consider the following short-cut calculation.

**Facts:**

- Company X borrows $5,000,000 with interest fixed at 6% per year and a five year term.
- Annual interest is $300,000 ($5,000,000 x 6%).
- In borrowing the $5,000,000, X incurs $150,000 in debt issuance costs consisting of points, legal fees, appraisal fees, etc.

Using a short-cut approach, the effective interest rate is computed as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross proceeds</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>Debt issuance costs</td>
<td>(150,000)</td>
</tr>
<tr>
<td>Net funds received</td>
<td>$4,850,000</td>
</tr>
<tr>
<td>Annual interest</td>
<td>$300,000</td>
</tr>
<tr>
<td>Effective interest rate</td>
<td>6.19%</td>
</tr>
</tbody>
</table>
Should X disclose both the 6% nominal contract rate and the effective rate of 6.19%?

The technical answer is "yes." However, for most businesses involved in traditional financing (e.g., bank loans), deferred issuance costs are not more than 2 to 3% of the loan amount. Thus, the net proceeds received are not significantly lower than the gross loan amount.

When computing the effective rate versus the contract rate, the difference is insignificant. Using the previous example, an effective interest rate of 6.19% versus 6% contract rate is not material.

So, what is the answer?

The author suggests using generic language to address the fact that ASU 2015-03 might result there being a difference between the effective and nominal interest rate. Below the author inserts into a disclosure language "Interest

NOTE X: LONG-TERM DEBT:

Long-term debt consists of a $5,000,000 term loan with fixed interest payable monthly at 6% per annum, which approximates the effective interest rate. The loan is secured by certain equipment and personally guaranteed by company shareholders. The entire principal balance due on December 31, 20X11.

If, in rare instances, the effective rate is significantly higher than the nominal contract rate, the disclosure can be changed as follows:

NOTE X: LONG-TERM DEBT:

Long-term debt consists of a $5,000,000 term loan with fixed interest payable monthly at 6% per annum (effective interest rate of 6.55%). The loan is secured by certain equipment and personally guaranteed by company shareholders. The entire principal balance due on December 31, 20X11.
**Presentation- ASU 2015-03:**

**Example 1:**

**Facts:**

- Company X borrows $10 million from a local bank. X incurs $200,000 of debt issuance costs for legal fees, appraisals, and points related to closing the $10 million loan.

- X has other long-term debt obtained years ago with a balance of $5 million. There are no remaining debt issuance costs related to that loan.

- The $10 million loan closes and is funded on December 31, 20X6.

- X is issuing financial statements for the year ended December 31, 20X6.

- Assume there is no current portion of debt for simplicity purposes.

**Conclusion:**

X must present the $200,000 of debt issuance costs as a reduction in the $10 million loan outstanding in accordance with ASU 2015-03.

There are two approaches to the presentation on the balance sheet:

**Presentation 1: Debt issuance costs are presented separately from the gross amount of the debt:**

<table>
<thead>
<tr>
<th>Long-term debt:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal amount</td>
<td>$15,000,000</td>
</tr>
<tr>
<td>Less unamortized debt issuance costs</td>
<td>(200,000)</td>
</tr>
<tr>
<td>Total long-term debt</td>
<td>$14,800,000</td>
</tr>
</tbody>
</table>

**Presentation 2: Debt issuance costs presented net:**

<table>
<thead>
<tr>
<th>Long-term debt:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>[$15,000,000 face amount, less unamortized debt issuance costs of $200,000]</td>
<td>$14,800,000</td>
</tr>
</tbody>
</table>
Sample Disclosure:

NOTE 10: LONG-TERM DEBT

At December 31, 20X6, the company had the following long-term debt:

<table>
<thead>
<tr>
<th>Principal</th>
<th>Unamortized debt issuance costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>$10,000,000</td>
<td>$200,000</td>
</tr>
</tbody>
</table>

Term loan: Interest only payable monthly at 6% per annum, which *approximates the effective interest rate*. The loan is secured by certain equipment and personally guaranteed by company shareholders. The entire principal balance due on December 31, 20X11.

Term loan: Interest only payable monthly at 4.5% per annum, secured by qualifying inventories and trade receivables, and personally guaranteed by company shareholders. Principal balance is due on July 31, 20X9.

$15,000,000  $200,000

Example 2:

Same facts as Example 1 except that the company's $5,000,000 loan has a $300,000 discount that was calculated at inception based on an imputed rate of 7%.

*Presentation 1: Discount and debt issuance costs are presented separately from the gross amount of the debt:*

<table>
<thead>
<tr>
<th>Long-term debt:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal amount</td>
</tr>
<tr>
<td>Less <em>unamortized discount and debt issuance costs</em></td>
</tr>
<tr>
<td>Total long-term debt</td>
</tr>
</tbody>
</table>

*Presentation 2: Debt issuance costs presented net:*

<table>
<thead>
<tr>
<th>Long-term debt:</th>
</tr>
</thead>
<tbody>
<tr>
<td>[$15,000,000 face amount, less <em>unamortized discount and debt issuance costs of $500,000</em>]</td>
</tr>
</tbody>
</table>
**Sample Disclosure:**

**NOTE 10: LONG-TERM DEBT**

At December 31, 20X6, the company had the following long-term debt:

<table>
<thead>
<tr>
<th>Principal</th>
<th>Unamortized discount and debt issuance costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Term loan:</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Interest only payable monthly at 6% per annum, which <strong>approximates the effective interest rate</strong>. The loan is secured by certain equipment and personally guaranteed by company shareholders. The entire principal balance due on December 31, 20X11.</td>
<td>$200,000</td>
</tr>
<tr>
<td>Term loan:</td>
<td>$15,000,000</td>
</tr>
<tr>
<td>Interest only payable monthly at 4.5% per annum, secured by qualifying inventories and trade receivables, and personally guaranteed by company shareholders. Principal balance is due on July 31, 20X9. <strong>[Discount is based on imputed interest rate of 7%]</strong></td>
<td>$300,000</td>
</tr>
</tbody>
</table>

**How should debt issuance costs be accounted for on the statement of cash flows?**

In accordance with ASC 230, *Statement of Cash Flows*, debt issuance costs should be accounted for as follows:

1. When the debt issuance costs are incurred, they are presented in financing activities as a reduction of the net proceeds received from the new financing.

2. When the debt issuance costs are amortized to interest expense, the amortization is an adjustment to cash from operating activities.

**Example:** On January 1, 2016, Company X borrows $2,000,000 and incurs $50,000 of debt issuance costs, resulting in net proceeds of $1,950,000.

In 2016, X amortizes the $50,000 of costs over five years ($10,000 per year), on a straight-line basis, which approximates the effective interest method.

**Conclusion:** The 2016 statement of cash flows is presented as follows:
Operating activities:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income</td>
<td>$XX</td>
</tr>
</tbody>
</table>
| Adjustments:
  - Depreciation and amortization                 | XX     |
  - Change in receivables, payables, inventories   | XX     |
| Change in debt issuance costs                    | 10,000 |
| Net cash from operating activities               | XX     |

Financing activities:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net proceeds from long-term debt, net of debt acquisition costs</td>
<td>1,950,000</td>
</tr>
</tbody>
</table>

**What was the Private Company Council's opinion of ASU 2015-03?**

According to the FASB, most of the PCC members were against the issuance of ASU 2015-03.

Although the objectives of the PCC are consistent with those of the FASB in its Simplification Initiative, in theory, the PCC should have little impact on the FASB choosing its Simplification Initiative.

According to the FASB, during the exposure process, a majority of the Private Company Council members and certain other respondents that focus on private companies stated that they disagree with the guidance in ASU 2015-03.

The PCC members asserted that:

1. The face amount of borrowings is the most relevant amount for the users of private company financial statements.

2. Requiring the amount of borrowing to be presented net of the debt issuance costs could be misleading to users of private company financial statements and would be a significant change for private company preparers.

The Private Company Council presented two alternatives for the FASB to consider for private companies.

- Option 1: Retain current GAAP by recording debt issuance costs as assets, or
- Option 2: Expense debt issuance costs

There were mixed views from Private Company Council members on the alternatives. According to the FASB, the PCC members were split between the two options.

Finally, the FASB rejected both of the PCC recommendations for several reasons:
a. Different guidance for public business entities and for private companies would not meet the objective of this project, which is to simplify GAAP.

b. Retaining current GAAP would contradict the guidance in Concepts Statement No. 6 in that debt issuance costs are not an asset.

c. Disclosure of the face amount of the debt either on the balance sheet or in the notes, does provide users information about the debt.

IV. Implementation of ASU 2015-03

1. ASU 2015-03 is effective as follows:

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

   b. For **all other entities**, for financial statements issued for fiscal years **beginning after December 15, 2015**, and interim periods within fiscal years beginning after December 15, 2016.

2. Earlier application of the ASU is permitted for the financial statements that have not been previously issued.

3. An entity shall apply the ASU **retrospectively** to all prior periods presented.

   a. Prior year's balance sheet is restated to reflect the change.

4. An entity shall disclose in the first fiscal year after the entity's adoption date, and in the interim periods within the first fiscal year, the following:

   a. The nature of and reason for the change in accounting principle
   b. The transition method
   c. A description of the prior-period information that has been retrospectively adjusted
   d. The effect of the change on the financial statement line item (that is, the debt issuance cost asset and the debt liability).

**Example:** At December 31, 2015, Company X has the following related to its long-term debt:

<table>
<thead>
<tr>
<th>Other assets:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt issuance costs</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Long-term debt:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Term loan</td>
<td>$5,000,000</td>
</tr>
</tbody>
</table>
The term loan requires annual principal payments of $200,000 plus interest at 6% per annum.

X adopts ASU 2015-03 effective January 1, 2016.

X amortizes debt issuance costs on a straight-line basis which approximates the result if the effective interest method had been used.

In 2016, X issued comparative financial statements for 2015 and 2016.

**Conclusion:** X should apply the ASU retrospectively by restating 2015 which is presented comparatively with 2016.

In addition, in 2016, X must disclose the following information:

a. The nature of and reason for the change in accounting principle
b. The transition method
c. A description of the prior-period information that has been retrospectively adjusted
d. The effect of the change on the financial statement line item (that is, the debt issuance cost asset and the debt liability).

**Disclosures: (2016)**

**NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Debt issuance costs:**

Debt issuance costs incurred in connection with the issuance of long-term debt are capitalized and amortized to interest expense over the term of the debt using the straight-line method, which approximates the effective interest method. The unamortized amount is presented as a reduction of long-term debt on the balance sheet.

**NOTE 5: CHANGE IN ACCOUNTING FOR DEBT ISSUANCE COSTS**

Effective January 1, 2016, the company adopted Accounting Standards Update (ASU) No. 2015-03: Interest—Imputation of Interest (Subtopic 835-30), Simplifying the Presentation of Debt Issuance Costs. ASU 2015-03 requires that the company change the presentation of debt issuance costs on the company’s financial statements. Under the new method, effective January 1, 2016, debt issuance costs are presented as a reduction of long-term debt instead of being presented as an asset on the company's balance sheet. The December 31, 2015, balance sheet has been restated to reclassify $100,000 of debt issuance costs from long-term assets to a reduction of $5,000,000 of long-term debt.

On the December 31, 2016 balance sheet, debt issuance costs in the amount of $80,000 are presented as a reduction of $5,000,000 of long-term debt.
NOTE 8: LONG-TERM DEBT

At December 31, 2016 and 2015, the company had the following long-term debt:

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Term loan:</td>
<td>$4,800,000</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>Unamortized debt issuance costs</td>
<td>(80,000)</td>
<td>(100,000)</td>
</tr>
<tr>
<td>Less current portion (1)</td>
<td>180,000</td>
<td>180,000</td>
</tr>
<tr>
<td>Long-term debt</td>
<td>$4,540,000</td>
<td>$4,720,000</td>
</tr>
</tbody>
</table>

(1): Calculation: Principal payments ($200,000), less $20,000 amortization of debt issuance costs equals $180,000 current portion of long-term debt.

A summary of the annual maturities of long-term debt for each of the five years subsequent to 2016 follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Annual Maturity (2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2017</td>
<td>$200,000</td>
</tr>
<tr>
<td>2018</td>
<td>200,000</td>
</tr>
<tr>
<td>2019</td>
<td>200,000</td>
</tr>
<tr>
<td>2020</td>
<td>200,000</td>
</tr>
<tr>
<td>2021</td>
<td>200,000</td>
</tr>
<tr>
<td>Beyond 2021</td>
<td>3,800,000</td>
</tr>
<tr>
<td></td>
<td>$4,800,000</td>
</tr>
</tbody>
</table>

(2): Annual maturities are computed exclusive of the debt issuance costs

-end of disclosures-

The restated balance sheet is presented below:
Company X  
Balance Sheet  
December 31, 2016 and 2015

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other assets:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>REMOVED</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Current liabilities:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current portion of long-term debt</td>
<td>180,000</td>
<td>180,000</td>
</tr>
<tr>
<td>Long-term debt:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Face amount, less unamortized debt issuance costs</td>
<td>4,540,000</td>
<td>4,720,000</td>
</tr>
</tbody>
</table>

How should the debt issuance costs be treated for tax purposes?

For years, companies amortized debt issuance costs on a straight line basis for tax purposes. Those rules changed with the introduction of Reg. sec. 1.446.5 which now requires that debt issuance costs be amortized using the constant yield method as defined by Reg 1.1272-1(b).

Under the constant yield method, the debt issuance costs are treated as if they adjusted the yield on the debt and decreased the issue price of the debt. Thus, the debt issuance costs increase or create original issue discount (OID).

Reg 1.1272.1 provides the authority for computing the portion of debt issuance costs amortized to interest under the constant yield method. There is also a de minimis rule that can be used.

In looking at the constant yield method, it is similar to use of the effective interest method.
ASU 2015-15: Interest—Imputation of Interest (Subtopic 835-30) Presentation and Subsequent Measurement of Debt Issuance Costs Associated with Line-of-Credit Arrangements

Amendments to SEC Paragraphs Pursuant to Staff Announcement at June 18, 2015 EITF Meeting August 2015

Issued: August 2015

Effective date: ASU 2015-05 follows the effective date of ASU 2015-03 and is effective as follows:

1. For public business entities, for financial statements issued for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years

2. For all other entities, for financial statements issued for fiscal years beginning after December 15, 2015, and interim periods within fiscal years beginning after December 15, 2016. Early application is permitted for the financial statements that have not been previously issued.

I. Objective

ASU 2015-15 is issued as part of the FASB's Simplification Initiative. The objective of the Simplification Initiative is to identify, evaluate, and improve areas of GAAP for which cost and complexity can be reduced while maintaining or improving the usefulness of the information provided to users of financial statements.

The objective of ASU 2015-15 is to provide guidance as to the presentation of debt issuance costs related to line-of-credit arrangements.

II. Background

On April 7, 2015, the FASB issued ASU 2015-03, Interest—Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs, which requires entities to present debt issuance costs related to a recognized debt liability as a direct deduction from the carrying amount of that debt liability.

The guidance in ASU 2015-03:

- Addresses how to account for outside costs related to term debt.
- Does not address how to present costs incurred to secure revolving lines of credit, which at inception, are not associated with an outstanding loan balance.
As a result, there have been questions as to whether ASU 2015-03 applies to costs incurred to secure a line of credit instead of a term loan.

Given the lack of guidance, the SEC was asked to rule as to how debt issuance costs related to line-of-credit arrangements should be presented on the balance sheet.

On June 18, 2015, the SEC issued an SEC Staff Announcement.

ASU 2015-15 adds to GAAP the paragraphs in the SEC Staff Announcement at the June 18, 2015 Emerging Issues Task Force (EITF) meeting about the presentation and subsequent measurement of debt issuance costs associated with line-of-credit arrangements.

III. Rules

1. The SEC rules that debt issuance costs related to a line-of-credit arrangement are not within the scope of ASU 2015-03.
   a. An entity is not required to present such costs as a reduction of the debt outstanding under the ASU 2015-03 rules.

2. The SEC staff would not object to such costs being handled as follows:
   a. Defer the costs and present debt issuance costs as an asset and
   b. Amortize the deferred debt issuance costs ratably over the term of the line-of-credit arrangement, regardless of whether there are any outstanding borrowings on the line-of-credit arrangement.

Observation: ASU 2015-03 requires debt issuance costs related to debt obtained to be presented on the balance sheet by netting such deferred costs against the debt to which such costs relate. Yet, the SEC concluded that similar costs incurred for a line of credit can be presented as an asset and amortized over the term of the credit arrangement, regardless of whether the line of credit has a balance outstanding.

The logic behind permitting the costs related to a line of credit to be presented as an asset is that such costs represent costs incurred for an entity to retain the benefit of being able to access capital over the contractual term regardless of whether the line of credit is accessed. Conversely, debt issuance costs related to actual debt obtained represent the transaction costs incurred to complete the actual loan and receive the funding.
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. Don Trump CPA is working on debt issuance costs for his client, Kelly Clinic who just obtained a five-year loan from a local bank. Which of the following is considered a debt issuance cost:
   a. Kelly Clinic’s various overhead costs
   b. General and administrative costs of Kelly Clinic
   c. Legal costs incurred to close the loan
   d. Accounting fees for Don’s year-end review engagement

2. Bernard Sanders CPA is performing a review engagement on Clinton Inc. Bernie has to determine how to present debt issuance costs on Clinton’s balance sheet under ASU 2015-03. How does ASU 2015-03 require Clinton’s debt issuance costs to be presented:
   a. Such costs are not presented on the balance sheet because they must be expensed
   b. Presented as an asset and amortized
   c. Presented as a direct deduction from the face amount of the note
   d. Shown as part of other comprehensive income in stockholder’s equity

3. Nick’s Foods seeks financing to expand its operations. Nick’s spends approximately $100,000 on seeking funding. Ultimately, Nick’s attempts fail and no financing is obtained. How should Nick account for the $100,000 spent to seek financing that does not come to fruition:
   a. Capitalize the costs as deferred issuance costs and amortize them
   b. Capitalize the costs as deferred costs and amortize them if and when future financing is obtained
   c. Expense the costs
   d. Net the costs against existing financing that exists

4. Company X has recorded debt issuance costs and has to decide how to account for them once capitalized. Which is the manner in which X may account for the costs:
   a. Amortize the costs on a straight-line basis under all circumstances
   b. Not amortize the costs
   c. Amortize the costs using the interest method
   d. Depreciate them
5. Company X receives a new loan of $5,000,000 and incurs $100,000 of debt issuance costs. How should the transaction be presented on the statement of cash flows:
   a. The $5,000,000 is recorded in financing activities while the $100,000 is presented in investing activities
   b. The transaction is disclosed only
   c. The net proceeds of $4,900,000 is presented in financing activities
   d. The $5,000,000 is presented in investing activities while the $100,000 is an adjustment in operating activities

6. Company Z obtains a line of credit from a local bank and incurs debt issuance costs associated with obtaining the line of credit. The line of credit is open for one year and Z has not accessed the line. Z expects that the bank will automatically renew the line from year to year for at least five years. How should Z account for the debt issuance costs:
   a. Expense the costs unless Z uses the line
   b. Capitalize the costs and amortize them over one year
   c. Capitalize the costs but not amortize them because the line has not been used
   d. Capitalize the costs and amortize them over five years
SUGGESTED SOLUTIONS

1. Don Trump CPA is working on debt issuance costs for his client, Kelly Clinic who just obtained a five-year loan from a local bank. Which of the following is considered a debt issuance cost:
   a. Incorrect. Overhead costs are not considered debt issuance costs because they are not directly attributable to a specific loan.
   b. Incorrect. General and administrative costs of Kelly Clinic should not be considered part of debt issuance costs because they are not attributable to Kelly obtaining the specific bank loan. Debt issuance costs are those costs that relate to a specific loan.
   c. Correct. Because legal costs are incurred to close the company’s specific loan, those costs are considered part of debt issuance costs.
   d. Incorrect. Accounting fees related to the specific debt obtained would be part of debt issuance costs but those fees related to the year-end review engagement are not directly attributable to obtaining the specific debt and, therefore, are not part of debt issuance costs.

2. Bernard Sanders CPA is performing a review engagement on Clinton Inc. Bernie has to determine how to present debt issuance costs on Clinton’s balance sheet under ASU 2015-03. How does ASU 2015-03 require Clinton’s debt issuance costs to be presented:
   a. Incorrect. Such costs are not expensed as incurred and therefore are presented on the balance sheet, making the answer incorrect.
   b. Incorrect. Previous rules have required such costs to be presented as an asset and amortized. ASU 2015-03 no longer permits debt issuance costs to be presented as an asset making the answer incorrect.
   c. Correct. A key change made by the ASU is that debt issuance costs must be presented as a direct deduction from the face amount of the note, and not presented as an asset.
   d. Incorrect. Nothing in the ASU permits the debt issuance costs to be presented as a component of other comprehensive income in stockholder’s equity.

3. Nick’s Foods seeks financing to expand its operations. Nick’s spends approximately $100,000 on seeking funding. Ultimately, Nick’s attempts fail and no financing is obtained. How should Nick account for the $100,000 spent to seek financing that does not come to fruition:
   a. Incorrect. Because the financing was aborted, such costs should not be capitalized as the costs do not relate to any particular debt obtained.
   b. Incorrect. Costs associated with unsuccessful or aborted funding should not be capitalized under any circumstances because such costs did not result in the entity successfully obtaining financing.
   c. Correct. There is existing guidance that states that costs of an aborted offering may not be deferred. Thus, expensing such costs is the appropriate action.
   d. Incorrect. Netting such costs against other existing financing makes no sense because such costs did not result in new financing. Debt issuance costs relate to obtaining specific financing should not be capitalized and netted against old, existing financing.
4. Company X has recorded debt issuance costs and has to decide how to account for them once capitalized. Which is the manner in which X may account for the costs:
   a. Incorrect. Using the straight-line basis is permitted only if the results obtained are not materially different from the results if the interest method had been used. Thus, using the straight-line method in all circumstances is not correct.
   b. Incorrect. GAAP requires the costs to be amortized making the answer incorrect.
   c. Correct. GAAP requires that debt issuance costs be amortized using the interest method.
   d. Incorrect. Debt issuance costs represent an intangible asset which is amortized, not depreciated.

5. Company X receives a new loan of $5,000,000 and incurs $100,000 of debt issuance costs. How should the transaction be presented on the statement of cash flows:
   a. Incorrect. ASC 230 does not allow debt issuance costs to be presented in investing activities, making the answer incorrect.
   b. Incorrect. ASC 230 does not provide for the issuance of debt to be disclosed only as there is a flow of cash in the transaction.
   c. Correct. ASC 230 states that debt issuance costs should be shown as a reduction of net proceeds received from the financing, which, in this case, would result in $4,900,000 presented in financing activities.
   d. Incorrect. Per ASC 230, the $100,000 is not shown separately from the net proceeds received from the financing, making the answer incorrect.

6. Company Z obtains a line of credit from a local bank and incurs debt issuance costs associated with obtaining the line of credit. The line of credit is open for one year and Z has not accessed the line. Z expects that the bank will automatically renew the line from year to year. How should Z account for the debt issuance costs:
   a. Incorrect. The costs are capitalized, not expensed, under ASU 2015-15, regardless of whether the line is used or not.
   b. Correct. ASU 2015-15 states that such costs should be amortized over the term of the line, which is one year.
   c. Incorrect. ASU 2015-15 provides that such costs should be amortized making the answer incorrect.
   d. Incorrect. The costs are amortized over the term of the line, which is one year, not five years.
ASU 2015-04: Compensation—Retirement Benefits (Topic 715)
Practical Expedient for the Measurement Date of an Employer’s Defined Benefit Obligation and Plan Assets

Issued: April 2015

Effective date: ASU 2015-03 is effective as follows:

a. For public business entities, for financial statements issued for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. Early adoption is permitted.

b. For all other entities, for financial statements issued for fiscal years beginning after December 15, 2016, and interim periods within fiscal years beginning after December 15, 2017. Early adoption is permitted.

I. Objective

ASU 2015-04 is issued as part of the FASB's Simplification Initiative. The objective of the Simplification Initiative is to identify, evaluate, and improve areas of GAAP for which cost and complexity can be reduced while maintaining or improving the usefulness of the information provided to users of financial statements.

The objective of ASU 2015-04 is to provide a practical expedient that permits an entity (employer) to measure defined benefit plan assets and obligations using the month-end that is closest to the entity’s fiscal year-end and apply that practical expedient consistently from year to year.

II. Background

Existing GAAP requires an employer that sponsors one or more defined benefit plans to record on its balance sheet the funded status of the plan.

ASC 715, Compensation-Retirement Benefits, states:

1. If the projected benefit obligation exceeds the fair value of the plan assets, the employer is requires to record in its balance sheet a liability equal to the unfunded projected benefit obligation (e.g., the funding shortfall).

2. If, instead, the fair value of the plan assets exceeds the projected benefit obligation, the employer is required to record on its balance sheet an asset representing the overfunded projected benefit obligation.
ASC 715 requires the employer to measure the fair value of defined benefit plan assets as of the date of its year-end statement of financial position, except in the following cases:

a. The plan is sponsored by a subsidiary that is consolidated using a fiscal period that differs from its parent’s fiscal period.

b. The plan is sponsored by an investee that is accounted for using the equity method of accounting and using financial statements of the investee for a fiscal period that is different from the investor’s fiscal period.

For entities with a fiscal year-end that does not coincide with a month-end, it often is more difficult to measure plan assets as of the date of the balance sheet when information about the fair value of plan assets obtained from third parties is reported as of the month-end.

There are instances in which the reporting entity (employer) has a fiscal year-end that differs from a month-end.

A reporting entity with a fiscal year-end that does not coincide with a month-end may incur more costs than other entities when measuring the fair value of plan assets of a defined benefit pension or other postretirement benefit plan.

The primary reason is due to the fact that:

- Information about the fair value of plan assets obtained from a third-party service provider typically is reported as of the month-end, and then,

- That information is adjusted to reflect the fair value of plan assets as of the fiscal year-end.

On October 14, 2014, the FASB issued an exposure draft of a proposed Accounting Standards Update, Compensation—Retirement Benefits (Topic 715): Practical Expedient for the Measurement Date of an Employer’s Defined Benefit Obligation and Plan Assets.

The exposure draft was followed up with the April 2015 issuance of the final statement in the form of ASU 2015-04.

ASU 2015-04 states that for an entity with a fiscal year-end that does not coincide with a month-end, the ASU offers a solution by permitting the entity to measure both the defined benefit plan assets and obligations using the *month-end that is closest to the entity’s fiscal year-end* and apply that practical expedient consistently from year to year. The practical expedient should be applied consistently to all plans if an entity has more than one plan.

The ASU also requires disclosure the accounting policy election and the date used to measure defined benefit plan assets and obligations if the entity elects to measure the assets and liabilities based on the month end that is closest to the entity’s fiscal year end.
The ASU reflects a change from the employer's perspective. Employee benefit plans are not within the scope of ASU 2015-04.

III. Scope

1. ASU 2015-04 applies to employers who sponsor defined benefit pension plans.

2. The ASU does not apply to employee benefit plans.

IV. Rules

Defined benefit pension plans

1. If an employer’s fiscal year-end does not coincide with a month-end, the employer may measure plan assets and benefit obligations using the month-end that is closest to the employer’s fiscal year-end.

   a. The election shall be applied consistently from year to year and consistently to all of its defined benefit plans if an employer has more than one defined benefit plan.

2. If an employer measures plan assets and benefit obligations in accordance with (1) above, and a contribution or significant event caused by the employer (such as a plan amendment, settlement, or curtailment that calls for a remeasurement) occurs between the month-end date used to measure both plan assets and benefit obligations and the employer’s fiscal year-end, the employer shall adjust the fair value of plan assets and the actuarial present value of benefit obligations so that those contributions or significant events are recognized in the period in which they occurred.

   a. An employer shall not adjust the fair value of plan assets and the actuarial present value of benefit obligations for other events occurring between the month-end date used to measure plan assets and benefit obligations and the employer’s fiscal year-end that may be significant to the measurement of defined benefit plan assets and obligations, but are not caused by the employer (for example, changes in market prices or interest rates)

3. If a significant event caused by the employer (such as a plan amendment, settlement, or curtailment) that requires an employer to remeasure both plan assets and benefit obligations does not coincide with a month-end, the employer may remeasure plan assets and benefit obligations using the month-end that is closest to the date of the significant event.

   a. If an employer remeasures plan assets and benefit obligations during the fiscal year in accordance with paragraph (3) above, the employer shall adjust the fair value of plan assets and the actuarial present value of benefit obligations for any effects of the significant event that may or may not be captured in the month-end measurement (for example, if the closest month-end is before the date of a partial settlement, then the measurement of plan assets may include assets that are no longer part of the plan).
b. An employer shall not adjust the fair value of plan assets and the actuarial present value of benefit obligations for other events occurring between the month-end date used to measure plan assets and benefit obligations and the employer’s fiscal year-end that may be significant to the measurement of defined benefit plan assets and obligations, but are not caused by the employer (for example, changes in market prices or interest rates).

**Observation:** The FASB decided to simplify current requirements and reduce costs for entities that have a fiscal year-end that does not coincide with a month-end by permitting those entities to measure defined benefit plan assets and obligations as of the month-end that is closest to their fiscal year-end. The FASB concluded that for entities that elect this accounting policy, the defined benefit obligation also should be measured as of the same date used to measure plan assets so that each reflects economic conditions and assumptions as of the same point in time.

**Defined Benefit Plans- Other Postretirement**

1. If an employer’s fiscal year-end *does not coincide* with a month-end, the employer may measure plan assets and benefit obligations using the month-end that is closest to the employer’s fiscal year-end.

   a. The election shall be applied consistently from year to year and consistently to all of its defined benefit plans if an employer has more than one defined benefit plan.

2. If an employer measures plan assets and benefit obligations in accordance with (1) above, and a contribution or significant event caused by the employer (such as a plan amendment, settlement, or curtailment that calls for a remeasurement) occurs between the month-end date used to measure plan assets and benefit obligations and the employer’s fiscal year-end, the employer **shall adjust the fair value of plan assets and the actuarial present value of benefit obligations** so that those contributions or significant events are recognized in the period in which they occurred.

   a. An employer shall not adjust the fair value of plan assets and the actuarial present value of benefit obligations for other events occurring between the month-end date used to measure plan assets and benefit obligations and the employer’s fiscal year-end that may be significant to the measurement of defined benefit plan assets and obligations, but are not caused by the employer (for example, changes in market prices or interest rates)

3. If a significant event caused by the employer (such as a plan amendment, settlement, or curtailment) that requires an employer to **remeasure both plan assets and benefit obligations** does not coincide with a month-end, the employer may elect to remeasure plan assets and benefit obligations using the month-end that is closest to the date of the significant event.

   a. If an employer remeasures plan assets and benefit obligations during the fiscal year in accordance with paragraph (3) above, the employer shall adjust the fair value of plan
assets and the actuarial present value of benefit obligations for any effects of the significant event that may or may not be captured in the month-end measurement (for example, if the closest month-end is before the date of a partial settlement, then the measurement of plan assets may include assets that are no longer part of the plan).

b. An employer shall not adjust the fair value of plan assets and the actuarial present value of benefit obligations for other events occurring between the month-end date used to measure plan assets and benefit obligations and the employer’s fiscal year-end that may be significant to the measurement of defined benefit plan assets and obligations, but are not caused by the employer (for example, changes in market prices or interest rates).

V. Disclosures

1. The ASU adds the following disclosures for an employer that sponsors one or more defined benefit pension plans or one or more defined benefit other postretirement plans, if:

   a. An employer's fiscal year-end does not coincide with a month-end, and

   b. The employer elects to determine the measurement date of plan assets using the month end that is closest to the employer's fiscal year-end.

Public entities:

1. The accounting policy election to measure plan assets and benefit obligations using the month-end that is closest to the employer's fiscal year-end and the month-end measurement date.

2. If the employer contributes assets to the plan between the measurement date and its fiscal year-end.

   a. The employer shall not adjust the fair value of each class of plan assets for the effects of the contribution.

   b. The employer shall disclose the amount of the contribution to permit reconciliation of the total fair value of all the classes of plan assets to the ending balance of the fair value of plan assets.

Following is an example of how the contributions might be shown in a disclosure:
<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Total</th>
<th>Quoted prices in Active Markets (Level 1)</th>
<th>Significant observable inputs (Level 2)</th>
<th>Significant unobservable inputs (Level 3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$XX</td>
<td>$XX</td>
<td>$ -</td>
<td>$ -</td>
</tr>
<tr>
<td>Equity securities- U.S. companies</td>
<td>XX</td>
<td>XX</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Mortgage-backed securities</td>
<td>XX</td>
<td></td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Assets at fair value at measurement date of 1-31-X5</td>
<td>XX</td>
<td>$XX</td>
<td>$XX</td>
<td>$XX</td>
</tr>
<tr>
<td><strong>Contributions after measurement date</strong></td>
<td><strong>XX</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total assets reported at 2-3-X5</td>
<td>$XX</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: ASU 2015-04, as modified by the author.

**Nonpublic entities:**

1. The accounting policy election to measure plan assets and benefit obligations using the month-end that is closest to the employer's fiscal year-end and the month-end measurement date.

2. If the employer contributes assets to the plan between the measurement date and its fiscal year-end.
   a. The employer *shall not* adjust the fair value of each class of plan assets for the effects of the contribution.
   b. The employer *shall* disclose the *amount of the contribution to permit reconciliation* of the total fair value of all the classes of plan assets to the ending balance of the fair value of plan assets.
Following is an example of how the contributions might be shown in a disclosure:

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Total</th>
<th>Quoted prices in Active Markets (Level 1)</th>
<th>Significant observable inputs (Level 2)</th>
<th>Significant unobservable inputs (Level 3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$XX</td>
<td>$XX</td>
<td>$ -</td>
<td>$ -</td>
</tr>
<tr>
<td>Equity securities- U.S. companies</td>
<td>XX</td>
<td>XX</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Mortgage-backed securities</td>
<td>XX</td>
<td>-</td>
<td>XX</td>
<td>XX</td>
</tr>
<tr>
<td>Assets at fair value at measurement date of 1-31-X5</td>
<td>XX</td>
<td>$XX</td>
<td>$XX</td>
<td>$XX</td>
</tr>
<tr>
<td><strong>Contributions after measurement date</strong></td>
<td><strong>XX</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total assets reported at 2-3-X5</strong></td>
<td><strong>$XX</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: ASU 2015-04, as modified by the author.

VI. Transition

1. ASU 2015-03 is effective as follows:
   a. For public business entities, for financial statements issued for fiscal years *beginning after December 15, 2015*, and interim periods within those fiscal years. *Early adoption is permitted.*
   b. For all other entities, for financial statements issued for fiscal years *beginning after December 15, 2016*, and interim periods within fiscal years beginning after December 15, 2017. Early adoption is permitted.

2. The ASU shall be applied prospectively.

3. An entity shall provide the transition disclosure required by paragraph 250-10-50-1(a) in the period the entity adopts ASU 2015-04.
ASU 2015-05: Intangibles—Goodwill and Other Internal-Use Software (Subtopic 350-40) Customer’s Accounting for Fees Paid in a Cloud Computing Arrangement

Issued: April 2015

Effective date: ASU 2015-05 is effective as follows:

For public business entities, the ASU is effective for annual periods, including interim periods within those annual periods, beginning after December 15, 2015.

For all other entities, the ASU is effective for annual periods beginning after December 15, 2015, and interim periods in annual periods beginning after December 15, 2016. Early adoption is permitted for all entities.

I. Objective

ASU 2015-05 is issued as part of the FASB's Simplification Initiative. The objective of the Simplification Initiative is to identify, evaluate, and improve areas of GAAP for which cost and complexity can be reduced while maintaining or improving the usefulness of the information provided to users of financial statements.

The objective of ASU 2015-05 is to provide guidance to customers about whether a cloud computing arrangement includes a software license.

II. Background

Currently, GAAP does not include specific guidance about a customer’s accounting for fees paid in a cloud computing arrangement.

Examples of cloud computing arrangements include:

- Software as a service
- Platform as a service
- Infrastructure as a service, and
- Other similar hosting arrangements.

The FASB received input from stakeholders that the absence of explicit guidance has resulted in some diversity in practice and has created unnecessary costs and complexity to evaluate the accounting for those fees.
As a result of input, the FASB added guidance to Subtopic 350-40, *Intangibles—Goodwill and Other—Internal-Use Software*, to assist entities in evaluating the accounting for fees paid by a customer in a cloud computing arrangement.

The larger question is whether customer fees paid in a cloud computing arrangement represent a license to use software or fees for a service contract.

ASC 350-40-05-2, *Intangibles-Goodwill and Other- Internal-Use Software*, defines internal-use software as having *both* of the following characteristics:

a. The software is acquired, internally developed, or modified solely to meet the entity's internal needs, and

b. During the software's development or modification, no substantive plan exists or is being developed to market the software externally.

ASC 350-40-35-4 states that internal-use software licensed or acquired is amortized on a *straight-line basis* unless another systematic or rational basis is more representative of the software's use.

With respect to cloud services, the FASB's existing guidance is limited and found in ASC 985-605-55-121 through 55-123, *Software-Revenue Recognition*; however that guidance pertains to revenue received by cloud service providers to determine whether an arrangement includes the sale or license of software. It does not address the accounting for cloud services fees paid from the customer's perspective.

ASU 2015-05 provides guidance to customers about whether a cloud computing arrangement is a license for internal use, or whether it is a service contract:

- If a cloud computing arrangement *includes a software license*, then the customer should account for the software license element of the arrangement consistent with the *licensing of internal-use software*, which is generally capitalized and amortized.

- If a cloud computing arrangement *does not include a software license*, the customer should account for the arrangement as a *service contract*.

ASU 2015-05 does not change GAAP for a customer’s accounting for service contracts. In addition, the guidance in ASU 2015-05 supersedes ASU 350-40-25-16, *Intangibles- Goodwill and Other- Internal-Use Software*. Consequently, all software licenses within the scope of Subtopic 350-40 will be accounted for consistent with other licenses of intangible assets.
III. Definitions

ASU 2015-05 adds the following definition to the Glossary of Subtopic 340:

**Hosting Arrangement**: In connection with the licensing of software products, an arrangement in which an end user of the software does not take possession of the software; rather, the software application resides on the vendor’s or a third party’s hardware, and the customer accesses and uses the software on an as-needed basis over the Internet or via a dedicated line.

IV. Rules

1. The scope of internal-use software found in ASC 350-40-15-4 does not apply to software that a customer obtains access to in a hosting arrangement if it does not meet the following two criteria:

   a. The customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty, and

   b. It is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software.

2. The term without significant penalty contains two distinct concepts:

   a. The ability to take delivery of the software without incurring significant cost, or

   b. The ability to use the software separately without a significant diminution in utility or value.

3. Hosting arrangements that do not meet both criteria in (1)(a) and (b) above, are considered service contracts and do not constitute a purchase of, or convey a license to, software.

4. ASU 2015-05 supersedes the following paragraph found in ASC 350-40-25-16:

   **REMOVED:**
   Entities often license internal-use software from third parties. Though Subtopic 840-10 excludes licensing agreements from its scope, entities shall analogize to that Subtopic when determining the asset acquired in a software licensing arrangement.

**Note:** The ASU states that some cloud computing arrangements include one or more licenses to software as well as a promise to provide services, in which case the customer should allocate the contract consideration between the license(s) and the service element(s).
Note: In determining the two criteria in (1)(a) and (b), the FASB followed the guidance found in ASC 985-605, *Software*, with respect to revenue recognition by software vendors. Those two criteria are:

a. The customer has the contractual right to take *possession of the software* at any time during the hosting period *without significant penalty*, and

b. It is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software.

*Why isn't the licensing of cloud services considered a lease to be accounted for under ASC 840, Leases?*

ASC 840-10, *Leases*, excludes licensing agreements from the scope of leases. Moreover, a licensing of cloud software does not involve use of a specific software asset as the cloud service provider can substitute software. ASC 840-10-15 states that a lease must involve use of a specific asset that is not substituted.

**Example 1:** Company X uses Microsoft’s Cloud Service to host its various business software applications. X has a contract with the cloud service under which it pays $5,000 per month for 24 months.

X does not have the contractual right to take possession of the software during the 24 months and X is not permitted to run the software on its own hardware.

**Conclusion:** In order for X to treat the cloud fees as a license of internal-use software, two *criteria* must be satisfied:

a. The customer (X) must have the contractual right to take *possession of the software* at any time during the 24 month hosting period *without significant penalty*, and

b. It is feasible for X to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software.

In this example, X *does not* have the contractual right to take possession of the software or run the software on its own hardware.

The result is that the cloud contract is considered a *service contract* and *not the licensing of internal-use software*. As a service contract, X should record the month payments to expense as incurred.

**Change the facts:** Same facts as Example 1 except:

a. The customer (X) has the contractual right to take *possession of the software* at any time during the 24 month hosting period *without significant penalty*, and
b. It is feasible for X to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software.

**Conclusion:** Because X satisfies both criteria, the cloud fees are treated as the licensing of internal-use software and should be capitalized under ASC 350-40 and amortized over the 24-month period. The internal-use software asset should be capitalized at the present value of the $5,000 monthly payments over 24 months. However, because the interest component is not likely to be material, a more realistic approach would be for X to simply capitalize the asset for $120,000 ($5,000 x 24 months) and amortize the $120,000 over 24 months on a straight-line basis.

**V. Transition**

1. ASU 2015-05 provides the following rules to transition into the ASU:

   a. For public business entities, the ASU is effective for annual periods, including interim periods within those annual periods, **beginning after December 15, 2015**.

   b. For all other entities, the ASU is effective for annual periods **beginning after December 15, 2015**, and interim periods in annual periods beginning after December 15, 2016.

   c. Early adoption is permitted for all entities.

   d. The ASU may be applied either prospectively to all arrangements entered into or materially modified after the effective date, or retrospectively.

   e. A public business entity that elects prospective transition shall disclose the following in the first interim period and annual period after the effective date:
      - The nature of and reason for the change in accounting principle
      - The transition method
      - A qualitative description of the financial statement line items affected by the change.

   f. A public business entity that elects retrospective transition shall disclose the following in the first annual period after the entity’s adoption date and in the interim periods within the first annual period:
      - The nature of and reason for the change in accounting principle
      - The transition method
      - A description of the prior-period information that has been retrospectively adjusted
      - The effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), any other affected financial statement line item(s), and any affected per-share amounts for the current period and any prior periods, retrospectively adjusted
• The cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the earliest period presented.

g. All other entities shall disclose the information in (e) and (f) for prospective transition or retrospective transition, as applicable, in the first annual period after the entity’s adoption date, unless the entity elects to early adopt the pending content that links to this paragraph in an interim period, in which case the entity also shall disclose that information in the interim periods within the first annual period after the entity’s adoption date.
**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 has a defined benefit plan. Z’s fiscal year end is January 5, 2017. Which date is Z permitted to use to measure plan assets and benefit obligations:
   a. January 10, 2017
   b. December 31, 2016
   c. January 31, 2017
   d. December 31, 2017

2. Ralph is a CPA and controller for Company K. K has a cloud arrangement with an outside vendor under which certain software functions are run and held on the vendor’s cloud. Ralph is evaluating how K should account for the costs of the cloud arrangement which are paid monthly. The cloud arrangement does not include a software license. How should the cost be accounted for:
   a. As internal-use software
   b. As a service contract
   c. As a prepaid asset
   d. Split with a portion expensed and a portion capitalized as a fixed asset

3. Which of the following are elements of a hosting arrangement under ASU 2015-05:
   a. End user takes possession of software
   b. The software application resides on the vendor’s hardware
   c. Customer accesses the software through storage on its own hardware
   d. The asset is either software or hardware products

4. In order to satisfy the term “without significant penalty” as used in ASU 2015-05, which of the following concepts is required:
   a. The ability to take delivery of the software by incurring a significant amount of cost
   b. The ability to use the software in conjunction with other hardware and software
   c. The ability to use the software separately without a significant diminution in utility
   d. The ability to acquire the software at a diminished value
5. Company X has a licensing arrangement for cloud services related to software. Which of the following is correct:
   a. X can treat the arrangement as a lease under ASC 840 because software is a lease asset
   b. X can treat the arrangement as a lease because the host can substitute software
   c. X cannot treat the arrangement as a lease under ASC 840
   d. X can treat a portion of the arrangement as a lease with the remainder treated as an internal-use software arrangement
SUGGESTED SOLUTIONS

1. Company Z has a defined benefit plan. Z’s fiscal year end is January 5, 2017. Which date is Z permitted to use to measure plan assets and benefit obligations:
   a. Incorrect. Nothing in ASU 2015-04 permits an entity to use a date that is three days after the fiscal year end date, making the answer incorrect.
   b. Correct. ASU 2015-04 permits an employer to select the month-end that is closest to the entity’s fiscal year end, which, in this case, is December 31, 2016.
   c. Incorrect. ASU 2015-04 permits use of the month-end that is closest to the fiscal year end, which is December 31, 2016, not January 31, 2017.
   d. Incorrect. ASU 2015-04 does not permit using the next calendar year end, which is December 31, 2017.

2. Ralph is a CPA and controller for Company K. K has a cloud arrangement with an outside vendor under which certain software functions are run and held on the vendor’s cloud. Ralph is evaluating how K should account for the costs of the cloud arrangement which are paid monthly. The cloud arrangement does not include a software license. How should the cost be accounted for:
   a. Incorrect. The transaction should be accounted for as internal-use software only if it includes a software license, which it does not. Thus, the answer is incorrect.
   b. Correct. If a cloud computing arrangement does not include a software license, the customer should account for the arrangement as a service contract.
   c. Incorrect. At best, the asset is an intangible asset, and not a prepaid one, as there is no evidence to suggest there is a prepaid expense that should be recorded.
   d. Incorrect. GAAP does not provide for expensing a portion while capitalizing the remainder.

3. Which of the following are elements of a hosting arrangement under ASU 2015-05:
   a. Incorrect. In a hosting arrangement, the end user does not take possession of software.
   b. Correct. One element of a hosting arrangement is that the software application resides either on the vendor’s hardware or on a third party’s hardware, and not on the customer’s hardware.
   c. Incorrect. A hosting arrangement does not include a situation in which a customer accesses the software through storage on its own hardware. The hosting is not on the customer’s hardware but rather on the vendor’s hardware.
   d. Incorrect. The asset must be software and not hardware, making the answer incorrect.

4. In order to satisfy the term “without significant penalty” as used in ASU 2015-05, which of the following concepts is required:
   a. Incorrect. One of the concepts is the ability to take delivery of the software without incurring significant cost, not by incurring a significant amount, making the answer incorrect.
   b. Incorrect. One of the concepts is the ability to use the software separately, not in conjunction with other hardware and software.
c. Correct. The ASU provides that “without significant penalty” means using the software separately without a significant diminution in utility or value, making the answer correct.

d. Incorrect. The ASU deals with use, not acquisition of software, making the answer incorrect.

5. Company X has a licensing arrangement for cloud services related to software. Which of the following is correct:

a. Incorrect. Licensing arrangements are excluded from the scope of leases under ASC 840, making the statement incorrect.

b. Incorrect. The fact that the host can substitute software is one of the reasons why it cannot be considered a lease as it does not involve a specific asset.

c. Correct. ASC 840 does not permit the arrangement to be treated as a lease under ASC 840 due to a specific exclusion under the ASC.

d. Incorrect. GAAP does not provide for splitting the transaction into two elements, making the answer incorrect.
Glossary

**Debt issuance costs:** specific third-party incremental costs that are directly attributable to issuing a debt instrument, either in the form of Issuing bonds or closing a bank or private loan.

**Hosting Arrangement:** In connection with the licensing of software products, an arrangement in which an end user of the software does not take possession of the software; rather, the software application resides on the vendor’s or a third party’s hardware, and the customer accesses and uses the software on an as-needed basis over the Internet or via a dedicated line.

**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:

A. Significant GAAP Changes in 2016 and Beyond

2016 should continue to be a very active year at the FASB as there are numerous new statements about to be issued. A key driver to the FASB’s rapid-fire approach is its goal to accelerate the international convergence project so that U.S. companies will be in a position to adopt international accounting standards if the SEC mandates the use of international standards in the future. The author addresses the international FASB-IASB joint convergence project further on in this course.

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

The FASB’s most significant projects in progress follow:

FASB PROJECT SCHEDULE
AS OF MARCH 2016

F = final statement expected to be issued in 2016
X = FASB expects to issue exposure draft or final statement after 2016

<table>
<thead>
<tr>
<th>PROJECTS:</th>
<th>SCHEDULED ISSUANCE DATE</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>F</strong> Financial Instruments:</td>
<td></td>
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<tr>
<td>Impairment</td>
<td>F</td>
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<tr>
<td>Hedging</td>
<td>X</td>
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<tr>
<td>Interest Rate Disclosures</td>
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<tr>
<td>PCC Issue No. 2015-01, Effective Date and Transition Guidance</td>
<td>F</td>
</tr>
<tr>
<td><strong>X</strong> Financial Statements of Not-for-Profit Entities (Phases 1 and 2)</td>
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<td><strong>X</strong> Disclosure Framework</td>
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<td><strong>X</strong> Accounting for Goodwill for Public Business Entities and Not-for-Profits</td>
<td>X</td>
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<tr>
<td><strong>X</strong> Accounting for Income Taxes: Intra-Entity Asset Transfers</td>
<td>X</td>
</tr>
<tr>
<td><strong>X</strong> Clarifying the Definition of a Business</td>
<td>X</td>
</tr>
<tr>
<td><strong>F</strong> Consolidation: Principal versus Agent Analysis</td>
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B. FASB Starts Up Financial Performance Reporting Project

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

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

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

Key proposed changes identified in the Staff Draft included:

a. Financial statements would be functionalized and separated into five main categories as follows:
   - Business section
   - Financing section
   - Income taxes section
   - Discontinued operations section
   - Multi-category transaction section

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

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

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

In 2011, the financial statement presentation project was one of the top priorities at the FASB. But, given the importance of other projects, including revenue recognition, financial instruments, and leases, the financial statement project was taken off the FASB’s docket.
The FASB announced it was bringing the financial statement project back to life under the named *Financial Performance Reporting Project*. The plan is to bring the project back as a re-scoping of a research project.

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

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

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

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

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

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

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

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

1. The cost of such a change would be significant.
   a. Everything from textbooks to internal and external financial statement formats would have to be changed.

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

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

3. Contract formulas for bonuses, joint ventures, etc. that are based on GAAP net income would have to be rewritten.
4. Tax return M-1 reconciliations would differ.

**Project update:** At the January 20, 2016 FASB meeting, the project staff made a presentation of its research into the current practice of reporting functional and nature lines in the performance statement as well as considering how to disaggregate functional lines into certain nature components. This project is still in its infancy is will take several years to reach conclusion.
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 not a category or subcategory of financial statements proposed under the financial performance reporting project:
   a. Business section
   b. Financial section
   c. Income tax section
   d. Debt section

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

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

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

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

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

According to the PBGC:¹

- Defined benefit plan terminations were 69 in 2014 and 111 in 2013.
- The number of employees enrolled in defined benefit plans covered by the PBGC has gradually declined from year to year to about 29 million in 2015.
- Now, only 7% of private sector employees are part of defined benefit plans, down from 62% in 1980.

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

- 74% of respondents stated that U. S. companies cannot continue providing employees with pensions that adequately cover their retirement years.
- 54% indicated that the erosion of benefits would hurt recruiting and retention efforts.
- 57% believe rising healthcare costs are the biggest barrier to a company’s ability to offer pension benefits.
- 30% stated the pressures to compete in the marketplace outweigh the pressures to provide retirement benefits.
- 65% of respondents offer 401(k) plans with matching contributions.
- 59% believe that Americans need to educate themselves about retirement savings strategies.

2. New defined benefit plan mortality tables

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

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

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

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

The results of the new tables follow:

1. Life expectancies of 65-year-olds in the United States have increased from:
   - 84.6 years to 86.6 years for men, and
   - 86.4 years to 88.8 years for woman.

2. The effects of the new tables follow:

   For companies with significant defined benefit pension and OPEB obligations, longer life expectancies will probably significantly increase the plan obligations.
   - An average of two years of future benefit payments will have to be added to the plan obligation liability on sponsor financial statements.

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

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

   **Note:** ASC 715 requires that the best available information be considered as of the measurement date including using the best estimate when using assumptions, including life expectancy.

   More specifically, ASC 715 states the following:

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

   - If the new tables are used to calculate the plan sponsor’s benefit costs and obligations, they should also be used for the plan’s financial statements.
• The IRS did not reflect the new tables in its minimum funding standards for 2014 and 2015 but is expected to consider the new estimates when setting minimum funding standards for plans beginning in 2016.

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

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

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

Not necessarily.

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

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

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

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

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

**AICPA Technical Practice Aid (TPA)**

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

Following is the TPA:

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

*February 2015*

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

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

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

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

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

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

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

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

**SEC wants the new mortality tables used in 2014 and beyond**

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

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

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

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

**What was the impact of the using the new mortality tables on 2014 pension plans?**
Think about it. An entity that used the new mortality tables for 2014 and 2015, they are adds an average of 2 years of pension payments in the computation of pension obligations.

That amount is likely to be significant.

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

- Overall funded status of the top 400 companies declined from 89% to 80% due to mortality table changes and a decline in interest rates.\(^2\)

As to individual companies, some had more significant impacts on their liabilities than others:\(^3\)

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

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

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

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

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

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

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\(^2\) Longer Lives Hit Companies With Pension Plans Hard- Firms’ balance sheets will have to reflect higher costs, Wall Street Journal, February 2015

\(^3\) Long lives pinching pension plan funds, Bloomberg News, February 2015
REVIEW QUESTIONS

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

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

1. The results of an AICPA survey of more than 3,000 of its members in both publicly and privately held companies show that _____ do not believe that U.S. companies can continue providing employees with pensions that adequately cover their retirement years:
   a. 30%
   b. 54%
   c. 65%
   d. 74%

2. Based on the new mortality assumptions, which of the following is likely to occur:
   a. There will be lower pension contribution requirements
   b. Funded status will be lower
   c. There will be lower lump-sum payouts
   d. There will be lower PBGC variable rate premiums
SUGGESTED SOLUTIONS

1. The results of an AICPA survey of more than 3,000 of its members in both publicly and privately held companies show that ______ do not believe that U.S. companies can continue providing employees with pensions that adequately cover their retirement years:
   a. Incorrect. The results of the AICPA study show that 30% stated the pressures to compete in the marketplace outweigh the pressures to provide retirement benefits.
   b. Incorrect. The results of the AICPA study show that 54% indicated that the erosion of benefits would hurt recruiting and retention efforts.
   c. Incorrect. The results of the AICPA study show that 65% of respondents offer 401(k) plans with matching contributions.
   d. Correct. The results of the AICPA study show that 74% of respondents stated that U.S. companies cannot continue providing employees with pensions that adequately cover their retirement years.

2. Based on the new mortality assumptions, which of the following is likely to occur:
   a. Incorrect. Because the mortality life of both males and females have increased by about two years, pension contribution requirements will be higher to accommodate the longer lives of plan participants.
   b. Correct. Because pension liabilities will be higher, the funded status (liability less asset) will be lower
   c. Incorrect. Because the liability will be higher due to longer actuarial lives, there will be high lump-sum payout requirements.
   d. Incorrect. Higher liabilities will require higher, not lower, PBGC variable rate premiums because those premiums are based on liability amounts.
D. International Accounting Standards Convergence

Its looks like the effort to force U.S. companies to adopt international standards (IFRS) is essentially dead. After more than a decade of effort, the SEC has given up on its previous goal of having one set of international accounting standards. Simply put, U.S. investors and stakeholders do not want it.

Background

During the past decade, a new set of International Financial Reporting Standards (IFRS) was adopted in Europe. Presently, United Kingdom companies are governed by the International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB). Effective in 2005, all companies listed on European stock exchanges (approximately 8,000 total) adopted international standards.

As of 2016:

- Approximately 122 countries require or allow their companies to adopt the new international standards including the U.K., Australia, Japan, and New Zealand.
- To no surprise, Cuba, Iran and Egypt have rejected international standards.
- More than 12,000 companies are now using IFRS worldwide.

The United States has not adopted IFRS and it now looks like it will not happen in the foreseeable future.

- 2015-2016- Put a fork in the convergence project- it is done!
- Although the FASB and IASB have several significant joint projects in the works, including revenue recognition, recently issued FASB statements demonstrate that the two bodies are issuing standards with greater independence from the other.
- Consider, for example, the FASB made several tentative decisions with respect to its financial instruments project, that differ from the approach being proposed by the IASB.
- The FASB retained certain existing requirements for embedded derivative features in hybrid financial assets.
- The FASB's impairment of financial instruments approaches differ from the IASB's method, and
- The FASB's proposed credit loss model for financial instruments recognizes loan losses earlier than the IASB’s proposal.

- In its document entitled *Strategic Plan, U.S. Securities and Exchange Commission, Fiscal Years 2014-2018* (Draft for Comment), and all indications are that the SEC is not moving in the direction of international convergence.

- In the document, the SEC states:

  "The SEC will continue to work closely with its regulatory counterparts abroad, as well as with relevant international organizations, to promote high-quality securities regulation worldwide and convergence where appropriate. The SEC will conduct technical assistance programs that promote emerging and recently-emerged markets’ capacity to take steps to minimize the likelihood of regulatory arbitrage and promote cross-border enforcement and supervisory assistance."

Contrast the above quote with a quote from the SEC's earlier plan for 2010 to 2015:

"...the agency will promote high-quality financial reporting worldwide through, among other things, support for a single set of high-quality global accounting standards and promotion of the ongoing convergence initiatives between the FASB and the International Accounting Standards Board." In the new SEC draft, it is stated that "...the agency will work to promote higher quality financial reporting worldwide and will consider, among other things, whether a single set of high-quality global accounting standards is achievable."

- In the plan for 2014-2018, the SEC suggests it will cooperate and converge "where appropriate" while for the 2010-2015 period, the SEC appears to suggest that there was consideration to "a single set of high-quality global accounting standards."

- **No way says Schnurr**

- In July 2015, SEC Chief Accountant James Schnurr said he probably won’t recommend that the SEC mandate use of IFRS for U.S. companies.

On May 7, 2015, speaking at the Baruch College Financial Reporting Conference, James Schnurr addressed current thinking with respect to IFRS, including the key question whether the SEC is still committed to the objective of a single set of high-quality, globally accepted accounting standards.

Schnurr noted:
• Based on interactions with constituents including investors, auditors, regulators and standard-setters, there is “virtually no support” to have the SEC mandate IFRS for all U.S. public companies.

• There is little support for the SEC to provide an option allowing U.S. companies to prepare their financial statements under IFRS.

• There still remains support for the objective of a single set of such globally accepted accounting standards.

• Although the FASB and IASB have worked on joint projects over the past decade, that cooperation has run its course with both boards now starting to move in different directions.

• Chief Accountant Schnurr stated that plans to mandate IFRS, or to provide companies with the option to use them, probably will not be his recommendation to SEC Chair White.

• Unless there is a true change in direction at the SEC, the goal of requiring U.S. companies to adopt international accounting standards is over.

• What was the hold up in requiring use of international standards by U.S. companies?

• Although the convergence had steam in the mid-2000s, its impetus has dwindled in part to a change in direction at the SEC with a different commissioner and administration.

• There are other considerations that might be affecting the decision not to converge:

  1. The cost to change would be significant:


     b. Accounting systems would have to be changed to capture revised IFRS data.

     c. U.S. accountants, auditors, actuaries, and other parties would be required to receive extensive education and training in IFRS versus U.S. GAAP.

  2. IFRS may not be better than the current U.S. standards:

     a. There are certain standards within IFRS that are not acceptable to many U.S. companies such as IFRS’s disallowance of the use of LIFO inventories.
b. Much of IFRS is based on a principles-based system while the U.S. GAAP is generally based on a rules-based system which is more litigation proof.

c. The amount of authoritative literature in IFRS is small relative to the volumes of U.S. GAAP, particularly with respect to industry-specific guidance.

E. **FASB issues ASU 2016-01: Financial Instruments—Overall**

For the past decade, the historical cost model that has been the basis of GAAP accounting has slowly deteriorated, being gradually replaced by fair value accounting, but perhaps not fast enough for the investment community.

In one survey, *A Comprehensive Business Reporting Model*, (CFA Institute), investors noted 12 proposed changes to the business reporting model. Among them, was the need for full fair value financial statements.

Given the fact that the source of the survey is the end user of many financial statements, (that is, the investor), its results should be looked at seriously.

In January 2016, the FASB made dramatic changes to the accounting for financial instruments with the issuance of ASU 2016-01, *Financial Instruments- Overall*.

ASU 2016-01 is effective for public companies for fiscal years *beginning after December 15, 2017* (including interim periods within those fiscal years). For private companies, not-for-profit organizations, and employee benefit plans, the ASU is effective for fiscal years *beginning after December 15, 2018*.

The ASU changes the current GAAP model and affects:

- The accounting for equity investments
- The accounting for financial liabilities under the fair value option
- The presentation and disclosure requirements for financial instruments, and
- The guidance related to the valuation allowance assessment when recognizing deferred tax assets from available-for-sale debt securities.

The ASU makes no significant changes to the accounting for other financial instruments, such as loans, investments in debt securities, and financial liabilities is unchanged.

The amendments made by ASU 2016-01 include the following:

1. Require *equity investments* (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income.
2. *Eliminates* the categorization of an equity investment as *available-for-sale* with the change presented as part of other comprehensive income in stockholders’ equity.

**Note:** An entity may choose to measure equity investments that do not have readily determinable fair values at cost minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer.

3. Simplify the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment. When a qualitative assessment indicates that impairment exists, an entity is required to measure the investment at fair value.

4. Eliminate the requirement to disclose the fair value of financial instruments measured at amortized cost for entities that are not public business entities.

5. Eliminate the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet.

6. Require public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes.

7. Require an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments.

8. Require separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (that is, securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements.

9. Clarify that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity’s other deferred tax assets.

Details related to ASU 2016-01 follow:

**Equity investments**

a. Under the ASU, *all equity investments* in unconsolidated entities (other than those accounted for using the equity method of accounting) are measured at fair value with the change being recorded through earnings on the income statement.
b. For equity securities, the existing available-for-sale classification with the change in fair value reported in other comprehensive income, is eliminated.

c. For equity investments without readily determinable fair values, the cost method is eliminated.

d. Entities (other than certain investment companies and broker-dealers) are permitted to elect to record equity investments without readily determinable fair values using a formula based on cost, minus any impairment, and any subsequent adjustments for observable price changes. Any change in the basis is reported on the income statement.

e. The ASU provides a one-step impairment model for equity investments and eliminates the current two-step approach.

Under the single-step model:

- An entity performs a qualitative assessment at each reporting period to identify impairment.

- When a qualitative assessment indicates an impairment exists, the entity will estimate the fair value of the investment and recognize in current earnings an impairment loss equal to the difference between the fair value and the carrying amount of the equity investment.

**Debt securities**

a. There is no change to the accounting for debt securities which continue to be accounted for by categorizing those securities into one of three categories:

- Held to maturity
- Trading securities, and
- Available-for sale securities.

**Financial liabilities and the fair value option**

a. If the fair value option has been elected for financial liabilities, the ASU requires the changes in fair value due to instrument-specific credit risk to be recognized separately in other comprehensive income.

- The accumulated gains and losses due to these changes will be reclassified from accumulated other comprehensive income to earnings if the financial liability is settled before maturity.
- The ASU permits (but does not require), companies to measure the change in fair value due to instrument-specific credit risk based on the portion of the total change in fair value that does not result from a change in a base market risk, such as a risk-free rate or a benchmark interest rate.
Disclosure

a. The ASU provides that entities (other than public business entities) are no longer required to disclose the fair value of financial instruments carried at amortized cost.

b. For public business entities, the ASU eliminates the requirement to disclose the methods and significant assumptions used to estimate the fair value of financial instruments recorded at amortized cost.

c. Public business entities are required to use the exit price when measuring the fair value of financial instruments measured at amortized cost for disclosure purposes.

d. Financial assets and financial liabilities must be presented separately in the notes to the financial statements, grouped by measurement category (e.g., fair value, amortized cost, lower of cost or market) and form of financial asset (e.g., loans, securities).
REVIEW QUESTIONS

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

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

1. In accordance with newly issued ASU 2016-01, how must equity investments be measured:
   a. At cost
   b. At fair value with the change presented in net income
   c. At fair value with the change presented as part of other comprehensive income
   d. At lower of cost or market

2. Under newly issued ASU 2016-01, which of the following is the impairment model for equity investments:
   a. The ASU offers a two-step model consistent with existing standards
   b. The ASU does not offer an impairment model
   c. The model uses a quantitative assessment
   d. The ASU offers a new one-step model different from the existing GAAP model
SUGGESTED SOLUTIONS

1. In accordance with newly issued ASU 2016-01, how must equity investments be measured:
   a. Incorrect. ASU 2016-01 requires that equity investments be measured at fair value, not cost.
   b. Correct. ASU 2016-01 makes a change to require that all equity investments are measured at fair value with the change in fair value presented in net income.
   c. Incorrect. Although equity investments would be presented at fair value, the change would be presented in net income, not presented as part of other comprehensive income.
   d. Incorrect. Fair value, not lower of cost or market, would be the measurement.

2. Under newly issued ASU 2016-01, which of the following is the impairment model for equity investments:
   b. Incorrect. The ASU offers an investment impairment model although its application differs from the current GAAP model.
   c. Incorrect. The model uses a qualitative (not quantitative) assessment at each reporting period to identify an impairment.
   d. Correct. Unlike existing GAAP, the ASU offers a new, simpler one-step model under which an impairment loss is recorded on the income statement on the difference between the fair value and carrying amount of the equity investment.
F. FASB Issues New Lease Standard – ASU 2016-02

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842).

ASU 2016-02 represents a culmination of a decade’s work to dramatically transform how companies account for leases.

The amendments made by the ASU request that most leases be capitalized resulting in billions of dollars of assets and liabilities being recorded on company balance sheets.

ASU 2016-02 is effective for fiscal years beginning after December 15, 2018, (including interim periods within those fiscal years), for any of the following:

a. A public business entity
b. 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
c. An employee benefit plan that files financial statements with the U.S. Securities and Exchange Commission (SEC).

For all other entities (including nonpublic entities), the amendments are effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Early application of the amendments in the ASU is permitted for all entities.

In this section, the author discusses the general concepts that are included in the final statement.

Background

Under current GAAP, ASC 840, Leases (formerly FASB No. 13), divides leases into two categories: operating and capital leases. Capital leases are capitalized while operating leases are not. In order for a lease to qualify as a capital lease, one of four criteria must be met:

1. The present value of the minimum lease payments must equal or exceed 90% or more of the fair value of the asset.
2. The lease term must be at least 75% of the remaining useful life of the leased asset.
3. There is a bargain purchase at the end of the lease, or
4. There is a transfer of ownership.

In practice, it is common for lessees to structure leases to ensure they do not qualify as capital leases, thereby removing both the leased asset and obligation from the lessee’s balance sheet.
This approach is typically used by restaurants, retailers, and other multiple-store facilities.

Consider the following example:

**Facts:**

**Lease 1:** The present value of minimum lease payments is 89% and the lease term is 74% of the remaining useful life of the asset.

**Lease 2:** The present value of minimum lease payments is 90% or the lease term is 75% of the remaining useful life of the asset.

**Conclusion:** There is a one percent difference between Lease 1 and 2. Lease 1 is an operating lease not capitalized, while Lease 2 is a capital lease under which both the asset and lease obligation are capitalized.

**SEC pushes toward changes in lease accounting**

In its report entitled, *Report and Recommendations Pursuant to Section 401(c.) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuer*, the SEC targeted lease accounting as one of the areas that results in significant liabilities being off-balance sheet.

According to the SEC Report that focused on U.S. public companies and a U.S. Chamber of Commerce report:

- a. 63 percent of companies record operating leases while 22 percent record capital leases.
- b. U.S. companies have approximately $1.5 trillion in operating lease obligations that are off-balance sheet.
- c. European companies have a total of approximately $928 billion in off-balance sheet operating lease obligations.
- d. 73 percent of all leases held by U.S. public companies ($1.1 trillion) involve the leasing of real estate.

In its Report, the SEC noted that because of ASC 840’s (formerly FASB No. 13’s) bright-line tests (90%, 75%, etc.), small differences in economics can completely change the accounting (capital versus operating) for leases.

Keeping leases off-balance sheet while still retaining tax benefits, is an industry unto itself. So-called synthetic leases are commonly used to maximize the tax benefits of a lease while not capitalizing the lease for GAAP purposes.
In addition, lease accounting abuses have been the focus of restatements with approximately 270 companies, mostly restaurants and retailers, restating or adjusting their lease accounting in the wake of Section 404 implementation under Sarbanes-Oxley.

Retailers have the largest amount of operating lease obligations outstanding that are not recorded on their balance sheets. Consider the following table:

<table>
<thead>
<tr>
<th>Retailer</th>
<th>Lease Obligations (in thousands)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Office Depot Inc.</td>
<td>$1,104</td>
</tr>
<tr>
<td>Walgreens Co.</td>
<td>27,434</td>
</tr>
<tr>
<td>CVS</td>
<td>38,917</td>
</tr>
<tr>
<td>Whole Foods</td>
<td>6,322</td>
</tr>
<tr>
<td>Sears</td>
<td>7,608</td>
</tr>
</tbody>
</table>

Source: Annual reports

The previous table shows the amount of off-balance sheet lease obligations for some of the largest U.S. retailers. These numbers are significant and bring to the forefront the pervasive impact the new lease standard may have on the larger retailers. For example, CVS has almost $39 billion of off-balance sheet lease obligations that it will be required to record on its balance sheet when the ASU becomes effective.

**FASB-IASB lease project**

Since the Sarbanes-Oxley Act became effective, the FASB has focused on standards that enhance transparency of transactions and that eliminate off-balance-sheet transactions, the most recent of which was the issuance of ASC 810, *Consolidation of Variable Interest Entities* (formerly FIN 46R). The FASB added to its agenda a joint project with the IASB that replaces existing lease accounting rules found in ASC 840 (formerly FASB No. 13) and its counterpart in Europe, IASB No. 17. The FASB and IASB started deliberations on the project in 2007, and issued a discussion memorandum in 2009, followed by the issuance of an exposure draft in 2010 entitled, *Leases (Topic 840)*.

The 2010 exposure draft was met with numerous criticisms that compelled the FASB to issue a second, replacement exposure draft on May 16, 2013 entitled, *Leases (Topic 842), a revision of the 2010 proposed FASB Accounting Standards Update, Leases (Topic 840)*.

The final statement was issued in February 2016 as ASU 2016-02.
Following are some of the changes found in ASU 2016-02:

**Basic concepts of the final statement**

The core principle of the lease standard is that an entity should use the right-of-use model to account for leases which requires the entity to recognize assets and liabilities arising from a lease. Thus, most existing leases will be brought onto the balance sheet under the new standard.

In accordance with the right-of-use model:

1. A lessee will recognize assets and liabilities for any leases that have a maximum possible lease term of more than 12 months.
   
   a. Leases with terms of 12 months or less will have the option of keeping their leases off balance sheet or recording lease assets and liabilities under the new ASU.

**Lessee rules:**

1. At the commencement date, a lessee will measure both of the following:

   - A lease liability (liability to make lease payments)
   - A right-of-use asset (right to use the leased asset for the lease term)

   a. **Lease liability:** The lease liability will be recorded at the present value of the lease payments over the lease term, discounted using the rate the lessor charges (the lessor's imputed rate) the lessee based on information available at the commencement date.

      1) If the lessor's imputed rate cannot be readily determined, the lessee will use its incremental borrowing rate.

      2) Nonpublic entities will be permitted to use a risk-free discount rate, determined using a period comparable to that of the lease term, as an accounting policy election for all leases. The risk-free discount rate is defined as a U.S. Treasury instrument rate for the same term as the lease.

   b. **Right-of-use asset:**

      1) At the commencement date, the cost of the right-of-use asset will consist of all of the following:

         - The amount of the initial measurement of the lease liability
         - Any lease payments made to the lessor at or before the commencement date, less any lease incentives received from the lessor, and
- Any initial direct costs incurred by the lessee.

2) At the commencement date, initial direct costs will be included as part of the cost of the right-of-use asset capitalized and may include:

- Commissions
- Legal fees
- Evaluating the prospective lessee’s financial condition
- Evaluating and recording guarantees, collateral, and other security contracts
- Negotiating lease terms and conditions
- Preparing and processing lease documents, and
- Payments made to existing tenants to obtain the lease.

The following items are examples of costs that are not be initial direct costs:

- General overheads, including for example, depreciation, occupancy and equipment costs, unsuccessful origination efforts, and idle time, and

- Costs related to activities performed by the lessor for advertising, soliciting potential lessees, servicing existing leases, or other ancillary activities.

c. Lease payments- lessee:

1) At the commencement date, lease payments included in the lease liability will consist of the following payments related to the use of the underlying asset during the lease term that are not yet paid:

- Fixed payments, (including in substance fixed payments, less any lease incentives receivable from the lessor

- Variable lease payments that depend on an index or a rate (such as the Consumer Price Index or a market interest rate), initially measured using the index or rate at the commencement date

- Variable lease payments that are in-substance fixed payments

   **Note:** The final statement changed the exposure draft so that variable lease payments are included in the initial measurement of lease assets and liabilities only if such payments depend on an index or a rate.

- Amounts expected to be payable by the lessee under residual value guarantees
• The exercise price of a purchase option if the lessee is “reasonably certain” that the lessee will exercise the purchase option

• Payments for penalties for terminating the lease, if the lease term, reflects the lessee exercising an option to terminate the lease
  
  • Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction

  • For a lessee only, amounts probable of being owed by the lessee under residual value guarantees

d. **Lease term:** An entity will determine the lease term as the *noncancellable period of the lease*, together with all of the following:

  1) Periods covered by an option to *extend the lease* if the lessee is “reasonably certain” to exercise that option, and

  2) Periods covered by an option to terminate the lease if the lessee is “reasonably certain” not to exercise that option.

  3) Periods covered by an option to extend (or not to terminate) the lease in which exercise of the option is controlled by the lessor.

**Reassessment of lease term:** A lessee shall reassess the lease term only if at the point in time any of the following occurs:

a. There is a significant event or a *significant change in circumstances that is within the control of the lessee* that directly affects whether the lessee is “reasonably certain” to exercise or not to exercise an option to extend or terminate the lease or to purchase the underlying asset.

b. There is an event that is written into the contract that obliges the lessee to exercise (or not to exercise) an option to extend or terminate the lease.

c. The lessee *elects to exercise an option* even though the entity had previously determined that the lessee was not reasonably certain to do so.

d. The lessee elects *not to exercise an option* even though the entity had previously determined that the lessee was reasonably certain to do so.

e. **Classification of leases for lessees:**

   ASU 2016-02 establishes *two types of leases for lessees:*
- Finance lease (Type A lease)
- Operating lease (Type B lease)

**Finance lease (type A lease) - lessee**

**Definition of a finance lease**

A lessee shall classify a lease as a finance lease when the lease meets any of the following criteria at lease commencement:

a. The lease *transfers ownership* of the underlying asset to the lessee by the end of the lease term.

b. The lease grants the lessee an *option to purchase the underlying asset* that the lessee is reasonably certain to exercise.

c. The lease term is for the *major part of the remaining economic life* of the underlying asset. However, if the commencement date falls at or near the end of the economic life of the underlying asset, this criterion shall not be used for purposes of classifying the lease.

**Note:** A lease term that is *75 percent or more* of the remaining economic life of the underlying asset is considered a major part of the remaining economic life of that asset.

d. The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments *equals or exceeds substantially all of the fair value of the underlying asset.*

**Measurement of a finance lease**

A finance lease:

- Applies to most leases of assets other than property (for example, equipment, aircraft, cars, trucks).

- Recognizes a right-of-use asset and a lease liability, initially measured at the present value of lease payments.

- Recognizes the unwinding of the discount on the lease liability as interest separately from the amortization of the right-of-use asset.

- Total expense is accelerated and shown in two expense components:

  - Interest expense (accelerated), and
  - Amortization expense (straight-line)
Operating lease (type B lease) - lessee

Definition of an operating lease

For a lessee, ASU 2016-02 defines an operating lease (Type B lease) as *any lease other than a finance lease*.

Thus, an operating lease is any lease that *does not* do any of the following:

a. The lease *does not transfers ownership* of the underlying asset to the lessee by the end of the lease term.

b. The lease *does not grant the lessee an option to purchase the underlying asset* that the lessee is reasonably certain to exercise.

c. The lease term *is not* for the **major part of the remaining economic life** of the underlying asset.

   **Note:** A lease term that is *75 percent or more* of the remaining economic life of the underlying asset is considered a **major part of the remaining economic life** of that asset.

d. The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments *does not equal or exceed substantially all of the fair value of the underlying asset*.

Measurement of an operating (Type B) lease

- Applies to most leases of property (that is, land and/or a building or part of a building).

- Recognizes a right-of-use asset and a lease liability, initially measured at the present value of lease payments (same as a finance lease).

- Recognizes a single lease cost (expense), combining the unwinding of the discount on the lease liability (interest) with the amortization of the right-of-use asset, on a **straight-line basis**.

- Total expense is recorded on a **straight-line basis** throughout the lease term.

The following chart compares the final lease standard with existing GAAP for leases.
# Comparison of Existing GAAP Versus ASU 2016-02’s Final Lease Standard

## Lessee Side

<table>
<thead>
<tr>
<th>Description</th>
<th>Current GAAP for Operating Leases</th>
<th>ASU 2016-02</th>
</tr>
</thead>
</table>
| Lease type                       | Leases are classified as operating or capital leases (financing arrangements) based on satisfying one of four criteria.  
  - 75% rule  
  - 90% rule  
  - Bargain purchase  
  - Transfer of ownership                                                                 | All leases classified as financing arrangements (as if asset purchases)       |
|                                 |                                                                                                    | Right-of-use asset and lease liability recorded at present value of payments over the lease term |
| Lease term                       | Non-cancellable periods  
Option periods generally not included in lease term                                                                                   | Non-cancellable period together with any options to extend or terminate the lease when it is *reasonably certain* that the lessee will exercise an option to extend the lease |
| Contingent/variable rents        | Contingent rents excluded from lease payments. When paid, they are period costs                     | Variable rents included in lease payments in certain instances               |
| Income statement                 | Operating leases- lease expense straight-line basis  
Capital leases- depreciation and interest expense                                                                 | Two Approaches:                                                             |
|                                 |                                                                                                    |     *FINANCE LEASE (Type A):* Interest and amortization expense recorded. Accelerated expense |
|                                 |                                                                                                    |     *OPERATING LEASE (Type B):* Lease expense recorded as combination of interest and amortization- straight-line expense |
| Assessment                       | Terms are not re-assessed                                                                            | Leases reassessed in certain instances                                        |
Short-term leases:

1. A lessee will be permitted to make an accounting policy election not to recognize lease assets or lease liabilities for short-term leases.

2. A short-term lease is defined as follows:

   "A lease that, at the date of commencement of the lease, has a maximum possible term, including any options to renew, of 12 months or less."

3. For short-term leases, the lessee recognizes lease payments as rent expense in the income statement on a straight-line basis over the lease term, unless another systematic and rational basis is more representative of the time pattern in which use is derived from the underlying asset.

Note: The final standard carves out an exception for short-term leases of 12 months or less by permitting a lessee not to record the lease asset and liability. Instead, rent expense is recorded on a straight-line basis as incurred. The ASU permits an entity to use another
approach (other than a straight-line method) to record rent expense if that alternative is more representative of the time pattern in which the lessee uses the lease asset.

4. A lessee is permitted (but is not required) to record a lease asset and liability for a short-term lease.

**Lessor rules:**

The accounting applied by a lessor is generally unchanged from that applied under previous GAAP.

ASU 2016-02 establishes *three types of leases for lessees:*

- Sales-type lease
- Direct financing lease
- Operating lease

**Note:** For most lessors, the majority of existing operating leases will remain off balance sheet with the lessors continuing to recognize lease income for those leases on a straight-line basis over the lease term.

The ASU does make some changes to lessor lease accounting to align the lessor and lessee rules.

**Disclosures:**

1. Both lessees and lessors will be required to provide disclosures to meet the objective of enabling users of financial statements to understand the amount, timing, and uncertainty of cash flows arising from leases.

**Transition- existing leases:**

1. Existing leases *are not grandfathered* thereby requiring existing leases to be brought onto the balance sheet under the new rules.

   a. In transition, lessees and lessors are required to recognize and measure leases at the beginning of the earliest period presented using a *modified retrospective approach.*

   b. The modified retrospective approach includes a number of optional practical expedients that entities may elect to apply.

**Note:** An entity that elects to apply the practical expedients will continue to account for leases that commence before the effective date in accordance with previous GAAP unless the lease is modified. The exception is that lessees are required to recognize a right-of-use asset and a lease liability for all operating leases at each reporting date based on the present
value of the remaining minimum rental payments that were tracked and disclosed under previous GAAP.

**Impact of changes to lease accounting**

The ASU changes may be devastating to many companies and may result in many more leases being capitalized which will impact all financial statements.

In particular, retailers will be affected the most.

If leases of retailers, for example, are capitalized, the impact on financial statements will be significant, as noted below:

- Lessee’s balance sheets must be grossed up for the recognized lease assets and the lease obligations for all lease obligations.

  **Note:** Including contingent lease payments and renewal options may result in overstated liabilities given the fact that contingent payments must be included in the lease payments and renewal options must be considered in determining the lease term.

- For finance (Type A) leases, lessee income statements may be adversely affected with higher lease expense in the earlier years of new leases.

  **Note:** Even though total lease expense is the same over the life of a lease, lease expense (interest and amortization expense) under a finance lease is higher in the earlier years as compared with lease expense under an operating lease.

  On average, a 10-year lease will incur approximately 15-20% higher annual lease expense in the earlier years, if capitalized, as compared with a lease not being capitalized. That higher lease amount reverses in the later years.

- For finance (Type A) leases, on the statement of cash flows, there will be a positive shift in cash flow to cash from operations from cash from financing activities. A portion of rent expense previously deducted in arriving at cash from operations will now be deducted as principal payments in cash from financing activities. Thus, companies will have *higher cash from operating activities* and *lower cash from financing activities*.

- In most cases, annual lease expense for GAAP (interest and amortization) will not match lease expense for income tax purposes thereby resulting in deferred income taxes.

Changes to both the balance sheets and income statements of companies may have rippling effects on other elements of the lessee companies.
1. On the positive side, a lessee’s earnings before interest, taxes, depreciation and amortization (EBITDA) may actually improve as there is a shift from rent expense under operating leases to interest and amortization expense under the ASU.

   a. Both interest and amortization expense are not deducted in arriving at EBITDA while rent expense is.

   b. Changes in EBITDA may affect existing agreements related to compensation, earn outs, bonuses, and commissions.

2. On the negative side, for both finance (Type A) and operating (Type B) leases, lessee debt-equity ratios may be affected with entities carrying significantly higher lease obligation debt than under existing GAAP. Higher debt-equity ratios could put certain loan agreements into default. Moreover, net income will be lower in the earlier years of the lease term due to higher interest and amortization expense replacing rental expense.

**How significant will the change to the lease standard be for U.S. companies?**

As previously noted, there are approximately $1.5 trillion of operating lease obligations that are not recorded on public company balance sheets. That $1.5 trillion is magnified by the many nonpublic companies that have unpublished operating lease obligations that are unrecorded.

The author estimates that unrecorded lease obligations of nonpublic operating leases is at least another $1.3 trillion bringing to estimated total unrecorded lease obligations at approximately $2.8 billion.

Consider the following estimated impacts of converting existing leases to capitalized right-of-use leases:

   a. Earnings of retailers could decline significantly. One recent study suggested that there could be a median drop in EPS of 5.3 percent and a median decline in return on assets of 1.7 percent.

   b. Public companies could face $10.2 billion of added annual interest costs.

   c. There could be a loss of U.S. jobs in the range of 190,000 to 3.3 million.

   d. Cost of compliance with the new standard could lower U.S. GDP by $27.5 billion a year.

   e. Lessors could lose approximately $14.8 billion in the value in their commercial real estate.

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4 Based on a report issued by Change & Adams Consulting, commissioned by the U.S. Chamber of Commerce and Others. Amounts are based on current data and likely to change by the implementation date.
f. Balance sheets might be loaded with significant lease obligations that could impact debt-equity ratios.

- Aggregate debt of nonfinancial S&P 500 companies could increase by 17 percent if all leases were capitalized.

- Return on assets could decline as total assets (the denominator) would increase by approximately 10 percent.

- The S&P 500 could record an estimate of $549 billion of additional liabilities under the new lease standard on existing operating leases.\(^5\)

- U. S. companies, as a whole (public and nonpublic), could record approximately $7.8 trillion of additional liabilities if operating leases are capitalized.\(^6\)

According to a Credit Suisse study,\(^7\) there are 494 of the S&P 500 companies that are obligated to make $634 billion of total future minimum lease payments under operating leases. On a present value basis, including contingent rents, the $634 billion translates into an additional liability under the lease standard of $549 billion. Of the $549 billion of additional liabilities, 15 percent of that total relates to retail companies on the S&P 500.

In some cases, the effect of capitalizing lease obligations under the lease standard is that the additional liability exceeds stockholders’ equity.

Consider the following table:

<table>
<thead>
<tr>
<th>Retailer</th>
<th>Operating lease Obligations</th>
<th>PV converter 5 years 4% (a)</th>
<th>Additional liability under new lease standard</th>
<th>Stockholders’ equity</th>
<th>% equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Office Depot</td>
<td>$ 2 B</td>
<td>.822</td>
<td>$1.6 B</td>
<td>$661M</td>
<td>248%</td>
</tr>
<tr>
<td>Walgreens</td>
<td>35 B</td>
<td>.822</td>
<td>28.8 B</td>
<td>18 B</td>
<td>160%</td>
</tr>
<tr>
<td>CVS</td>
<td>28 B</td>
<td>.822</td>
<td>23.0 B</td>
<td>38 B</td>
<td>61%</td>
</tr>
<tr>
<td>Whole Foods</td>
<td>6.8 B</td>
<td>.822</td>
<td>5.6 B</td>
<td>3.8 B</td>
<td>147%</td>
</tr>
<tr>
<td>Sears</td>
<td>4.5 B</td>
<td>.822</td>
<td>3.7 B</td>
<td>3.1 B</td>
<td>119%</td>
</tr>
</tbody>
</table>

Source: Annual Reports, as obtained by the author.

(a) Assumes the weighted-average remaining lease term is 5 years, and the incremental borrowing rate is 4%.

---

\(^5\) Leases Landing on Balance Sheet (Credit Suisse)  
\(^6\) Author’s estimate: $1.5 trillion for public companies and $6.3 trillion for nonpublic companies  
\(^7\) Leases Landing on Balance Sheet (Credit Suisse)
The previous table identifies the sizeable problem that exists for many of the U.S. retailers which is that there are huge off-balance sheet operating lease liabilities as a percentage of company market capitalization. Under the lease standard, these obligations will be recorded, thereby having a devastating impact on those retailers’ balance sheets. For example, look at Office Depot and its $1.6 billion lease liability that, based on today’s balance sheet, would represent 248% of its stockholders’ equity of $661 million.

**How will the lease standard impact how leases are structured?**

Companies are going to consider the balance sheet impact when structuring leases and in deciding whether to lease or buy the underlying asset, in the first place. There are several likely actions that will come from the new lease standard:

1. **Lease-versus-buy decision impacted:** By implementing the lease standard, the GAAP differences between leasing and owning an asset will be reduced. Having to capitalize all leases may have a significant effect on the lease versus purchase decision, particularly with respect to real estate:

   a. Tenants, in particular those in single-tenant buildings with long-term leases, may choose to purchase a building instead of leasing it:

   - A similar amount of debt would be included on the tenant’s balance sheet under a long-term lease as compared with a purchase.
   - GAAP depreciation under a purchase may actually be lower than amortization under a lease because the amortization life under the lease (generally the lease term) is likely to be shorter than the useful life under a purchase.

   **Example:** Assume there is a 10-year building lease with two, 5-year lease options, resulting in a maximum lease term of 20 years. Assume further that the useful life of the building is 30 years for depreciation purposes.

   If the entity leases the real estate, the right-of-use asset would be amortized over a maximum of 20 years. If, instead, the entity were to purchase the real estate, the building would be depreciated over the useful life of 30 years.

   **Note:** In some instances, lessees may choose to purchase the leased asset rather than lease it, if the accounting is the same. In particular, the purchase scenario may be more appealing for longer-term leases that have significant debt obligations on the lessee balance sheets. Lessees with shorter-term leases will not be burdened with the extensive debt obligations and, therefore, may choose not to purchase the underlying lease asset.
b. **Lease terms are likely to shorten**: For many companies who do not wish to purchase the underlying leased asset, lease terms may shorten to reduce the amount of the lease obligation (and related asset) that is recorded at the lease inception.

- The lease standard may affect not only the landlords and tenants, but also brokers as there will be much greater emphasis placed on executing leases for shorter periods of times thereby increasing the paperwork over a period of time and the commissions earned.

c. **Deferred tax assets will be created**: Because many operating leases may be capitalized for GAAP but not for tax purposes, total GAAP expense (interest and amortization) will likely be greater than lease expense for tax purposes, resulting in deferred tax assets for the future tax benefits that will be realized when the temporary difference reverses in later years.

Under existing GAAP, most, but not all, leases are treated as operating leases for tax purposes. Therefore, rarely are operating leases capitalized for tax purposes. Now, the game is about to change if operating leases are capitalized as right-of-use assets under GAAP, while they continue to be treated as operating leases for tax purposes. As we have seen in the previous examples, most leases capitalized under the lease standard will result in the creation of a deferred tax asset.

**Other considerations- dealing with financial covenants:**

The lease standard could cast a wide web across the accounting profession. By capitalizing leases that were previously off-balance sheet, there may be consequences.

Examples:

- **Impact on state apportionment computations**: Many states compute the apportionment of income assigned to that state using a property factor based on real and tangible personal property held in that particular state.

  **Note**: When it comes to rent expense, most states capitalize the rents using a factor such as eight times rent expense. Although each state has its own set of rules, the implementation of the standard may have a sizeable positive or negative impact on state tax apportionment based on shifting rent expense to capitalized assets.

- **Impact on tax planning**: Capitalizing leases might have a positive effect in tax planning.

  **Note**: One example is where there is a C corporation with accumulated earnings and exposure to an accumulated earnings tax (AET). The additional lease obligation liability would certainly help justify that the accumulation of earnings is not subject to the AET.

- **Impact on total asset and liability thresholds**: Companies should also be aware that not only will the lease standard increase liabilities, but will also increase total assets.
Note: In some states, there are total asset thresholds that drive higher taxes and reporting requirements.

Dealing with financial covenants:

A critical impact of the lease standard may be that certain loan covenants will be adversely impaired thereby forcing companies into violations of their loans.

Consider the following ratios:

<table>
<thead>
<tr>
<th>Ratio</th>
<th>Likely impact of ASU 2016-02’s lease standard</th>
</tr>
</thead>
<tbody>
<tr>
<td>EBITDA:</td>
<td>Finance (type A) leases:</td>
</tr>
<tr>
<td>[Earnings before interest, taxes, depreciation and amortization]</td>
<td>Favorable impact due to shift from rental expense to interest and amortization expense, both of which are added back in computing EBITDA.</td>
</tr>
<tr>
<td></td>
<td>Operating (type B) leases:</td>
</tr>
<tr>
<td></td>
<td>May be favorable impact depending on whether “lease expense” is added back to compute EBITDA.</td>
</tr>
<tr>
<td>Interest coverage ratio:</td>
<td>May be negatively impacted from lower ratio</td>
</tr>
<tr>
<td>[Earnings before interest and taxes ] [Interest expense]</td>
<td></td>
</tr>
<tr>
<td>Debt-equity ratio:</td>
<td>Negative impact from higher ratio</td>
</tr>
<tr>
<td>[Total liabilities ] [Stockholders’ equity]</td>
<td></td>
</tr>
</tbody>
</table>

There is likely to be a favorable impact on EBITDA for finance (Type A) leases by implementing the lease standard. Rent expense recorded for operating leases under existing GAAP will be reduced while interest expense and amortization expense will increase once the leases are capitalized.

However, the issue is what happens to EBITDA for the new operating (Type B) leases. Under the new lease standard, interest and amortization are combined as one line item on the income statement entitled “lease cost (expense).” The question is whether that line item is added back in arriving at EBITDA. The author believes it should be added back because it represents interest and amortization despite the lease expense label.

As to the interest coverage ratio, the impact on the ratio depends on the whether there is a finance (Type A) or operating (Type B) lease. For a finance lease, earnings before interest and taxes will
likely be higher as rent expense is removed and replaced with interest and amortization expense. For finance (Type A) leases, the denominator increases significantly due to the higher interest expense. On balance, the slightly higher earnings before interest and taxes divided by a higher interest expense in the denominator yields a lower interest coverage ratio.

For the new operating (Type B) lease, the impact on the ratio is unclear. Although interest expense, along with amortization expense, will be embedded in the caption line item “lease expense,” most analysts will likely carve out the interest and amortization components and adjust the interest coverage ratio by the interest portion.

Perhaps the most significant impact of capitalizing leases under the lease standard will be its effect on the debt-equity ratio. With sizeable liabilities being recorded, this ratio will likely turn quite negative and severely impact company balance sheets. In some cases, the debt-equity ratio will result in violation of existing loan covenants thereby requiring a company to renegotiate the covenants with its lenders or at least notify lenders in advance of the likely lack of compliance with loan covenants.

**What about the impact on smaller nonpublic entities?**

One leasing organization noted that more than 90 percent of all leases involve assets worth less than $5 million and have terms of two to five years. That means that smaller companies have a significant amount of leases most of which are currently being accounted for as operating (off balance sheet) leases. The author estimates that the present value of unrecorded lease obligations under operating leases of nonpublic entities to be at least $1.3 trillion in addition to an estimated $1.5 trillion of unrecorded lease obligations of public companies.

Unless these smaller, nonpublic entities choose to use the tax basis for their financial statements, under GAAP, these companies will be required to capitalize their operating leases.

**What about related-party leases?**

Some, but not all, related-party leases result in the lessee (parent equivalent) consolidating the lessor (subsidiary equivalent) under the consolidation of variable interest entity rules (ASC 810) (formerly FIN 46R). The common example of a related-party lease is where an operating company lessee leases real estate from its related-party lessor. In general, under FIN 46R, if there is a related party lessee and lessor, consolidation is required if:

1. The real estate lessor is a variable interest entity (VIE) (e.g., it is not self-sustaining), and,
2. The lessee operating company and/or the common shareholder provide financial support to the real estate lessor in the form of loans, guarantees of bank loans, above-market lease payments, etc.

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If these two conditions are met, it is likely that the real estate lessor must be consolidated in with the operating company lessee’s financial statements. If there is consolidation, capitalizing the lease under ASU 2016-2 would be moot because the asset and liability, and lease payments would be eliminated in the consolidation.

In 2014, the Private Company Council (PCC) issued ASU 2014-07, *Consolidation (Topic 810) Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements (a consensus of the PCC)*, which provides private (nonpublic) entities an election not to apply the consolidation of VIE rules to a related-party lease arrangement. The ASU provides most private companies with relief from the VIE rules for related-party leases. Thus, most private (nonpublic) entities involved in related-party leases will not be consolidating the real estate lessor into the lessee.

When it comes to a related-party lease in which there is no consolidation, under the ASU, the parties will have to account for that lease as a right-of-use lease asset and obligation, just like any other lease transaction. Consequently, under the lease standard, the operating company lessee will be required to record a right-of-use asset and lease obligation based on the present value of the lease payments.

Many related parties either do not have formal leases or the leases are short-term. If the operating company lessee will be required to record a significant asset and liability, it may make sense to write a related-party lease that has a lease term of 12 months or less or is a tenant-at-will arrangement.

With respect to a related-party lease that is 12 months or less, the ASU permits (but does not require) use of the short-term lease rules as follows:

a. A lessee may make an accounting policy election:

   - Not to recognize the lease asset and liability, and
   - To record the lease payments as rent expense on a straight-line basis.

With many related-party leases, the operating company lessee may issue financial statements while the real estate lessor does not. Therefore, how the lessee accounts for the transaction under GAAP may be more important than the lessor’s accounting for the transaction.

Let’s look at a simple example:

**Example:** Company X is a real estate lessor LLC that leases an office building to a related-party operating Company Y. X and Y are related by a common owner.

The companies sign an annual 12-month lease with no renewals, and no obligations that extend beyond the twelve months.
Monthly rents are $10,000.

Y issues financial statements to its bank while X does not issue financial statements.

There is no consolidation under the variable interest entity (VIE) rules.

**Conclusion:** Because the entities have a short-term lease of 12 months or less, Y, as lessee, qualifies for the short-term lease rules. Therefore, Y is permitted to make an accounting policy election under which Y would not record a lease asset and liability, and would record the monthly rent payments and rent expense on a straight-line basis over the short-term lease period.

Alternatively, Y could elect to treat the short-term lease as a standard lease by recording both the lease asset and liability.

**Observation:** Many nonpublic entities will take steps to avoid its arduous rules. One approach will likely be to make sure the related-party leases have terms that are 12 months or less so that the lease can be treated as an operating lease and not capitalized. Another approach would be to issue tax basis financial statements.

**Plenty of time to implement the new lease standard:**

Because the effective date of ASU 2016-02 is 2019 for public entities and 2020 for nonpublic entities, there is ample time for entities to restructure leases in anticipation of the effective date.
REVIEW QUESTIONS

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

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

1. Under existing GAAP (Leases (ASC 840) (formerly FASB No. 13)), in order for a lease to qualify as a capital lease, which one of the following conditions must be satisfied:
   a. The future value of the minimum lease payments must be equal to or exceed 10% or more of the fair value of the asset
   b. The lease term must be no more than 50% of the remaining useful life of the leased asset
   c. There must be a bargain purchase at the end of the lease
   d. There must not be a transfer of ownership

2. Which of the following models does ASU 2016-02’s lease standard use:
   a. Right-of-use model
   b. Fixed-asset model
   c. Capital lease model
   d. True lease model

3. How are options to extend a lease accounted for in determining the lease term under the ASU 2016-02 lease standard:
   a. The lease term should take into account the effect of any options to extend the lease in certain cases
   b. Lease options are only considered once they are exercised
   c. The lease standard states that options are too vague and should never be considered in determining the lease term
   d. Only certain options to extend within a short-term period are considered because it is difficult to estimate the likelihood of the options being exercised

4. Under ASU 2016-02’s lease standard, expense on the lessee’s income statement consists of which of the following components under a finance (Type A) lease:
   a. Rent expense
   b. Interest and depreciation expense
   c. Rent and interest expense
   d. Interest and amortization expense

5. Facts: A company is a lessee of a lease with a lease term of 12 months. How may the lessee account for this lease under ASU 2015-02’s lease standard:
a. The company is required to record a lease asset and liability
b. The company is not permitted to record a lease asset and liability
c. The company has the option to record the lease asset and liability, or not record the lease
   as an asset and liability
d. The ASU standard does not address shorter-lease terms

6. According to the author, which of the following might be an effect of ASU 2016-02’s lease standard:
   a. For finance leases, the lessee’s income statement may have lower total lease expense in
      the earlier years of new leases
   b. There could be a negative shift in cash from operations from cash from financing activities
      in the statement of cash flows
   c. In most cases, total expense for GAAP will be the same as total expense for income tax
      purposes
   d. The lessee’s EBITDA may increase as there is a shift from rent expense to interest and
      amortization expense

7. One change that may occur as a result of implementing ASU 2015-02’s lease standard is___________.
   a. Companies that typically purchase a single-tenant building may choose to lease instead
      of buy the building
   b. Tenants in multi-tenant buildings may likely sign longer-term leases
   c. Tenants in single-tenant buildings with long-term leases may choose to buy the asset
   d. There is likely to be no change

8. Annual GAAP depreciation expense for a purchase of a leased asset may be____________
   assuming there is a finance (Type A) lease:
   a. Higher than annual amortization expense under a lease
   b. Lower than annual amortization expense under a lease
   c. The same as annual amortization expense under a lease
   d. Either higher or lower than amortization expense under a lease, depending on whether
      options are part of the lease term

9. Under ASC 810 (formerly FIN 46R), if there is a related-party lessee and lessor, which of
   the following would possibly result in consolidation of the two entities:
   a. The real estate entity is self-sustaining
   b. The real estate lessor is a variable interest entity
   c. The real estate lessor guarantees its own loan
   d. The lease is at market value
1. Under existing GAAP (Leases (ASC 840) (formerly FASB No. 13)), in order for a lease to qualify as a capital lease, which one of the following conditions must be satisfied:
   a. Incorrect. In order for a lease to qualify as a capital lease, the present value of the minimum lease payments must be equal to or exceed 90% or more (and not 10%) of the fair value of the asset.
   b. Incorrect. In order for a lease to qualify as a capital lease, the lease term must be at least 75% (not more than 50%) of the remaining useful life of the leased asset.
   c. Correct. Existing GAAP provides that if there is a bargain purchase at the end of the lease, the lease is a capital lease.
   d. Incorrect. If there is a transfer of ownership, the lease qualifies as a capital lease, making the answer incorrect.

2. Which of the following models does ASU 2016-02’s lease standard use:
   a. Correct. ASU 2016-02 uses the right-of-use model under which a lease obligation is recorded at the present value of cash flows with the recording of a corresponding right-of-use asset.
   b. Incorrect. The ASU does not reference any fixed asset model. Further, a fixed asset model suggests that a leased asset is a tangible asset when, in fact, a right-of-use asset is an intangible asset under ASU 2016-02’s lease model.
   c. Incorrect. The term “capital lease” is part of existing GAAP and is not used in the new lease model even though the new model does capitalize assets and liabilities.
   d. Incorrect. The concept of “true lease” is found in taxation and not in GAAP.

3. How are options to extend a lease accounted for in determining the lease term under the ASU 2016-02 lease standard:
   a. Correct. The lease term takes into account the effect of any options to extend the lease where it is reasonably certain that the lessee will exercise the option.
   b. Incorrect. The lease standard does not provide for lease options being considered only once they are exercised.
   c. Incorrect. The lease standard states that in certain circumstances, options are to be considered in determining the lease term, making the statement incorrect.
   d. Incorrect. The lease standard does not differentiate between an option to extend within a short-term period as compared with one that is long-term.

4. Under ASU 2016-02’s lease standard, expense on the lessee’s income statement consists of which of the following components under a finance (Type A) lease:
   a. Incorrect. The ASU does not provide for presenting the expense under the category “rent expense,” and instead separates the expense into two components, not one.
   b. Incorrect. Interest is recorded under a finance lease, but amortization is the second component, not depreciation.
   c. Incorrect. Interest expense, but not rent expense, is a component of a finance lease. Rent expense is not a component under the standard, making the answer incorrect.
d. **Correct. Both amortization and interest expense are components of expense recorded under a finance lease. Amortization relates to the right-of-use asset capitalized while interest expense relates to the lease obligation.**

5. **Facts:** A company is a lessee of a lease with a lease term of 12 months. How may the lessee account for this lease under ASU 2016-02’s lease standard:
   a. Incorrect. ASU 2016-02 does not require the company to record a lease asset and liability for a short-term lease of 12 months or less, making the answer incorrect.
   b. Incorrect. The ASU does permit, but not require, that the company record a short-term lease as an operating lease, making the answer incorrect.
   c. **Correct. If the lease is 12 months or less, a lessee is able to make an accounting policy election either not to record the lease asset and liability, or to record the lease asset and liability, similar to other leases.**
   d. Incorrect. The ASU does address short-term leases with a lease term of 12 months or less, making the answer incorrect.

6. According to the author, which of the following might be an effect of ASU 2016-02’s lease standard:
   a. Incorrect. For finance leases, total expense (interest and amortization) on the lessee’s income statement will be higher, not lower, in the earlier years of new leases.
   b. Incorrect. There will likely be a positive (not negative) shift to cash from operations from cash from financing activities in the statement of cash flows. Rent expense is replaced by interest and amortization expense.
   c. Incorrect. Total expense for GAAP will most likely differ from total expense for income tax purposes resulting in deferred income taxes being recorded. Most leases are not capitalized for tax purposes.
   d. **Correct. The lessee’s EBITDA may increase as there is a shift from rent expense to interest and amortization expense. Interest and amortization are not deducted in arriving at EBITDA while rent expense is deducted.**

7. One change that may occur as a result of implementing ASU 2015-02’s lease standard is__________.
   a. Incorrect. The new lease standard is not likely to expand leases because those leases will have lease obligations that have to be recorded on the lessee’s balance sheet.
   b. Incorrect. Shorter, not longer leases will be the trend so that smaller liabilities are recorded on the lessee’s balance sheet.
   c. **Correct. Tenants in single-tenant buildings with long-term leases may choose to buy the asset because they already have to record lease obligations that are similar to the debt they will have to record in a purchase.**
   d. Incorrect. The status quo is not likely to be the case given the enormity of the impact of the lease standard on company balance sheets.

8. **Annual GAAP depreciation expense for a purchase of a leased asset may be ______________ assuming there is a finance (Type A) lease:**
a. Incorrect. GAAP depreciation under a purchase may be lower, not higher, because the useful life used to depreciate the purchased asset is usually longer than the lease term used to amortize the lease.

b. Correct. The useful life used to depreciate an asset under a purchase is likely to be longer than the lease term used to amortize a lease thereby resulting in lower depreciation with a purchase than amortization with a Type A lease.

c. Incorrect. There is no indication that the amounts would be the same.

d. Incorrect. Even if the option periods are included in the lease term, that term will be lower than the useful life of the purchase. Thus, depreciation will always be lower than amortization, making the answer incorrect.

9. Under ASC 810 (formerly FIN 46R), if there is a related-party lessee and lessor, which of the following possibly result in consolidation of the two entities:
   a. Incorrect. Consolidation may be required only if the real estate entity is not self-sustaining.
   b. Correct. If the real estate lessor is a variable interest entity (VIE), consolidation may be required.
   c. Incorrect. If the lessee operating company or the common shareholder guarantee the lessor’s loan, consolidation may be required. This is not the case where the real estate lessor guarantees its own loan.
   d. Incorrect. If the lease is above market, and not at market value, consolidation may be required.
G. Big GAAP – Little GAAP

In 2016, there finally has been progress toward the creation of a little-GAAP alternative to U.S. GAAP for nonpublic (private) companies. After all, it has only taken more than 40 years to get to the point where practitioners and their clients are fed up with the extensive growth of GAAP much of which is not relevant to nonpublic entities. For purposes of this section, the author uses the terms "nonpublic" and "private" interchangeably.

Background

For years there has been discussion about establishing two sets of GAAP rules; one for private (nonpublic) companies, and the other for SEC companies. Yet, each time there has been a little-GAAP proposal, the discussion has fallen into oblivion with no real support from the AICPA and FASB.

The Big-GAAP, Little-GAAP issue has been around since 1974. There is a long history of various attempts to develop two sets of rules for GAAP, one for private companies, and the other for public companies. For purposes of this discussion, the term “Big-GAAP” refers to GAAP for public companies, while “Little GAAP” refers to a modified and simplified version of GAAP applicable to private (nonpublic) companies.

Because prior to 2014, the continued start and stop of the Big GAAP-Little GAAP debate had yielded little fruit, nonpublic companies and their accountants had to apply the same standards used by IBM and Microsoft, to Joe’s Pizza Shop and Mary’s Office Supply Store.

Nevertheless, the Big GAAP-Little GAAP movement has received new impetus over the past few years. Here is the status of events:

1. In the past decade, the FASB has issued several extremely controversial FASB statements and interpretations that are costly and difficult for nonpublic entities to implement, and not meaningful to the third party users they serve.

2. The Sarbanes-Oxley Act of 2002 mandated that the FASB’s funding come primarily from SEC registrants, thereby motivating the FASB to focus on issues important to public entities.

3. Presently, accountants from smaller CPA firms and nonpublic companies are not serving as FASB staff or board members which results in no small business representation or perspective within the FASB.

4. On the auditing side, the role of the Auditing Standards Board (ASB) has diminished to issuing auditing standards for nonpublic entities only. The Public Company Accounting Oversight Board (PCAOB) is now the standard-setter for SEC auditors. Thus, the AICPA’s ASB, and the AICPA, in general, are now more closely aligned with the needs of nonpublic entities.
Over the past decade, there has been sharp criticism pointed toward the FASB in their issuance of several extremely controversial statements that are difficult to implement for smaller, nonpublic companies including:

- **Consolidation of Variable Interest Entities** (ASC 810) (formerly FIN 46R): Requires entities (large and small) to consolidate their operating entities with their off-balance real estate leasing entities, if certain conditions are met.

- **Accounting for Uncertainty in Income Tax** (An Interpretation of FASB No. 109) (ASC 740) (formerly FIN 48): Clarifies the accounting for uncertainty in tax positions related to income taxes recognized in an entity’s financial statements.

In addition, layers of mindless disclosures have been added to GAAP over the past decade many of which are targeted at larger publicly held entities. Yet, in most cases, the FASB has not exempted nonpublic entities from the application of those disclosures.

In general, there have been few instances in which the FASB has issued standards that exempt private companies:

A few of those instances include:

- ASC 260 (formerly FASB No. 128: *Earnings Per Share*)

- ASC 280 (formerly FASB No. 131: *Disclosures about Segments of an Enterprise and Related Information*)

- ASC 825 (formerly FASB No. 107: *Disclosure About Fair Value of Financial Instruments*)

In fact, the extent to which the FASB has carved out GAAP exclusions for private companies has been limited to delaying the effective date of a new standard and, in very limited cases, exempting private companies from one or two disclosures. Otherwise, private (nonpublic) companies have had to adopt the same standards that public companies do.

Consequently, accountants and their clients have defaulted to using several techniques to avoid the burdensome task of having to comply with recently issued difficult and irrelevant accounting standards, including:

- a. Using tax-basis financial statements
- b. Including a GAAP exception in the accountant’s/auditor’s report, or
- c. Ignoring the new GAAP standards by arguing their effect is not material
However, some third parties have not been receptive to receiving tax basis financial statements and reports with a GAAP exception. Simply ignoring the new GAAP standards has its obvious problems.

Adding to the difficulty has been the FASB’s unwillingness to focus on the needs of private companies. Prior to the issuance of Sarbanes-Oxley in 2002, the FASB received most of its funding from the SEC’s Fortune 500 companies. After the Sarbanes-Oxley Act, essentially all of the FASB’s funding is financed by SEC companies as mandated by Sarbanes-Oxley, so that the FASB’s emphasis is in serving the public company arena. Consequently, the needs of nonpublic entities have been ignored.

The FASB established a Blue Ribbon Panel to evaluate the little-GAAP issue from which they issued a report. In that report, the Panel recommended to the FASB that the best course of action to deal with the little-GAAP dilemma was to:

> establish a new separate private company standard board to offer exceptions and modifications from GAAP for nonpublic (private companies).

The Panel's recommendation was used as the basis for the FASB to move forward with a little-GAAP solution.

**FASB and AICPA simultaneously jump on the little-GAAP bandwagon**

Prior to May 23, 2012, it had taken more than 40 years for there to be a legitimate alternative to regular (big) GAAP. During that time, practitioners and their nonpublic company clients had used a variety of alternatives to avoid the traditional complex GAAP that had evolved. Such solutions included using GAAP exceptions and issuing tax-basis financial statements, among others.

On May 23, 2012, a rather profound series of events happened. After more than 40 years of the profession seeking a little-GAAP alternative, both the FASB and AICPA simultaneously announced their own independent proposals for a little-GAAP alternative for nonpublic companies as follows:

1. FASB’s new Private Company Council (PCC) was created to issue GAAP exceptions and modifications for private companies

2. AICPA created its new Financial Reporting Framework for Small and Medium-Sized Entities (FRF for SMEs)

Let’s take a look at the status of each of these little-GAAP alternatives:

**FASB’s Private Company Council (PCC)**
On May 23, 2012, the FASB’s Financial Accounting Foundation (FAF) Board of Trustees announcing that it was establishing a new body to improve the process of setting accounting standards for private companies, referred to as the **Private Company Council (PCC)**.

According to the FAF, the PCC has the following principal responsibilities:

1. Based on criteria mutually developed and agreed to with the FASB, the PCC determines whether exceptions or modifications to existing nongovernmental U.S. GAAP are necessary to address the needs of users of private company financial statements.

2. The PCC identifies, deliberates, and votes on any proposed changes, which are then subject to *endorsement* by the FASB and submitted for public comment before being incorporated into GAAP.

3. The PCC also serves as the primary advisory body to the FASB on the appropriate treatment for private companies for items under active consideration on the FASB’s technical agenda.

**FASB’s PCC comes to life**

As of April 2016, the PCC Members consist of the following:

<table>
<thead>
<tr>
<th>PCC Members</th>
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<tbody>
<tr>
<td>Candace E. Wright (Council Chair)</td>
</tr>
<tr>
<td>Postlethwaite &amp; Netterville</td>
</tr>
<tr>
<td>Mr. George Beckwith</td>
</tr>
<tr>
<td>National Gypsum Company</td>
</tr>
<tr>
<td>Mr. Steven Brown</td>
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<tr>
<td>U.S. Bank</td>
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<tr>
<td>Mr. Jeffery Bryan</td>
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<tr>
<td>Dixon Hughes Goodman LLP</td>
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<tr>
<td>Timothy J. Curt</td>
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<tr>
<td>Warburg Pincus LLC</td>
</tr>
<tr>
<td>Mr. Mark Ellis</td>
</tr>
<tr>
<td>PetCareRx Inc.</td>
</tr>
<tr>
<td>Carleton Olmanson</td>
</tr>
<tr>
<td>GMB Mezzanine Capital</td>
</tr>
<tr>
<td>Mr. Thomas Groskopf</td>
</tr>
<tr>
<td>Barnes, Dennig &amp; Co., Ltd.</td>
</tr>
<tr>
<td>Mr. Neville Grusd</td>
</tr>
<tr>
<td>Merchant Financial Corporation</td>
</tr>
<tr>
<td>Mr. Carleton Olmanson</td>
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<tr>
<td>GMB Mezzanine Capital</td>
</tr>
<tr>
<td>Ms. Diane Rubin</td>
</tr>
<tr>
<td>Novogradac &amp; Company LLP</td>
</tr>
<tr>
<td>Mr. Lawrence Weinstock</td>
</tr>
<tr>
<td>Mana Products, Inc.</td>
</tr>
<tr>
<td>David S. Lomax</td>
</tr>
<tr>
<td>Liberty Mutual Insurance</td>
</tr>
<tr>
<td>Harold L. Monk Jr.</td>
</tr>
<tr>
<td>Carr, Riggs &amp; Ingram LLC</td>
</tr>
</tbody>
</table>

**PCC Issues Private Company Decision-Making Framework**

The purpose of the Guide is to assist the FASB and PCC in determining whether and in what circumstances to provide alternative recognition, measurement, disclosure, display, effective date, and transition guidance for private company reporting under U.S. GAAP.

**PCC passes its first four statements:**

In January 2014, the FASB endorsed and passed two new statements at the request of the PCC.

In March 2014, the FASB endorsed a third statement, ASU 2014-07 to provide relief to private companies with respect to the consolidation of variable interest entity rules.

In December 2014, the PCC passed its fourth statement, ASU 2014-18: *Business Combinations (Topic 805): Accounting for Identifiable Intangible Assets in a Business Combination*, to allow private companies the option not to allocate a portion of the acquisition cost in a business combination to certain intangible assets other than goodwill.

These four statements, issued in the form of Accounting standards Updates (ASUs), provide exemptions and simpler GAAP application for nonpublic (private) companies as identified in the following table:

<table>
<thead>
<tr>
<th>Description of new ASU for Nonpublic Entities</th>
<th>What the New ASU Does</th>
</tr>
</thead>
</table>
| ASU No. 2014-02: *Intangibles-Goodwill and Other (Topic 350)* Accounting for Goodwill (Issued January 2014) | Allows a nonpublic (private) entity to amortize goodwill on a *straight-line basis over 10 years*, or less if another shorter life is more appropriate.  

Goodwill is tested for impairment when a triggering event occurs that indicates that the fair value of the entity may be below the carrying amount. The automatic annual goodwill impairment test is eliminated if a nonpublic entity elects to amortize goodwill under this ASU. |
| ASU No. 2014-03: *Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps- Simplified Hedge Accounting Approach* (Issued January 2014) | Allows a nonpublic (private) entity to use a simplified hedge accounting approach to account for swaps that are entered into for the purpose of economically converting a variable-rate borrowing into a fixed-rate borrowing.  

Under this approach, the income statement charge for interest expense is similar to the amount that would result if the entity had directly entered into a fixed-rate |
borrowing instead of a variable-rate borrowing and a receive-variable, pay-fixed interest swap.

| ASU 2014-07: Consolidation (Topic 810) - Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements (Issued March 2014) | Allows a nonpublic (private) company lessee to elect an accounting alternative not to consolidate a variable interest entity (VIE) if certain criteria are met. |
| ASU 2014-18: Business Combinations (Topic 805): Accounting for Identifiable Intangible Assets in a Business Combination (Issued December 2014) | Allows a nonpublic (private) company to elect an accounting alternative not to allocate a portion of the acquisition cost of a business combination to certain intangible assets other than goodwill. |

As of April 2016, the PCC has one project on its agenda as follows:

- Definition of a Public Business Entity (phase 2)

Note: The PCC is off to a good start by issuing four statements to date. If the PCC continues with its initial pace, private companies should see a rapid expansion in the number of GAAP exemptions and modification available to private companies.

**FIN 46R and the PCC**

Perhaps PCC's most important achievement to date is the issuance of ASU 2014-07: Consolidation (Topic 810) - Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements, which was issued in March 2014.

The ASU offers an accounting alternative for private companies in applying variable interest entity (VIE) guidance to lessor entities under common control.

Under the ASU, a private company (nonpublic entity) lessee may elect an accounting alternative in applying the variable interest entity rules to a lessor under common ownership.

Under the accounting alternative, a **private company** (nonpublic entity) lessee is not required to consolidate a variable interest entity (VIE) if all of the following **four criteria** are met:

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

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

**Criterion 3:** Substantially all activities between the private company lessee and the lessor entity are related to leasing activities between those two entities.
Criterion 4: If the private company lessee explicitly guarantees or provides collateral for any obligation of the lessor entity related to the asset leased by the private company, then the principal amount of the obligation at inception of such guarantee or collateral arrangement does not exceed the value of the asset leased by the lessee from the lessor entity.

If the four criterion above are met, a private company lessee is not required to consolidate a related-party lessor real estate entity.

Following is an example the illustrates the specific situation that the ASU addresses, which is a common problem for practitioners to apply:

Example: Lease with loan guarantee by owner

Facts:

- John is a 100% shareholder of Company X (lessor VIE) and Company Y (lessee operating company).

- X is a VIE and owns real estate that it leases to Company Y (e.g., LTV is greater than 65%).

- The lease is at a market lease rate with no residual value guarantee, no option to purchase at a fixed price, and no renewal options. There are no variable interests between the parties such as loans, guarantees, etc. (e.g., no financial support is coming from the lessee).

- X has a $1,000,000 bank loan and John has personally guaranteed that loan.

- Y has not guaranteed X’s loan although there are no restrictions to Y if it had chosen to guarantee X’s loan. Y has not guaranteed the loans of any entities in the past.

- John’s primary assets are his 100% equity holding in Y and X.
Under the current FIN 46R rules, if certain conditions are satisfied, FIN 46R requires that the real estate lessor (Company X) be consolidated into the financial statements of the related party lessee (Company Y). Of course, many lenders do not want consolidated financial statements. Moreover, the current FIN 46R rules are unworkable for nonpublic entities that have to test to determine whether a consolidation is required in the first place.

Under ASU 2014-07, Company Y (lessee), as a private company, would not be required to consolidate Company X (real estate lessor) if the four criteria are satisfied as follows:

**Criterion 1:** Y (the reporting entity) and X (lessor entity) are under common control.

**Criterion 2:** Y has a *lease arrangement* with X.

**Criterion 3:** *Substantially all activities* between Y and the X are related to leasing activities between those two entities.

**Criterion 4:** If Y *explicitly guarantees* or *provides collateral* for any obligation of X related to the asset leased by Y, then the principal amount of the obligation at inception of such guarantee or collateral arrangement *does not exceed the value of the asset* leased by Y from X.
**AICPA’s FRF for SMEs**

In the previous section, the author addressed the activities of the Private Company Council (PCC) which is the FASB’s solution to the little GAAP (private company) problem.

As a counter-punch to the FASB taking control over the nonpublic company issue through the newly established PCC, the AICPA took its own action to deal with the needs of nonpublic (private) companies.

On May 23, 2012, the AICPA announced that it was developing a financial reporting framework for private small-and medium-sized entities (FRF for SMEs) that do not need U.S. GAAP financial statements. Contrary to the FASB’s PCC that works within existing GAAP, the AICPA’s approach is to develop a non-GAAP alternative in the form of the FRF for SMEs.

According to the AICPA, the AICPA’s FRF for SME framework would be less complicated and a less costly alternative system of accounting to U.S. GAAP for private companies that do not need U.S. GAAP financial statements.

Barry Melancon, President of the AICPA stated:

“In addition to advocating for appropriate differences in U.S. GAAP to recognize the unique circumstances of the private company environment, we will be launching a complementary OCBOA financial reporting framework. The enhanced and simplified financial reporting framework will be a cost beneficial solution for smaller privately held entities that do not need to comply with U.S. GAAP.”

In 2013, the AICPA issued a final framework for FRF for SMEs, entitled, *Financial Reporting Framework for Small- and Medium-Sized Entities*. The framework consists of 188 pages, and represents the entire codification of FRF for SMEs.

The FRF for SMEs:

- Represents one additional financial reporting framework consisting of a set of criteria used to determine measurement, recognition, presentation, and disclosure of all material items appearing in the financial statements.

- Is a self-contained special-purpose framework intended for use by privately held small-to-medium-sized entities (SMEs) in preparing their financial statements.

- Draws upon a blend of traditional methods of accounting with some accrual income tax methods.

- Is a non-authoritative framework.
One key point that appears to be of great concern to practitioners is that the FRF for SMEs is a non-authoritative framework. The FRF for SMEs has not been approved, disapproved, or otherwise acted upon by any senior technical committee of the AICPA or the FASB and therefore has no official or authoritative status. Therefore, a large question is whether third party users will accept a non-authoritative framework, particularly if the AICPA does not get behind educating third party users about it.

Is the FRF for SMEs a special-purpose framework under auditing standards and the SSARSs?

Yes, the provisions of AU-C Section 800, Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks (AICPA, Professional Standards), apply to financial statements prepared under the FRF for SMEs. AU-C section 800, states that if special-purpose framework financial statements include items that are the same or similar to those in GAAP financial statements, similar informative disclosures are required.

The AICPA has stated that it believes the FRF for SMEs consists of disclosures that are similarly informative disclosures to GAAP.

What are some of the differences between FRF for SMEs and traditional GAAP?

Embedded within the 188 pages of the FRF for SMEs framework are numerous abbreviated disclosures.

Following is a listing of some of the key recognition, measurement and disclosure standards found in the FRF for SMEs:

<table>
<thead>
<tr>
<th>Key Provisions within FRF for SMEs Framework</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>General provisions:</strong></td>
</tr>
<tr>
<td>The proposed framework is built upon a foundation of reliable and comprehensive accounting principles:</td>
</tr>
<tr>
<td>• <strong>Historical cost is the primary measurement basis.</strong></td>
</tr>
<tr>
<td>• Disclosures are reduced, while still providing users with the relevant information they need.</td>
</tr>
<tr>
<td>• Familiar and traditional accounting methods are employed.</td>
</tr>
<tr>
<td>• Adjustments needed to reconcile tax return income with book income are reduced.</td>
</tr>
<tr>
<td>• The framework is a principles-based framework, usable across industries by incorporated and unincorporated entities.</td>
</tr>
<tr>
<td>• The framework contains less complicated, leaner, relevant financial reporting principles for SMEs.</td>
</tr>
</tbody>
</table>
• Only financial statement matters that are typically encountered by SMEs are addressed in the framework.

• There is no concept of comprehensive income.

Specific rules:
  • Historical cost is be used
    • Fair value is eliminated except for available-for-sale securities which are be recorded at fair value
    • Inventories are measured at lower of cost or market, using FIFO, LIFO, average cost
    • Fixed assets:
      – Same rules as existing GAAP
      – Depreciation based on useful lives of assets
      – Still does not allow 179/bonus depreciation
  • Lease accounting:
    – Recorded as a capital or operating lease based on whether substantially all of the risks and benefits of ownership transfer
    – Existing five-year disclosures of lease payments remain in effect
  • Financial instruments: cost is used except for available-for-sale securities for which fair value would be used
  • Derivatives are disclosed only
  • Equity method- follows existing GAAP and is used if there is significant influence presumed at 20-50% ownership
  • % completion or completed contract methods are retained
  • Consolidations:
    – No consolidation of variable interest entities (VIEs)
    – Consolidate occurs only if there is more than 50% ownership
    – Parent-only financial statements are available where the subsidiary could be recorded using the equity method instead of consolidating
  • Income taxes: The company has the choice of:
    – Recording deferred income taxes, or
    – Recording only the current tax provision without deferred income taxes
  • Intangible assets other than goodwill:
    - Would be amortized over their useful life.
    - Intangibles would be tested for impairment unless the life is indefinite.
  • Goodwill is amortized over the tax life of 15 years.
If GW is not amortized for tax purposes, it would be amortized over 10 years
No impairment tests is required for goodwill and indefinite-lived intangibles

- Impairment:
  - Impairment rules would apply to fixed assets, inventory, equity method investments, intangible assets with finite lives.
  - Reversal of impairment losses is required except for intangible assets with finite lives
  - Impairment rules do not apply to goodwill and indefinite lived intangibles.

- Pushdown accounting is allowed when there is a stock redemption or stock purchase

- Statement of cash flows required:
  - Cash and cash equivalents should include those bank accounts with positive balances only
  - Interest and income taxes paid would not be disclosed

- Start-up costs are capitalized if capitalized for tax purposes

- Defined benefit pension plans:
  - Pension liabilities may be measured using either the current contribution payable method (only the contribution attributable to the current year is expensed), or
  - the accrued benefit obligation method (an accrued benefit obligation is recorded)

- FRF for SMEs would not apply to non-profit organizations

- The FRF for SMEs framework would be “stable” so that changes would be made only every 3-4 years only

In a Q&A published by the AICPA:

**Question:** Will lenders/financial institutions accept financial statements prepared under the FRF for SMEs?

**AICPA Response:** Owner-managers and their CPA practitioners will need to consult with lenders and other key external stakeholders about the use of the FRF for SMEs. With substantial relevance and cost-benefit factors, the AICPA believes that the lending community will accept financial statements prepared under the FRF for SMEs. Lenders are often very flexible in accommodating various financial frameworks for smaller entities.

The AICPA’s response noted above is a foreshadowing of problems with FRF for SMEs. Notice “owners-managers and their CPA practitioners need to consult with lenders.” Nothing is mentioned about a vigorous marketing campaign initiated by the AICPA. Simply put, if the AICPA does not get behind its own product and endorse and promote it with third parties, its use will wither on the vine.

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Why wouldn’t a practitioner simply use tax-basis financial statements instead of the FRF for SMEs?

In looking at FRF for SMEs and the fact that it is a nonauthoritative framework with no AICPA promotion of its use, one has to ask why a practitioner wouldn’t simply suggest to his or her client to use tax-basis accrual financial statements instead of FRF for SMEs. Both frameworks are considered a special-purpose framework and not GAAP. FRF for SMEs looks very similar to the way GAAP looked thirty years ago before the FASB issued many of the recent complex and controversial standards. However, one might conclude that once there is a deviation from U.S. GAAP, income tax basis financial statements might be more easily accepted by banks. Moreover, tax-basis financial statements are probably a more meaningful special-purpose framework because it is based on income tax reporting, a framework that is understandable to a nonpublic company client.

Why doesn’t a U.S. private company simply adopt the European version of SMEs?

Europe’s IASB has been ahead of the U.S on the little-GAAP issue, with its own IFRS for SMEs (small and medium-sized entities) for their private companies.

IFRS for SMEs is not to be confused with the AICPA’s FRF for SMEs.

In Europe, the IASB already has its own small business GAAP framework for small to medium sized entities referred to as IFRS for SMEs, which was issued in July 2009.

The IFRS for SMEs is an abbreviated standard that was adopted by numerous countries. According to the IASB publication, *A Guide to the IFRS for SMEs*, more than 68 jurisdictions have either adopted IFRS for SMEs or have committed to adopt it over the next three years. United States companies can adopt it presently but few companies have done so.

The key difference between the IFRS for SMEs as compared with full IFRS, is that:

a. The *IFRS for SMEs* is much less complex than full IFRS due to the simpler reporting needs of most small and medium-sized entities, and

b. Listed companies (public companies) and financial institutions should not use IFRS for SMEs while they can and do use full IFRS. U.S. public companies are permitted to use IFRS but should not use IFRS for SMEs.

Consider the following attributes found in the IFRS for SMEs:

- There are only 230 pages of material in the IFRS for SMEs as compared with thousands of pages in the full set of IFRS.

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10 A Guide to the IFRS for SMEs (IASB)
- It is organized by topic within 35 sections.

- Topics that are not relevant to small and medium-sized private companies have been omitted and many principles have been simplified.

  Examples: Amortization of goodwill and the accounting for investments have been simplified from the approach under IFRS.

  - The IFRS for SMEs only allows use of the easiest option among a choice of accounting policies available under IFRS.

  - There are significantly fewer disclosures required (roughly 300 versus 3,000) as compared with the full IFRS.

  - The standard has been written in a clear and easily translatable language.

  - To further reduce the burden for SMEs, revisions to the IFRS for SMEs are limited to once every three years.

According to a document published by the IASB, more than 95 percent of all companies worldwide are eligible to use IFRS for SMEs: 11

a. There are only 45,000 public companies worldwide (listed on the 52 largest stock exchanges) that must use full IFRS or United States GAAP.

b. All other companies, which are primarily private companies, are eligible to use the IFRS for SMEs.

- Europe and the United States have approximately 53 million private companies:
  - Europe has 33 million (U.K. alone has 4.5 million)
  - United States has 20 million

**Note:** There is a discrepancy between the number of private companies in the United States as identified in the IASB report and the Blue Ribbon Panel Report. The IASB states that there are 20 million private companies in the United States while the Blue Ribbon Report states there are 28 million.

**Are U.S. private companies permitted to adopt the IASB’s IFRS for SMEs?**

Although public companies, in general, should not use IFRS for SMEs, U.S. private companies are permitted (but not required) to adopt the IFRS for SMEs.

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11 A Guide to the IFRS for SMEs (IASB)
Even though the rest of the world appears slated to adopt the IFRS for SMEs, the author believes it is dubious that many U.S. private companies will adopt IFRS for SMEs unless they have to use it for international reporting. Under the current reporting needs, few U.S. private companies have to issue their financial statements to international third parties. Consequently, use of IFRS for SMEs may be useful, but is not likely to be a priority for most U.S. private companies.

Moreover, if IFRS for SMEs were to be used by U.S. private companies, there is a question as to whether U.S. third-party users (banks, etc.) would understand it or even permit it. Most loan documents in the United States, for example, state that financial statements must be prepared in accordance with U.S. GAAP. Changing that requirement to IFRS for SMEs is likely to be difficult, if not impossible, as banks and other third parties are reluctant to accept an accounting standards that they do not understand.

**Why didn’t the AICPA simply adopt the IASB’s IFRS for SMEs instead of creating its own FRF for SMEs?**

It would seem that the AICPA could have endorsed and supported the existing IFRS for SMEs instead of adopting its own FRF for SMEs. After all, the codification for IFRS for SMEs was already written and approved for use by U.S. private companies.

It its Q&A, the AICPA offered the following question and answer:

**Question:** Why not promote the use of IFRS for SMEs rather than develop a new framework?

**AICPA Response:** The International Accounting Standards Board has been recognized by the AICPA as an international accounting standard setting body and, as a result, the IFRS for SMEs may be an alternative for those SMEs needing GAAP financial statements. Although there will be some similarities between the FRF for SMEs framework and the IFRS for SMEs, the AICPA believes that the FRF for SMEs framework will be more understandable and more useful at this time because it is specifically written for U.S. entities. Additionally, the FRF for SMEs framework will reduce differences between the FRF for SMEs framework and the U.S. tax code. For example, last-in, first-out (LIFO) inventory is not permitted by the IFRS for SMEs whereas it will be permitted by the FRF for SMEs framework.

**The multiple framework options for nonpublic entities**

With the advent of the FASB’s Private Company Council (PCC) and the AICPA’s FRF for SMEs, U.S. nonpublic companies now have several special-purpose frameworks from which to choose.

Consider the list of reporting alternatives for U.S. nonpublic entities:
## Types of Frameworks Available (or Pending) For U.S. Nonpublic Entities

<table>
<thead>
<tr>
<th>Framework</th>
<th>Comments</th>
</tr>
</thead>
</table>
| U.S. GAAP | • In effect but getting more complex  
• Generally accepted by all third parties |
| U.S. GAAP with GAAP exceptions | • Can be used but the number of GAAP exceptions that can be included in the report is limited |
| Income-tax-basis financial statements | • Popular special-purpose framework effective for profitable, nonpublic businesses  
• Many third parties accept its use |
| FASB’s Private Company Council Framework (GAAP Light) | • Goal is to create exceptions and exclusions to existing GAAP for nonpublic entities  
• Authoritative and endorsed by the FASB |
| AICPA’s Financial Reporting Framework for Small- to Medium-Sized Entities (FRF for SMEs) | • Simpler version of U.S. GAAP  
• Non-authoritative  
• Concern about whether third parties will accept its use |
| IASB’s IFRS for SMEs | • Can be used by U.S. nonpublic entities  
• U.S. accountants and third party users are not familiar with its application |

The FASB’s PCC framework and AICPA’s FRF for SMEs are in their infancy, but will evolve over the next two years. In the end, the author believes that survivors of this “little-GAAP” battle will be:

- U.S. GAAP
- FASB’s PCC framework
- Tax-basis financial statements

The author predicts that going forward, accountants will issue either full, traditional U.S. GAAP financial statements, or will default to the FASB’s PCC framework that will offer exemptions and exclusions to U.S. GAAP for nonpublic companies. The PCC framework is authoritative so that practitioners and their clients will not have trouble with third parties accepting the PCC framework. In situations in which the practitioner and his or her client seek to use a nonauthoritative framework, the author thinks that practitioners will use tax-basis financial statements and not the AICPA’s FRF for SMEs, unless, and only unless, FRF for SMEs becomes acceptable to third parties.
H. Going Concern Assessment by Management – ASU 2014-15

In this section, the author addresses the recently issued ASU 2014-15, Presentation of Financial Statements- Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern. ASU 2014-15 requires management to perform a going concern assessment of an entity.

With the introduction of ASU 2014-15, now both management and the auditor must perform their own separate going-concern assessments of the same entity. This section addresses the new GAAP rules in ASU 2014-15.

Background- going concern

For years, the rules for going concern have been found in auditing literature within AU-C Section 570, The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern (formerly SAS No. 59), which requires an auditor to assess whether an entity has the ability to continue as a going concern for a reasonable period of time (usually one year from the balance sheet date.) Because going concern is a GAAP issue, it belongs within accounting literature, in addition to auditing standards.

In 2015, Audit Analytics issued a report in which it performed a 15-year study of going-concern opinions.

The report, which samples financial statements through 2014, identifies the following trends:

1. 2014 going-concern report modifications were at the lowest level over a 15-year period.

<table>
<thead>
<tr>
<th>Year</th>
<th>Going-concern opinions</th>
</tr>
</thead>
<tbody>
<tr>
<td>2014</td>
<td>2,233</td>
</tr>
<tr>
<td>2013</td>
<td>2,403</td>
</tr>
<tr>
<td>2012</td>
<td>2,565</td>
</tr>
<tr>
<td>2011</td>
<td>2,670</td>
</tr>
<tr>
<td>2010</td>
<td>2,988</td>
</tr>
<tr>
<td>2009</td>
<td>3,102</td>
</tr>
<tr>
<td>2008</td>
<td>3,355</td>
</tr>
</tbody>
</table>

Source: Audit Analytics, 2015

2. 15.8% of auditor opinions filed in 2014 contained a going-concern report modification. [The highest percentage was 21.1% in 2008, and lowest was 14.2% in 2000.]

**What percentage of companies recover from a going-concern report modification?**

Interestingly, only a small percentage (ranging from 5% to 9%) of companies that had going concern report modifications rebounded with a clean opinion in the subsequent year.

The following table shows the details:

<table>
<thead>
<tr>
<th>Current year</th>
<th># going concerns prior year</th>
<th># clean opinions current year, going concern prior year</th>
<th>% recovery in subsequent year</th>
</tr>
</thead>
<tbody>
<tr>
<td>2014</td>
<td>2,403</td>
<td>200</td>
<td>8.3%</td>
</tr>
<tr>
<td>2013</td>
<td>2,565</td>
<td>188</td>
<td>7.3%</td>
</tr>
<tr>
<td>2012</td>
<td>2,670</td>
<td>144</td>
<td>5.4%</td>
</tr>
<tr>
<td>2011</td>
<td>2,988</td>
<td>208</td>
<td>7.0%</td>
</tr>
<tr>
<td>2010</td>
<td>3,102</td>
<td>276</td>
<td>8.9%</td>
</tr>
<tr>
<td>2009</td>
<td>3,355</td>
<td>265</td>
<td>7.9%</td>
</tr>
<tr>
<td>2008</td>
<td>3,309</td>
<td>200</td>
<td>6.0%</td>
</tr>
<tr>
<td>2007</td>
<td>2,878</td>
<td>253</td>
<td>8.8%</td>
</tr>
</tbody>
</table>

Source: Audit Analytics, 2015, as modified by Author.

**Observation:** The previous table illustrates a key point with respect to going-concern report modifications. If such a report modification is made, it can result in the demise of a company in the subsequent years. A very low percentage of companies subsequently survive a going-concern report modification.

**Going Concern- GAAP - FASB issues ASU 2014-15**


ASU 2014-15 provides guidance about *management’s responsibility* to evaluate an entity’s ability to continue as a going concern and to provide related disclosures. Previously, no such guidance existed in GAAP.

ASU 2014-15 is effective for the annual period *ending after December 15, 2016*, and for annual periods and interim periods thereafter. Early application is permitted.
The objective of ASU 2014-15 is to provide guidance for evaluating whether there is substantial doubt about an entity’s ability to continue as a going concern and about related footnote disclosures.

ASU 2014-15 does the following:

a. Requires *management to make an evaluation of going concern* every reporting period, including interim periods.

b. Defines the term *substantial doubt* about an entity’s ability to continue as a going concern (substantial doubt) as follows:

"Substantial doubt about an entity’s ability to continue as a going concern exists when conditions and events, considered in the aggregate, indicate that it is probable that the entity will be unable to meet its obligations as they become due within one year after the date that the financial statements are issued (or within one year after the date that the financial statements are available to be issued when applicable)."

**Note:** The term "probable" is used consistently with its use in Topic 450 on contingencies.

c. Provides that management should consider the mitigating effect of management’s plans only to the extent it is probable the plans will be effectively implemented and mitigate the conditions or events giving rise to substantial doubt.

d. Requires certain disclosures when substantial doubt is alleviated as a result of consideration of management’s plans

e. Requires an explicit statement in the notes that there is substantial doubt and other disclosures when substantial doubt is not alleviated, and

f. Requires an evaluation for a period of one year after the date that the financial are issued (or available to be issued if a nonpublic entity).\(^{12}\)

### I. Sustainability Standards – a Hot Issue

If keeping up with GAAP standards is not difficult enough, now there is a new set of standards that deal with "sustainable" accounting standards.

\(^{12}\) Auditing standards and SSARS No. 21 (compilation and review standards) have modified the going concern period to be the same as the one year period found in ASU 2014-15, which is one year from the issued or available to be issued date.
In 2011, the Sustainability Accounting Standards Board (SASB) was created with a goal to develop sustainability accounting standards that would "guide" SEC companies in disclosing material factors that the SEC requires companies to address in their filings.

According to the SASB, the Board is a non-profit organization funded by several private foundations. Some of its supporters include:

- Bloomberg Philanthropies
- Kresge Foundation
- Rockefeller Foundation
- FB Heron

The SASB notes the following based on information published on its website (www.sasb.org):

- Through 2016, SASB is developing sustainability accounting standards for more than 80 industries in 10 sectors.

- SASB standards are designed for the disclosure of material sustainability issues in mandatory SEC filings, such as the Form 10-K and 20-F.

- SASB is also an ANSI accredited standards developer. Accreditation by ANSI signifies that SASB’s procedures to develop standards meet ANSI’s requirements for openness, balance, consensus, and due process.

- SASB is not affiliated with FASB, GASB, IASB or any other accounting standards boards.

To date, the SASB has issued sustainability accounting standards for the following industries:

- Health care
- Financials
- Technology and communication
- Non-renewable resources
- Transportation
- Services

**Does GAAP or the SEC require disclosures of sustainability?**

The SASB is relying on certain provisions within SEC filing requirements and is interpreting them to mean that an SEC company must include disclosures about sustainability.

**SEC disclosure requirements**
When a public company is required to file a disclosure document with the SEC under SEC Regulation S-K and Regulation S-X\(^\text{13}\), in addition to information expressly required to be filed, the company must disclose:

> “such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading.”

Regulation S-K already requires companies to disclose environmental issues as they relate to:

**Description of business (Item 101):** including the material effects that compliance with Federal, State and local environmental laws may have upon the capital expenditures, earnings and competitive position.

**Legal proceedings (Item 103):** including any material pending legal proceeding to which it is a party including a description of material pending legal actions in which its property is the subject of the litigation.

**Risk factors (Item 503):** consisting of the most significant factors that make an investment in the registrant speculative or risky.

**Management Discussion and Analysis (Item 303):** consisting of various disclosures that provide a narrative explanation of the financial statements that enhance disclosures and provide information about the quality of, and potential variability of earnings and cash flow. Such disclosures includes known trends, events, demands, commitments, and uncertainties that are reasonably likely to have a material effect on financial condition or operating performance.

In addition to Regulation S-K disclosures, Securities Act Rule 408 and Exchange Act Rule 12b-20 require a registrant to disclose, in addition to the information expressly required by law or regulation:

> “such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading.”

In the SASB’s "Legal Q&A" the SASB addresses the issue of whether SEC companies must disclose information about sustainability.

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\(^{13}\) Regulation S-X deals with the form, content and requirements of financial statements issued by public companies.
LEGAL Q&A (SASB):

Are companies required to disclose material sustainability information under current regulations, rules, or case law?

Corporations subject to SEC filing requirements must disclose material information in their SEC filings, such as the Form 10-K. Several rules and regulations, including Regulation S-K and the Sarbanes-Oxley Act, arguably require the disclosure of material sustainability information on Form 10-K and other periodic SEC filings in some circumstances (e.g., as discussed in the SEC Guidance on Disclosures Regarding Climate Change⁸ and the SEC’s Disclosure Guidance on Cybersecurity).

Securities Act Rule 408 and Exchange Act Rule 12b-20 require a registrant to disclose, in addition to the information expressly required by line-item requirements, “such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading.” For example, if a pharmaceutical company states that its continued success depends on maintaining a strong reputation for safety, then the company should consider disclosing information regarding Drug Safety and Side Effects, Safety of Clinical Trial Participants, and Counterfeit Drugs, all of which are SASB disclosure topics in the Pharmaceutical industry. Making the disclosures about Drug Safety and Side Effects, Safety of Clinical Trial Participants, and Counterfeit Drugs can help the company satisfy Rule 12b-20. Depending on the company’s performance on the SASB disclosure topics, shareholders could allege that the disclosure about reputation for safety, by itself, is materially misleading. Further, the SEC explains that a company’s disclosure controls and procedures should not be limited to disclosure specifically required, but should also ensure timely collection and evaluation of “information potentially subject to [required] disclosure,” “information that is relevant to an assessment of the need to disclose developments and risks that pertain to the [company’s] businesses,” and “information that must be evaluated in the context of the disclosure requirement of Exchange Act Rule 12b-20.

Source: SASB Legal Q&A

Following is an excerpt from the SASB Sustainability Accounting Standard related to the Containers & Packaging industry.
1. Industry-Level Sustainability Disclosure Topics

For the Containers & Packaging industry, SASB has identified the following sustainability disclosure topics:

- Greenhouse Gas Emissions
- Air Quality
- Energy Management
- Water Management
- Waste Management
- Product Safety
- Product Lifecycle Management
- Materials Sourcing

Guidance on Accounting for Material Sustainability Topics

For each sustainability topic included in the Containers & Packaging industry Sustainability Accounting Standard, SASB identifies accounting metrics.

SASB recommends that each company consider using these sustainability accounting metrics when preparing disclosures on the sustainability topics identified herein;

As appropriate—and consistent with Rule 12b-206—when disclosing a sustainability topic identified by this Standard, companies should consider including a narrative description of any material factors necessary to ensure completeness, accuracy, and comparability of the data reported.

Where not addressed by the specific accounting metrics, but relevant, the registrant should discuss the following, related to the topic:

- The registrant’s **strategic approach** to managing performance on material sustainability issues;
- The registrant’s **relative performance** with respect to its peers;
- The **degree of control** the registrant has;
- Any **measures the registrant has undertaken** or **plans to undertake** to improve performance; and
- Data for the registrant’s **last three completed fiscal years** (when available).
SASB recommends that registrants use SASB Standards specific to their primary industry as identified in the Sustainable Industry Classification System (SICS™). If a registrant generates significant revenue from multiple industries, SASB recommends that it also consider sustainability topics that SASB has identified for those industries and disclose the associated SASB accounting metrics.

In disclosing to SASB Standards, it is expected that registrants disclose with the same level of rigor, accuracy, and responsibility as they apply to all other information contained in their SEC filings.

**Note:** The SASB is using SEC regulations to put pressure on SEC companies to include sustainability (climate change) disclosures in their SEC filings. In particular, the SASB is taking the position that an entity that does not including sustainability (climate change) disclosures in their filings and financial statements is issuing misleading financial statements.

As just discussed, Securities Act Rule 408 and Exchange Act Rule 12b-20 require a registrant to disclose, in addition to the information expressly required by law or regulation:

> “such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading.”

Even though Rule 408 is not specific, there is enough guidance to provide SASB with information to force SEC companies to include sustainability (climate change) disclosures.

**SEC created the impetus for sustainability disclosures**

The SEC helped create SASB by giving credibility to the “climate change” or “sustainability” movement.

It started in February 2010 when the SEC issued, *Commission Guidance Regarding Disclosure Related to Climate Change* (the SEC Release). The SEC Release provided public companies with interpretive guidance on existing SEC disclosure requirements as they apply to business or legal developments relating to the issue of climate change. Since time, the term "climate change" is more frequently replaced with the term "sustainability."

The SEC Release provides guidance on certain existing disclosure rules that may require a company to disclose the impact that business or legal developments related to climate change may have on its business.

The relevant rules cover a:

- Company's risk factors
- Business description
- Legal proceedings, and
- Management discussion and analysis.
Specifically, the SEC's interpretative guidance highlights the following areas as examples of where climate change may trigger disclosure requirements:

- **Impact of Legislation and Regulation**: When assessing potential disclosure obligations, a company should consider whether the impact of certain existing laws and regulations regarding climate change is material. In certain circumstances, a company should also evaluate the potential impact of pending legislation and regulation related to this topic.

- **Impact of International Accords**: A company should consider, and disclose when material, the risks or effects on its business of international accords and treaties relating to climate change.

- **Indirect Consequences of Regulation or Business Trends**: Legal, technological, political and scientific developments regarding climate change may create new opportunities or risks for companies such as:
  - Decreased demand for goods that produce significant greenhouse gas emissions, or
  - Increased demand for goods that result in lower emissions than competing products.

A company should consider, for disclosure purposes, the actual or potential indirect consequences it may face due to climate change related regulatory or business trends.

- **Physical Impacts of Climate Change**: Companies should also evaluate for disclosure purposes, the actual and potential material impacts of environmental matters on their business.

In October 2011, the SEC also issued guidance on cybersecurity and referenced the fact that SEC companies should disclose the risk of cyber incidents as significant risk factors, as well. Thus, once the SEC opened the notion that companies should address climate change/sustainability disclosures, it validated such disclosures.

**Are sustainability disclosures going to become a requirement under GAAP?**

There is a movement afloat to further push the SEC to force public companies to make disclosures related to risks associated with climate change, sustainability, and other environmental risks. Although a company’s financial statement users may be interested in the overall risks surrounding a company, query whether such information should involve risks that, in and of themselves, might be remote and, if active, would have a long-term (not short-term) impact on the entity, such as climate change and sustainability.

The purpose of this section of the course is to educate the reader as to the trend that is occurring in requiring companies to expand disclosures of sustainability and the advent of the SASB movement.
First, let’s look at the basic SEC rules related to disclosures of risks and uncertainties.

**GAAP disclosure requirements:**

The GAAP rules for disclosing risks and uncertainties are found in ASC 275, *Risks and Uncertainties* (formerly SOP 94-6), and apply to all companies.

ASC 275 requires reporting entities to make disclosures in their financial statements about the risks and uncertainties existing as of the date of those statements in the following areas:

a. Nature of operations
b. Use of estimates in the preparation of financial statements
c. Certain significant estimates
d. Current vulnerability due to certain concentrations (e.g., major customers, suppliers, etc.)

ASC 275’s disclosure requirements do not apply to risks and uncertainties that might be associated with any of the following:

- Management or key personnel
- Proposed changes in government regulations
- Proposed changes in accounting principles
- Deficiencies in the internal control structure, and
- The possible effects of acts of God, war, or sudden catastrophes.

The following chart compares the disclosure requirements for risks and uncertainties under SEC and GAAP rules:
### Disclosures of Risks and Uncertainties

<table>
<thead>
<tr>
<th>SEC</th>
<th>GAAP</th>
</tr>
</thead>
<tbody>
<tr>
<td>SEC Regulation S-K requires disclosure of:</td>
<td>ASC 275, Risks and Uncertainties (formerly SOP 94-6) requires disclosure of:</td>
</tr>
<tr>
<td>Risk factors (Item 503):</td>
<td>Current Vulnerability Due to Certain Concentrations:</td>
</tr>
<tr>
<td>Requires disclosure of the most significant factors that make an investment in the registrant speculative or risky.</td>
<td>Requires disclosure of the concentrations if, based on information known to management before the financial statements are issued or are available to be issued, and all of the following criteria are met:</td>
</tr>
<tr>
<td>SEC Act Rule 12b-20 require a registrant to disclose:</td>
<td>• The concentration exists at the date of the financial statements.</td>
</tr>
<tr>
<td>“such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading.”</td>
<td>• The concentration makes the entity vulnerable to the risk of a near-term severe impact (within one year).</td>
</tr>
</tbody>
</table>

---

**SEC puts pressure on SEC companies to expand climate change/risk disclosures:**

In looking at the GAAP and SEC disclosures related to sustainability/climate issues, the rules that push companies to expand climate change/risk disclosures are found within the SEC rules, not the GAAP rules.

Recapping, Regulation S-K requires companies to disclose environmental issues as they relate to:

- a. Description of business (Item 101)
- b. Legal proceedings (Item 103)
- c. **Risk factors (Item 503)**
- d. Management Discussion and Analysis (Item 303)

Notice that the author highlighted “risk factors” because this is one of the section of the Regulation S-K rules that the SASB and SEC are using the force companies to expand their environmental and climate risk disclosures.

**What is the future of climate change (sustainability) disclosures?**
SEC companies continue to be under pressure from environmental groups and the SEC to expand their disclosures of the potential risks associated with climate change and sustainability. Expansion of disclosures related to climate change/sustainability is just a symptom of a much larger challenge. In some instances, companies are being sued for not having effective climate change/sustainability disclosures.

Although the FASB does not have a specific project in the works to enhance disclosures involving environmental issues and climate change, expect this to change in the next few years. It is common for GAAP changes to start with proposed changes and enhancements for public company disclosures and then to be applied to nonpublic companies.

With the intensive drive of the SASB movement, it is just a matter of time before the FASB is coerced into expanding climate change and other environmentally related disclosures for all companies, public and nonpublic, alike.

**Are nonpublic companies required to make disclosures about climate change?**

Using today as a snapshot in time, nonpublic companies *are not required* to make climate change disclosures unless it is reasonably possible that the climate change risk could expose the company to *a near-term (one year or less) severe impact* on its operations. In most cases, such a risk does not exist.

Because SEC rules do not apply to nonpublic companies, the GAAP rules for disclosing risks and uncertainties are found in ASC 275, *Risks and Uncertainties* (formerly SOP 94-6).

ASC 275 requires that reporting entities shall make disclosures in their financial statements about the risks and uncertainties existing as of the date of those statements in the following areas:

a. Nature of operations  
b. Use of estimates in the preparation of financial statements  
c. Certain significant estimates  
   **d. Current vulnerability due to certain concentrations.**

ASC 275’s disclosure of the current vulnerability due to certain concentrations rules do not encompass risks and uncertainties that might be associated with any of the following:

- Management or key personnel  
- Proposed changes in government regulations  
- Proposed changes in accounting principles  
- Deficiencies in the internal control structure
The possible effects of acts of God, war, or sudden catastrophes.

Out of the four disclosures required for risks and uncertainties, the only one that could require a nonpublic entity to make general climate change disclosures would be the disclosure about the “current vulnerability due to certain concentrations.”

**Current vulnerability due to certain concentrations disclosure and climate/sustainability risk**

ASC 275 states that the vulnerability from concentrations arises because an entity is exposed to risk of loss greater than it would have had it mitigated its risk through diversification.

Financial statements shall disclose the concentrations if, based on information known to management before the financial statements are issued or are available to be issued, all of the following criteria are met:

1. The concentration exists at the date of the financial statements.
2. The concentration makes the entity vulnerable to the risk of a *near-term severe impact*.
3. It is at least *reasonably possible* that the events that could cause the severe impact will occur in the near term.

In order for there to be a concentration that exposes an entity to a *near-term severe impact*, it must be at least *reasonably possible* that such a severe impact will occur in the near term.

ASC 275 defines *near term*, and *severe impact* as the following:

**Near term**: is defined as a period of time *not to exceed one year* from the date of the financial statements.

**Severe impact**: is defined as a *significant financially disruptive effect on the normal functioning of an entity*. Severe impact is a higher threshold than material. Matters that are important enough to influence a user's decisions are deemed to be material, yet they may not be so significant as to disrupt the normal functioning of the entity.

**Examples of group concentrations:**

Concentrations can fall into the following categories, among others:

a. Concentrations in the volume of business transacted with a particular customer, supplier, lender, grantor, or contributor.

b. Concentrations in revenue from particular products, services, or fund-raising events.
c. Concentrations in the available sources of supply of materials, labor, or services, or of licenses or other rights used in the entity's operations.

d. Concentrations in the market or geographic area in which an entity conducts its operations.

So, do the concentration of risk rules under ASC 275 require a nonpublic company to make general risk disclosures about climate change?

The author believes there is no concentration of risk that requires disclosure pertaining to climate change or overall climate risk.

Here is the reason.

First, in order to have a concentration of risk and uncertainty disclosure under ASC 275, there must be a concentration of some kind.

Then, three conditions must be satisfied:

a. The concentration must exist at the date of the financial statements.

b. The concentration must make the entity vulnerable to the risk of a near-term (one year) severe impact.

c. It must be at least reasonably possible that the events that could cause the severe impact will occur in the near term.

As to climate change or general environmental disclosures, in order to apply the disclosure rules of ASC 275, there must be a concentration of some kind.

First, the concentration (exposure to climate change) must exist at the date of the financial statements. There could certainly be a concentration, particularly if an entity operates in an industry that is exposed to the risks from climate change.

Second, the concentration (e.g., exposure to climate or environmental change) must make the entity vulnerable to a risk of a near-term, severe impact. That means that the concentration (climate change) must expose the company to a significant financially disruptive effect on the normal operations, and it must be reasonably possible that it will occur within one year from the balance sheet date.

Third, it must be reasonably possible (less than probable and greater than remote) that the events that could occur (e.g., climate change) could cause a near-term severe impact.

The problem with climate change is that if it is real, it has its effect gradually over time and not necessarily within one year from the balance sheet. Thus, the ASC 275 rule that discloses that it
is reasonably possible that the concentration of risk could cause a near-term severe impact, is not likely to apply.

There is one additional point that supports that climate change disclosures are not required for nonpublic entities under ASC 275. Specifically, ASC 275’s disclosure requirements do not apply to risks and uncertainties that might be associated with any of the following:

- Management or key personnel
- Proposed changes in government regulations
- Proposed changes in accounting principles
- Deficiencies in the internal control structure
- *The possible effects of acts of God, war, or sudden catastrophes.*

Notice that the fifth exception is a concentration related to “*the possible effects of acts of God, war, or sudden catastrophes*.” There is an argument that climate change is an act of God for which GAAP (ASC 275) exempts disclosure of the risks and uncertainties.

In conclusion, unless a nonpublic entity is exposed to a short-term (one year or less) severe impact on its business due to climate change, there is no disclosure required for that nonpublic entity.

**AICPA is getting into the sustainability game**

It appears that sustainability engagements are becoming big business as more SEC companies are either compelled or motivated to engage in sustainability reporting.

In December 2012, the AICPA created a *Sustainability Task Force* to address sustainability issues. The Task Force was created under the guidance of the AICPA Assurance Services Executive Committee (ASEC).

**SOP 13-1**

In August 2012, the AICPA Auditing Standards Board (ASB) issued SOP 13-1, *Attest Engagements on Greenhouse Gas Emissions Information*, which addresses attest engagements on greenhouse gas emissions information. The SOP superseded previously issued SOP 03-2 under the same title.

SOP 13-1 provides guidance for practitioners who perform an *examination or a review* under the attestation standard, of a greenhouse gas emissions statement containing either a schedule
with the subject matter or an assertion relating to information about an entity's greenhouse gas (GHG) emissions.

The AICPA previously issued SOP 03-2, *Attest Engagements on Greenhouse Gas Emissions Information*, to provide guidance to CPAs on how to apply the attestation standards to GHG emissions reporting for an examination level of service with the expectation that it would be used to satisfy requirements for assurance in connection with GHG trading schemes or regulatory submissions.

According to the ASB, companies are primarily interested in voluntarily adding more credibility to green information they are reporting. Many companies seek a cost-effective means to do such reporting other than an examination under the attestation standard.

To respond to this need, SOP 13-1 updates SOP 03-2 by including guidance on how to apply the attestation standards for a *review engagement* to the specific subject matter of GHG emissions information.
1. Why has the Big GAAP-Little GAAP movement received new impetus over the past few years:
   a. Many changes that will be required by the single set of international GAAP standards will not be important to public entities
   b. Recent controversial FASB statements and interpretations are costly and difficult for nonpublic entities to implement
   c. The Sarbanes-Oxley Act mandates that the FASB’s funding come from nonpublic entities
   d. There is no large business representation or perspective on the FASB

2. Which of the following is one of the controversial statements that is difficult to implement for smaller closely held companies:
   a. Consolidation of Variable Interest Entities
   b. Disclosure about Fair Value of Financial Instruments
   c. Earnings Per Share
   d. Segment Reporting

3. Under the Blue Ribbon Panel Report on GAAP for private companies, how did the Panel recommend that GAAP for private companies be monitored:
   a. Establish a new separate private company standards board
   b. Have the FASB add two new board members that are from private companies
   c. Have the AICPA take over monitoring GAAP for private companies
   d. Have the SEC carve out staff to monitor GAAP for private companies

4. Which of the following is an accounting principle that is part of AICPA’s FRF for SMEs:
   a. Fair value is used instead of historical cost
   b. Tax return depreciation is used
   c. Deferred income taxes are still be required
   d. Goodwill is amortized over the tax life of 15 years

5. Which of the following is not an example of a disclosure required under Regulation S-K in connection with environmental issues:
   a. Description of business
   b. Legal proceedings
c. Risk factors  
d. Going concern

6. Which of the following is an example of a disclosure related to environmental issues required by a company under GAAP, in addition to those disclosures required under Regulations S-K and S-X:
   a. Revenue recognition  
b. Going concern  
c. Operating performance  
d. Risks and uncertainties

7. Which of the following is correct with respect to the requirement for nonpublic companies to make disclosures about climate change:
   a. GAAP requires such disclosures in all cases  
b. GAAP does not require such disclosures because the author believes there is no climate change  
c. GAAP does not require such disclosures because there is no concentration  
d. GAAP requires such disclosures for companies that have their manufacturing plants located on a waterway
SUGGESTED SOLUTIONS

1. Why has the Big GAAP-Little GAAP movement received new impetus over the past few years:
   a. Incorrect. The FASB and IASB are working on an international standards convergence project that will ultimately result in one set of international GAAP standards. Changes will be required to existing U.S. GAAP standards and many of those changes will not be important to nonpublic entities.
   b. Correct. The FASB has issued several extremely controversial FASB statements and interpretations that are costly and difficult for nonpublic entities to implement and are not meaningful to the third parties they serve. One example is the issuance of ASC 810 (formerly FIN 46R).
   c. Incorrect. Sarbanes-Oxley mandates that FASB’s funding come primarily from SEC registrants, thereby suggesting that the FASB’s focus continue to be on issues important to public entities, not nonpublic entities.
   d. Incorrect. Actually, accountants from smaller firms are not serving as FASB staff or board members, which results in no small business representation or perspective on the FASB.

2. Which of the following is one of the controversial statements that is extremely difficult to implement for smaller nonpublic companies:
   a. Correct. Consolidation of Variable Interest Entities requires certain companies to consolidate off-balance sheet entities referred to as variable interest entities. Since its inception, it has been quite difficult for smaller companies to implement as it requires technical expertise and knowledge of FIN 46R.
   b. Incorrect. In issuing Disclosure about Fair Value of Financial Instruments, the FASB chose to limit its application to public companies and large nonpublic entities. Thus, smaller nonpublic companies are exempt from its application.
   c. Incorrect. Because nonpublic entities are exempt from Earnings Per Share, its implementation by nonpublic entities is moot.
   d. Incorrect. Segment Reporting is one instance where the FASB has limited GAAP to public companies, thereby exempting nonpublic entities. Thus, it is not difficult to implement because it does not apply to nonpublic companies.

3. Under the Blue Ribbon Panel Report on GAAP for private companies, how did the Panel recommend that GAAP for private companies be monitored:
   a. Correct. The Panel recommended that a new separate private company standard board be established to ensure that sufficient exceptions and modifications are made to GAAP for private companies.
   b. Incorrect. The Panel did not recommend that the FASB be involved in monitoring GAAP for private companies.
   c. Incorrect. The Panel did not mention having the AICPA take over monitoring GAAP for private companies.
   d. Incorrect. The SEC deals with public companies and not private companies.
4. Which of the following is an accounting principle that is part of AICPA’s FRF for SMEs:
   a. Incorrect. Historical cost is the model. Fair value is eliminated except for available-for-sale securities.
   b. Incorrect. Depreciation is based on useful lives of assets, not tax return depreciation.
   c. Incorrect. A company has a choice of recording deferred income taxes or booking only the current taxes payable.
   d. Correct. The principle for goodwill is that goodwill is amortized over the tax life of 15 years in most cases.

5. Which of the following is not an example of a disclosure required under Regulation S-K in connection with environmental issues:
   a. Incorrect. Item 101 of Regulation S-K does require disclosures within the description of business including the material effects that compliance with environmental laws may have upon the company.
   b. Incorrect. Item 103 of Regulation S-K does require disclosure of legal proceedings including any material pending legal proceeding to which the company is a party.
   c. Incorrect. Item 503 of Regulation S-K requires disclosure of the most significant risk factors related to an investment in a registrant.
   d. Correct. Regulation S-K does not have a specific disclosure related to going concern.

6. Which of the following is an example of a disclosure related to environmental issues required by a company under GAAP, in addition to those disclosures required under Regulations S-K and S-X:
   a. Incorrect. Although there are disclosures required for revenue recognition, they do not typically relate to environmental issues making the answer incorrect.
   b. Incorrect. In general, going concern disclosures do not apply to environmental issues.
   c. Incorrect. Operating performance is generally not specific to environmental issues.
   d. Correct. ASC 275 (formerly SOP 94-6) requires disclosures related to significant estimates used to determine the carrying amounts of assets or liabilities, or in the disclosure of gain or loss contingencies, both of which may relate to environmental issues.

7. Which of the following is correct with respect to the requirement for nonpublic companies to make disclosures about climate change:
   a. Incorrect. GAAP does not require such disclosures in all cases. In fact, the author suggests that such disclosures would be required in rare cases.
   b. Incorrect. The author does not address the climate change debate and instead states that such a disclosure is not required for other reasons.
   c. Correct. One of the reasons why the author believes that such a disclosure is not required is because there is a concentration where it is reasonably possible that there could be a near-term (one year) severe impact. Most climate changes extend risk well beyond one year from the balance sheet date. Thus, there is not likely to be a disclosure required under GAAP.
   d. Incorrect. Although a plant on the water could have additional risks of damage to operations from rising water levels, the location on the water is not likely to severely
impact the entity’s operations within one year. Moreover, any impact from rising water levels is likely to be considered an act of God for which GAAP has a disclosure exemption.
J. Deferred Income Taxes and Other Tax Matters

ASC 740 *Income Taxes* (formerly FASB No. 109), has been around for almost two decades. Yet, there are several key issues related to deferred income taxes that exist because of the recent economic climate. In the section, the author addresses some of those issues.

1. Problems on the uncertain tax positions front

The rules for recording a liability for unrecognized tax benefits under FASB Interpretation 48 (FIN  48) have been around since 2006.

Yet, these rules continue to be controversial and reach far beyond the financial statements.

**Background**

The rules for uncertain tax positions were issued approximately one decade ago in FIN 48, which is now part of ASC 740, *Income Taxes*. Although the rules for uncertain tax positions may not be applicable to many smaller, nonpublic entities, there have been questions as to whether non-public entities are required to include certain FIN 48 disclosures if an entity has no uncertain tax positions.

**Question:** What are the general rules for accounting for tax positions?

**Response:** The authority for tax positions is found in ASC 740 *Income Taxes* (formerly FASB Interpretation No. 48 (FIN 48)), which provides guidance on the treatment of derecognition, classification, interest and penalties, accounting in interim periods, disclosures and transition, as they relate to tax positions.

The rules apply to *all tax positions* accounted for under ASC 740 (formerly FASB No. 109).

A *tax position* is defined as:

> “a position in a previously filed tax return or a position expected to be taken in a future tax return that is reflected in measuring current or deferred income tax assets or liabilities for interim or annual periods.”

A tax position results in either:

- A permanent reduction in income taxes payable
- A deferral of income taxes otherwise currently payable to future years, or
- A change in the expected realizability of deferred tax assets.

The rules found in ASC 740 apply as follows:
1. If it is *more likely than not* (*more than 50% probability*) that a tax position will be sustained upon IRS or state tax examination (including any appeals or litigation process), the amount of the tax effect of a tax position is retained on the financial statements.

2. If it is *not more likely than not* (not more than 50% probability) that the tax position will be sustained upon an IRS or state tax examination, all of the tax effect of the tax position is eliminated in the financial statements by recording a liability for the unrecognized tax position. This liability represents the hypothetical additional tax that will be paid when the tax position is disallowed upon IRS or state examination.

The rules for unrecognized tax positions apply to *federal, state and local and foreign income taxes, but do not apply to* sales and use taxes, franchise taxes, real estate and personal property taxes, and fees that are not taxes. Moreover, it is assumed that a company goes through an IRS or state tax examination, including, if applicable, appeals.

**Example 1: Tax Deduction:**

Company X computes its 20X7 tax provision as follows:

<table>
<thead>
<tr>
<th></th>
<th>Taxable Income</th>
<th>Tax rate</th>
<th>Tax (Fed/state)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$1,000,00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operating expenses:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Travel</td>
<td>(2,500)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>All other</td>
<td>(597,500)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total operating expenses</td>
<td>(600,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>NIBT</td>
<td>400,000</td>
<td>40%</td>
<td>160,000</td>
</tr>
<tr>
<td>M-1: Depreciation</td>
<td>(50,000)</td>
<td>40%</td>
<td>(20,000)</td>
</tr>
<tr>
<td>Taxable income</td>
<td>$350,000</td>
<td>40%</td>
<td>$140,000</td>
</tr>
</tbody>
</table>

**Entry:**

- Income tax expense 160,000
- Deferred income tax liability 20,000
- Accrued tax liability 140,000

Company X takes a $2,500 tax deduction for certain items that may be nondeductible travel related to a shareholder’s spouse. The tax benefit of the item embedded within the tax provision is $1,000 ($2,500 x 40%).

X believes that if it were audited by the IRS and Massachusetts Department of Revenue, it is more likely than not (more than 50% probability) that the entire deduction is sustainable even if X has to go to appeals or even tax court.
Conclusion: Because X believes it is more likely than not that the deduction would be sustained in the event of examination, including any required appeal or tax court decision, X would retain the tax benefit of the tax deduction on its financial statements. That means that X would not record an additional liability for the additional tax that would be paid if the deduction were disallowed upon examination.

Change the facts:

What if the more-likely-than-not threshold is not met for sustaining the deductibility of the $2,500?

Assume X believes that upon examination, the entire $2,500 deduction would be disallowed. In this case, it is not more likely than not that the $2,500 deduction would be sustained resulting in an additional tax in the amount of $1,000, for which an additional liability is recorded as follows:

The revised entry looks like this:

Revised Entry:
Income tax expense 161,000*
Deferred income tax liability 20,000
Accrued tax liability 140,000
Liability for unrecognized tax benefit 1,000

* Book income ($400,000) plus unrecognized deduction ($2,500) = $402,500 x 40% = $161,000.

Question: What types of entities are subject to the rules found in FIN 48?

Response: FIN 48 applies to all entities including:

- For-profit
- Not-for-profit
- Pass-through entities (S corporations, LLCs and partnerships, and
- Entities taxed in a manner similar to pass-through entities such as REITs and registered investment companies.\(^\text{14}\)

Note: Not-for-profit and pass-through entities, and tax-exempt organizations are subject to FIN 48 because they can pay taxes in certain situations. For example, an S corporation can be subject to a built-in gain tax under IRC section 1374 and can also be subject to state income taxes. Similarly, a not-for-profit entity can be subject to a tax on unrelated business income.

\(^\text{14}\) Entities whose liability is subject to 100 percent credit for dividends paid (REITs and registered investment companies).
A reporting entity must consider the tax positions of all entities within a related-party group of entities regardless of the tax status of the reporting entity.

ASU 2009-06 amended FIN 48 to include under the definition of a tax position an entity’s tax status such as an entity’s status as a pass-through entity (S corporation) or a tax-exempt not-for-profit entity. For example, one such tax position is the company’s position that it is properly in compliance with the IRC to be taxed as an S corporation, or it is an LLC that is taxed as a partnership instead of a corporation.

**Question:** What are the disclosures required by FIN 48?

**Response:** FIN 48 requires the following disclosures which apply to all entities:

1. The entity’s policy on classification of interest and penalties assessed by taxing authorities.

2. As of the end of each annual reporting period presented:
   a. The total amounts of interest and penalties recognized in the statement of operations and the total amounts of interest and penalties recognized in the statement of financial position, assessed by taxing authorities.
   b. For positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date:
      - The nature of the uncertainty
      - The nature of the event that could occur in the next 12 months that would cause the change
      - An estimate of the range of the reasonably possible change or a statement that an estimate of the range cannot be made
   c. A description of tax years that remain open subject to examination by major tax jurisdictions.

3. Public companies *only* shall include the following additional disclosures as of the end of each annual reporting period presented:
   a. A tabular reconciliation of the total amounts of unrecognized tax benefits at the beginning and end of the period which shall include at a minimum:
      - The gross amounts of the increases and decreases in unrecognized tax benefits as a result of tax positions taken during a prior period.
• The gross amounts of increases and decreases in unrecognized tax benefits as a result of tax positions taken during the current period.

• The amounts of decreases in the unrecognized tax benefits relating to settlements within taxing authorities.

• Reductions to unrecognized tax benefits as a result of a lapse of the applicable statute of limitations.

b. The total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate.

Example Disclosures:

Following are sample disclosures. In parentheses, the author has included the disclosure reference from the table above.

Example 1 Disclosure: Public Company

<table>
<thead>
<tr>
<th>Note X: Tax Uncertainties</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Company files income tax returns in the U.S. federal jurisdiction, and various states (not required).</td>
</tr>
</tbody>
</table>

The Company is subject to U.S. federal and state income tax examinations for tax years 20X4, 20X5, 20X6 and 20X7.

The Internal Revenue Service (IRS) commenced an examination of the Company’s U.S. income tax returns for 20X3 and 20X4 in the first quarter 20X7 which is expected to be completed by the end of 20X8. As of December 31, 20X7, the IRS has proposed certain significant tax adjustments to the Company’s research credits. Management is currently evaluating those proposed adjustments to determine if it agrees. If accepted, the Company anticipates that it is reasonably possible that an additional tax payment in the range of $80,000 to $100,000 will be made by the end of 20X8.

A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows (public company disclosure only).

<table>
<thead>
<tr>
<th>Balance at January 1, 20X7</th>
<th>$ 0</th>
</tr>
</thead>
<tbody>
<tr>
<td>Additions based on tax positions related to the current year</td>
<td>210,000</td>
</tr>
<tr>
<td>Additions for tax positions of prior years</td>
<td>30,000</td>
</tr>
<tr>
<td>Reductions for tax positions of prior years</td>
<td>(50,000)</td>
</tr>
<tr>
<td>Reductions due to settlements with taxing authorities</td>
<td>(40,000)</td>
</tr>
<tr>
<td>Reductions due to lapse in statute of limitations</td>
<td>(10,000)</td>
</tr>
<tr>
<td>Balance at December 31, 20X7</td>
<td>$140,000</td>
</tr>
</tbody>
</table>

The Company’s policy is to record interest expense and penalties assessed by taxing authorities in operating expenses.
For years ended December 31, 20X7, 20X6 and 20X5, the Company recognized approximately $12,000, $15,000 and $17,000, respectively of interest and penalties expense. At December 31, 20X7 and 20X6, accrued interest and penalties were $50,000 and $45,000, respectively.

Included in the balance at December 31, 20X7 and 20X6 are $30,000 and $25,000, respectively, of tax positions that relate to tax deductions that upon audit could be disallowed, resulting in a higher effective tax rate. Management believes that it is more likely than not that these tax positions would be sustained in the event of audit (public company disclosure only).

Example 2 Disclosure: Non-Public Company

**Note X: Tax Uncertainties**

The Company’s policy is to record interest expense and penalties assessed by taxing authorities in operating expenses.

For years ended December 31, 20X7 and 20X6, the Company recognized approximately $5,000 and $6,000, respectively of interest and penalties expense. At December 31, 20X7 and 20X6, accrued interest and penalties were $2,000 and $3,000, respectively.

The Company is subject to U.S. federal and state income tax examinations for tax years 20X4, 20X5, 20X6 and 20X7.

The Internal Revenue Service (IRS) commenced an examination of the Company’s U.S. income tax returns for 20X3 and 20X4 in the first quarter 20X7 which is expected to be completed by the end of 20X8. As of December 31, 20X7, the IRS has proposed certain significant tax adjustments to the Company’s research credits. Management is currently evaluating those proposed adjustments to determine if it agrees. If accepted, the Company anticipates that it is reasonably possible that an additional tax payment in the range of $80,000 to $100,000 will be made by the end of 20X8.

Example 3 Disclosure: Non-Public Company- Abbreviated Disclosure

Most nonpublic companies do not have tax positions that require the recording of an unrecognized liability. In such cases, the disclosures are as follows:

**Note X: Tax Uncertainties**

The Company’s policy is to record interest expense and penalties assessed by taxing authorities in operating expenses.

For years ended December 31, 20X7 and 20X6, there was no interest and penalties expense and no accrued interest and penalties recorded.

The Company is subject to U.S. federal and state income tax examinations for tax years 20X4, 20X5, 20X6 and 20X7.
2. Fixing the disclosures in uncertain tax positions for nonpublic entities

Since the issuance of FIN 48, the FASB has issued additional guidance with FASB Staff Position (FSP) FIN 48-1, and ASU 2009-6: Income Taxes: Implementation Guidance on Accounting for Uncertainty in Income Taxes and Disclosure Amendments for Nonpublic Entities (ASC 740). ASU 2009-6 amends FIN 48 to eliminate certain disclosures for nonpublic companies and to clarify the scope to which FIN 48 applies.

FIN 48, as amended by ASU 2009-6, requires numerous disclosures related to tax positions. Among those disclosures are three specific disclosures that have caused controversy in practice, particularly with respect to those companies that have no unrecognized tax positions recorded on their balance sheets. Those three disclosures are:

1. The company’s policy on classification of interest expense and penalties assessed by taxing authorities

2. The total amounts of interest and penalties recognized in the statement of operations, and the total amounts of interest and penalties recognized in the statement of financial position assessed by taxing authorities, and

3. A description of tax years that remain open subject to examination by major tax jurisdictions

Following are sample disclosures. In parentheses, the author has included the disclosure reference from the table above.

### Note X: Tax Uncertainties

The Company’s policy is to record interest expense and penalties assessed by taxing authorities in operating expenses.

For years ended December 31, 20X7 and 20X6, there was no interest and penalties expense and no accrued interest and penalties recorded.

The Company is subject to U.S. federal and state income tax examinations for tax years 20X4, 20X5, 20X6 and 20X7

In May 2010, the AICPA’s Financial Reporting Executive Committee (FinREC) issued a technical practice aid, TPA 5250-15. “Application of Certain FASB Interpretation No. 48 (codified in FASB ASC 740-10) Disclosure Requirements to Nonpublic Entities That Do Not Have Uncertain Tax Positions.”
In that TPA, the AICPA concluded that when a nonpublic entity did not have uncertain tax positions the disclosure found in ASC 740-10-50-15(e) of the number of years that remain open subject to tax examination was still required to be disclosed.

Since issuance of the TPA, critics have argued that the conclusion reached in the TPA is flawed and inconsistent with ASU 2009-6.

In the Basis of Conclusions section of ASU 2009-6, the FASB states:

BC13. The board concluded that the disclosure requirements in paragraph 740-10-50-15(c.) through (e) still provide value to users of nonpublic entity financial statements even without the disclosure of total unrecognized tax balances. As a result, the Board decided not to require nonpublic entities to disclose total unrecognized tax positions at the balance sheet dates.

BC14. One respondent asked if a disclosure would be required if management determined that there are no unrecognized tax benefits to record. The Board concluded that such a disclosure would not be required because it will set a precedent for requiring a similar disclosure for all accounting standards for which there was no material effect on the financial statements.

Although BC14 does not explicitly identify what "a disclosure" references, at a minimum it references the disclosure of the number of tax years that remain open as follows:

A description of tax years that remain open subject to examination by major tax jurisdictions

The FASB states that if there are no material uncertain tax positions recorded, the disclosure of "a description of tax years that remain open subject to examination by major tax jurisdiction" is not required.

But TPA 5250-15 erroneously contradicted the FASB’s conclusion by stating that the disclosure of the number of years open IS required even if an entity has no uncertain tax positions recorded. Some respondents have stated that the AICPA was not inconsistent with the FASB’s position because the Basis of Conclusions section is not formally part of the FASB’s Codification.

The FASB and the Private Company Council (PCC) discussed FIN 48 at a February 2015 PCC meeting. At that meeting, the FASB reaffirmed its position in Paragraph B14 by stating that:

“It did not intend to require disclosure of tax examination years that are open when a nonpublic entity does not have any (material) uncertain tax positions.”

The result is that:
a nonpublic entity that has no uncertain tax positions liability recorded is not required to disclose the number of tax years open for examination.

As a result, the AICPA has deleted TPA 5250-15 and has scheduled a reissue of the TPA shortly. That revised TPA will be consistent with ASU 2009-6 and will state that a description of tax years that are open subject to examination by major tax jurisdiction will not be required if an entity has no material unrecognized tax positions.

**Are other tax related disclosures required if the item does not exist?**

Once again, the three disclosures that are referenced above are:

1. The Company’s policy on classification of interest expense and penalties assessed by taxing authorities
2. The total amounts of interest and penalties recognized in the statement of operations and the total amounts of interest and penalties recognized in the statement of financial position, assessed by taxing authorities, and
3. A description of tax years that remain open subject to examination by major tax jurisdictions

As the author just reviewed, if an entity has no material liabilities for unrecognized tax positions, the third disclosure (description of tax years open) is not required.

But what about the other two disclosures related to interest and penalties? Are they required if an entity has no interest and penalties related to taxes?

Remember that Paragraph B14 of ASU 2009-6 states:

BC14. One respondent asked if a disclosure would be required *if management determined that there are no unrecognized tax benefits to record*. The Board concluded that *such a disclosure would not be required because it will set a precedent* for requiring a similar disclosure for all accounting standards for which there was no material effect on the financial statements.

The FASB notes that a disclosure is not required (of open tax years) if there are no unrecognized tax obligations or benefits. The FASB goes on to state that to require such an irrelevant disclosure would not be required because it will "set a precedent" meaning it would result in entities including disclosures on elements that do not exist.

In other words, the FASB is saying that it does not want to set a precedent for requiring disclosures where an item to which the disclosure relates is not material to the financial statements.
The same conclusion should apply to disclosures (1) and (2) above involving interest and penalties on taxes. If an entity has no interest or penalties related to their taxes, there is no requirement to disclose item (1) (the company's policy to record interest expense and penalties assessed, and item (2) (The total amounts of interest and penalties recognized in the statement of operations and the total amounts of interest and penalties recognized in the statement of financial position assessed by taxing authorities).

**Are any of the unrecognized tax benefit obligation disclosures required for an entity using tax basis financial statements?**

As to the disclosure of the number of years open for examination, no disclosure is required if using tax basis financial statements. The reason is because such a disclosure is not required unless an entity has an unrecognized tax benefit liability, which is not recorded for tax basis financial statements.

As to the disclosures about interest and penalties, such disclosures would only be required in a year in which an entity that uses the tax basis of accounting, has interest and penalties related to a tax obligation that are either recorded as expense or accrued. Otherwise, no disclosures would be required.

### 3. Impact of reduction in tax rates on deferred taxes

For the past decade, there have been numerous proposals and suggestions that U.S. corporate tax rates should be reduced as part an overall tax reform.

In the joint committee report entitled, *The Moment of Truth: Report of the National Commission on Fiscal Responsibility and Reform*, the committee recommended that the top corporate Federal tax rate be reduced from 35 percent to a rate within the range of 23-29 percent. Recently, the Treasury and White House mentioned a 25 percent target rate.

The current U.S. corporate tax rate is 35%, which is considered one of the highest among all countries.

When one adds a state tax rate in the 5 to 10% range, net of the federal tax benefit, most corporations have a federal and state effective tax rate that exceeds 40%.

According to the Tax Foundation:

- The United States has the third highest general top marginal corporate income tax rate (federal and state) in the world at 39.1%, exceeded only by Chad and the United Arab Emirates, and the highest federal corporate income tax rate (among the 34 industrialized nations of the Organization for Economic Cooperation and Development (OECD)).

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15 Report issued by the National Commission on Fiscal Responsibility and Reform
16 Tax Foundation, *Corporate Income Tax Rates Around the World, 2014*
The worldwide average top corporate income tax rate is 22.6% (30.6% weighted by GDP).

By region, Europe has the lowest average corporate tax rate at 18.6% (26.3% weighted by GDP); Africa has the highest average tax rate at 29.1%.

Larger, more industrialized countries tend to have higher corporate income tax rates than developing countries.

The worldwide (simple) average top corporate tax rate has declined over the past decade from 29.5% to 22.6%.

Every region in the world has seen a decline in their average corporate tax rate in the past decade.

<table>
<thead>
<tr>
<th>Corporate Tax Rates By Country</th>
<th>Corporate Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Country</td>
<td></td>
</tr>
<tr>
<td>United Arab Emigrates</td>
<td>55%</td>
</tr>
<tr>
<td>Chad</td>
<td>40%</td>
</tr>
<tr>
<td>United States</td>
<td>35%</td>
</tr>
<tr>
<td>Japan*</td>
<td>37%</td>
</tr>
<tr>
<td>France</td>
<td>34.4%</td>
</tr>
<tr>
<td>India</td>
<td>34%</td>
</tr>
<tr>
<td>Australia</td>
<td>30%</td>
</tr>
<tr>
<td>UK</td>
<td>21%</td>
</tr>
<tr>
<td>Italy</td>
<td>27.5%</td>
</tr>
<tr>
<td>Greece</td>
<td>26%</td>
</tr>
<tr>
<td>Mexico</td>
<td>30%</td>
</tr>
<tr>
<td>Spain</td>
<td>28%</td>
</tr>
<tr>
<td>Austria</td>
<td>25%</td>
</tr>
<tr>
<td>Israel</td>
<td>26.5%</td>
</tr>
<tr>
<td>Sweden</td>
<td>22%</td>
</tr>
<tr>
<td>Ireland</td>
<td>12.5%</td>
</tr>
<tr>
<td>Switzerland</td>
<td>8.5%</td>
</tr>
<tr>
<td>Bahamas</td>
<td>0%</td>
</tr>
<tr>
<td>British VI</td>
<td>0%</td>
</tr>
<tr>
<td>Bermuda</td>
<td>0%</td>
</tr>
</tbody>
</table>

| Worldwide average            | 22.6%             |

* Japan has approved tax reform that will lower its corporate rate.
Source: Tax Foundation and Source: Organization for Economic Co-operation and Development (OECD)
As corporate tax revenues decline and U.S. companies continue to hold more than $2 trillion of cash offshore, there is impetus to reduce the U.S. corporate tax rate from 35% to a rate that is in the 25 to 28% range.

**Background**

ASC 740 (formerly FASB 109), *Income Taxes*, is the GAAP authority for the accounting for income taxes:

The basic rules are as follows:

1. Total income taxes consist of the current portion and the deferred portion:

   **Current portion**: Recognized based on the estimated taxes payable or refundable on tax returns for the current year as a tax liability or asset.

   **Deferred portion**: Recognized as a deferred tax liability or asset for the estimated future tax effects attributable to temporary differences and carryforwards.

2. Temporary differences are the difference between the book and tax basis of an asset or liability that will result in taxable or deductible amounts in future years when the reported amount is recovered or settled.

3. Deferred tax assets and liabilities are computed based on *enacted tax rates expected to apply* to taxable income in the periods in which the deferred tax liability or asset is expected to be settled or realized.

**Example 1**: Company X is a C corporation is a first year entity and has the following M-1 reconciliation:

<table>
<thead>
<tr>
<th>Pretax book income</th>
<th>$5,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>M-1:</td>
<td></td>
</tr>
<tr>
<td>Depreciation</td>
<td>(1,000,000)</td>
</tr>
<tr>
<td>Taxable income</td>
<td>4,000,000</td>
</tr>
<tr>
<td></td>
<td>35%</td>
</tr>
<tr>
<td>Current federal income tax</td>
<td>$1,400,000</td>
</tr>
</tbody>
</table>

**Accumulated depreciation: 12-31-20X1:**

<table>
<thead>
<tr>
<th>Book</th>
<th>$2,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax</td>
<td>3,000,000</td>
</tr>
<tr>
<td>Temporary difference</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Tax rate</td>
<td>35%</td>
</tr>
<tr>
<td>Deferred tax liability</td>
<td>$350,000</td>
</tr>
</tbody>
</table>
**Entry:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income tax expense- current</td>
<td>1,400,000</td>
</tr>
<tr>
<td>Income tax expense- deferred</td>
<td>350,000</td>
</tr>
<tr>
<td>Accrued FIT</td>
<td>1,400,000</td>
</tr>
<tr>
<td>Deferred FIT</td>
<td>350,000</td>
</tr>
</tbody>
</table>

**Example 2:** Company Z has the following information for year ended 2015:

2015 tax net operating loss \(\text{\$(1,000,000)\)}

Temporary difference:

Accumulated depreciation at 12-31-15:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Book</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Tax</td>
<td>3,500,000</td>
</tr>
<tr>
<td>Temporary difference</td>
<td>$1,500,000</td>
</tr>
</tbody>
</table>

The \(\text{\$(1,000,000)\)} 2015 net operating loss is available for carryforward to 2035 (20 years).

The company had federal tax losses in the two carryback years (2013 and 2014) which were carried back to earlier years to obtain a federal tax refund. There is no portion of the 2015 NOL available for carryback.

The temporary difference related to accumulated depreciation (AD) will reverse in years 2016 through 2025. There are no other temporary differences.

There are no state income taxes.

A deferred income tax asset and liability was recorded with balances at 12-31-15 as follows:

Deferred income tax asset (federal):

2013 federal tax net operating loss \(\text{$1,000,000 \times 35\%$} \text{\$350,000\)}

[NOL expires in 2035, twenty years]

Deferred income tax liability:

Temporary difference: AD \(\text{$1,500,000 \times 35\%$} \text{\$(525,000\)}\)

What would be the impact of a reduction in the corporate tax rate from 35% to 28%?

Putting aside the political aspects of corporate tax rates, the question is what happens to deferred income tax balances if corporate rates decline from 35% to 28%?
In February 2015, the Georgia Tech Financial Analysis Lab issued a study entitled, *The Effects of Tax Reform on Deferred Taxes: The Winners and Losers*.

In the study, the authors examined 809 U.S. companies and the impact of US corporate income tax reform on deferred taxes and which companies and industries will gain and lose if tax reform were to come to fruition.

The focus of the study was to address the adjustment, if any that would occur to deferred tax assets and liabilities if tax rates were to be reduced from 35% to 28%.

Deferred tax assets and liabilities are recorded at the margin tax rate expected to be in effect when the temporary differences that create the deferred taxes reverse in future years.

A change in the corporate rate to 28% would result in a reduction in both deferred tax assets and liabilities, resulting a change in assets, liabilities and stockholders' equity in most companies.

For a sample of 809 U.S. companies with revenue greater than $500 million with reported deferred tax balances, the authors of the study present the financial statement effects of lowering the corporate income tax rate from 35% to 28%.

The results of the study reveal the following:

1. If rates were to decline from 35% to 28%, the 809 sampled companies would receive an overall *net increase in stockholders' equity of $104 billion* broken out as follows:
   a. 548 of the companies sampled with deferred tax liabilities would receive a $142 billion reduction in liabilities and increase in stockholders' equity.
      - Liabilities would decline by 2%
      - Stockholders' equity would increase by 3.3%
      - Financial leverage (liabilities to equity ratio) would decline by 5.5%
   b. 261 of the companies would see a decline of $38 billion in deferred tax assets and decrease in stockholders' equity.
      - Assets would decline by .4%
      - Stockholders' equity would decrease by 1.2%
      - Financial leverage (liabilities to equity ratio) would increase by 1.2%

2. Winners and losers from tax reform:
   a. Winners from tax reform, consisting of industries with large deferred tax liabilities that will be reduced include:
• Utilities and Energy sectors  
• Electric, gas and water utilities  
• Oil and gas exploration  
• Transportation, including railroad companies  

b. Losers from tax reform, consisting of industries with large deferred tax assets that will be reduced include:

• Mortgage, finance and banking sectors:  
  • Financial companies  
  • Commercial banks  
  • Consumer finance companies  
  • Leisure equipment  
  • Durables  
  • Pharmaceuticals  
  • Biotechnology  
  • Auto components  
  • Computer hardware and software

3. Companies that are net losers from tax reform (e.g., deferred tax assets and stockholders’ equity would decline) could violate existing loan covenants.

4. Entities with the largest reduction in liabilities (winners) follows:

<table>
<thead>
<tr>
<th>Company</th>
<th>Reduction in deferred tax liabilities</th>
<th>% reduction in total liabilities</th>
<th>Increase in stockholders' equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Comcast</td>
<td>$(6.3) billion</td>
<td>(5.9)%</td>
<td>12.5%</td>
</tr>
<tr>
<td>Time Warner</td>
<td>(2.3) billion</td>
<td>(5.7)%</td>
<td>33.9%</td>
</tr>
<tr>
<td>Hilton International</td>
<td>(967) million</td>
<td>(4.4)%</td>
<td>22.2%</td>
</tr>
<tr>
<td>Hertz</td>
<td>(584) million</td>
<td>(2.7)%</td>
<td>21.1%</td>
</tr>
<tr>
<td>N star</td>
<td>(303) million</td>
<td>(6.8)%</td>
<td>12.2%</td>
</tr>
<tr>
<td>Median- all sampled</td>
<td>(2.0)%</td>
<td></td>
<td>3.3%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Company</th>
<th>Reduction in deferred tax Assets</th>
<th>% reduction in total assets</th>
<th>Decrease in stockholders' equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fannie Mae</td>
<td>$9.5 billion</td>
<td>(.3)%</td>
<td>(99.7)%</td>
</tr>
<tr>
<td>Orbitz</td>
<td>32 million</td>
<td>(2.9)%</td>
<td>(77)%</td>
</tr>
<tr>
<td>Federal Home Loan</td>
<td>4.5 billion</td>
<td>(.2)%</td>
<td>(35.4)%</td>
</tr>
<tr>
<td>Delta</td>
<td>1.3 billion</td>
<td>(2.6)%</td>
<td>(11.6)%</td>
</tr>
<tr>
<td>Citigroup</td>
<td>10.6 billion</td>
<td>(.6)%</td>
<td>(5.2)%</td>
</tr>
<tr>
<td><strong>Median all sampled</strong></td>
<td></td>
<td><strong>(.4)%</strong></td>
<td><strong>(1.2)%</strong></td>
</tr>
</tbody>
</table>


**Question:** If the corporate tax rate were to decline from 35% to 28%, where would the adjustment of the deferred tax asset or liability be presented on financial statements?

**Response:** ASC 740-10-45-15 states “when deferred tax accounts are adjusted as required by paragraph 740-10-35-4 for the effect of a change in tax laws or rates, the effect shall be included in income from continuing operations for the period that includes the enactment date.”

Therefore, if the corporate tax rate is reduced to 28%, the deferred tax asset and/or liability would be adjusted to the lower rate with the offsetting entry to income tax expense.

Consider the following example:

**Example:** Company Z has the following information for year ended 2016:

2016 tax net operating loss  
$(1,000,000)$

Temporary difference:  
Accumulated depreciation at 12-31-16:  
| Book       | $2,000,000  |  
| Tax        | $3,500,000  |  
| Temporary difference | $1,500,000 |

The $(1,000,000) 2016 net operating loss is available for carryforward to 2036 (20 years).

The temporary difference related to accumulated depreciation (AD) will reverse in years 2017 through 2026. There are no other temporary differences.
There are no state income taxes.

A deferred income tax asset and liability was recorded with balances at 12-31-16 as follows:

Deferred income tax asset (federal):
- 2016 federal tax net operating loss: $1,000,000 x 35% = $350,000
  [NOL expires in 2036, twenty years]

Deferred income tax liability:
- Temporary difference: AD $1,500,000 x 35% = $(525,000)

Effective January 1, 2017, the U.S. corporate tax rate is reduced from 35% to 28%.

**Conclusion:** Effective January 1, 2017, the deferred tax asset and liability are recomputed at the new 28% rate as follows:

<table>
<thead>
<tr>
<th>Deferred tax asset:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Originally computed: 1,000,000 x 35% = $350,000</td>
</tr>
<tr>
<td>Revised: 1,000,000 x 28% = 280,000</td>
</tr>
<tr>
<td><strong>Adjustment:</strong> 70,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Deferred tax liability:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Originally computed</td>
</tr>
<tr>
<td>35%: $2,000,000</td>
</tr>
<tr>
<td>28%: $2,000,000</td>
</tr>
<tr>
<td>Revised: $3,500,000</td>
</tr>
<tr>
<td>Temporary difference</td>
</tr>
<tr>
<td>35%: 1,500,000</td>
</tr>
<tr>
<td>28%: 1,500,000</td>
</tr>
<tr>
<td><strong>Adjustment:</strong> $105,000</td>
</tr>
</tbody>
</table>

**Entry: (January 1, 2017)**
- Deferred tax liability 105,000
- Deferred tax asset 70,000
- Income tax expense- deferred (1) 35,000

(1) shown as a separate component of income tax expense
In 2017, the $35,000 deferred tax adjustment is shown as a separate component of income tax expense as follows:

NOTE X: Income Taxes:

A summary of the current and deferred portions of federal income tax expense follows:

<table>
<thead>
<tr>
<th>Current portion</th>
<th>$XX</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred</td>
<td>XX</td>
</tr>
<tr>
<td>Adjustment due to change in tax rates</td>
<td>(35,000)</td>
</tr>
<tr>
<td>Total income tax expense</td>
<td>XX</td>
</tr>
</tbody>
</table>

If there is a valuation allowance account, it too should be adjusted to reflect the reduction in the federal marginal tax rate with the offset to income tax expense as part of continued operations.

K. Accounting, Auditing and Tax Issues Related to Marijuana

As of early 2016, there are 27 states and the District of Columbia that have legalized some form of marijuana use. The state laws range from:

- Decriminalizing possession to legalizing marijuana sale
- Legalizing marijuana sale
- Production and use for medical purposes
- Legalizing marijuana sale, production and use for recreational use.

Many states are reviewing the laws in light of Colorado's and Oregon's recent approval for recreational use. Those states include California, Illinois, Massachusetts, Michigan and New York.

With the growth in the acceptable sale of marijuana in some form, restricted or otherwise, an entire industry of professionals, specializing in marijuana, is being created. Those professionals include accountants and auditors that understand the accounting, auditing and tax issues surrounding marijuana's use and sale.

The purpose of this section is not to advocate the use or sale of any type of drug. Yet, accountants must be aware of trends in the accounting field, one of which involves the legalization of marijuana use and sale.

As of April 2016, several states have authorized the use and sale of marijuana at some level:
## State Marijuana Laws and CPA Profession

<table>
<thead>
<tr>
<th>State</th>
<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>Colorado</td>
<td>Legalized recreational use</td>
</tr>
<tr>
<td>Washington State</td>
<td>Legalized recreational use</td>
</tr>
<tr>
<td>Alaska</td>
<td>Legalized recreational use</td>
</tr>
<tr>
<td>Oregon</td>
<td>Legalized recreational use</td>
</tr>
<tr>
<td>Washington D.C.</td>
<td>Decriminalized recreational use</td>
</tr>
<tr>
<td>Guam</td>
<td>Legalized recreational use</td>
</tr>
<tr>
<td>Massachusetts</td>
<td>Legalized for medical use</td>
</tr>
</tbody>
</table>

Source: *An Issue Brief on State Marijuana Laws and the CPA Profession*, AICPA, January 2015, as updated.

The trend is toward more states legalizing the sale of marijuana in some form due to the attractive tax revenues that states can derive from their sale.

The result is that the marijuana business is quickly becoming a high-growth segment in several state economies. As the demand for business services grows, CPAs are being asked to perform accounting, auditing, tax and consulting services for marijuana growers and sellers.

Because the marijuana business is certainly not mainstream, there are certain risks inherent in the business that accountants must be aware of.

**What are some of the issues an accountant or auditor must contend with in servicing a marijuana client?**

The accountant must be aware of some of the industry-specific risks:

**Federal illegality despite being legal at the state level**

Although certain states have made the use and sale of marijuana legal, it is still *illegal at the Federal level* as a Schedule I drug under the Controlled Substances Act of 1970. The Supreme Court has ruled that federal law takes precedent over state law.

There is always the risk that the Federal government could enforce the federal laws by raiding the business. Further, being illegal provides an overall cloud of illegality on an interstate level with suppliers, and users out of state.

**Note:** The Justice Department under the current administration is generally taking a hands-off approach to these state law experiments, but the Obama administration has expressed no strong desire to change the legal status of marijuana at the federal level and has warned of possible...
enforcement activity if the marijuana activities involve criminal elements, sales to minors, sales across state lines, other illegal drugs, or use of public lands or federal property.

The Internal Revenue Service follows the federal law in viewing these businesses as illegal businesses for tax purposes. This creates a number of tax issues for representing these clients, as well as criminal exposure and possible ethical issues with respect to the professional licenses that a particular tax advisor may hold.

**Doing business without a bank account or credit cards**

Most banks will not accept bank accounts or provide credit card services related to the marijuana business because of the federal law and money laundering regulations. Consequently, it is difficult to open bank accounts or utilize credit card services.

The result is that:

1. Most marijuana businesses are working on a literal cash basis and retaining large sums of cash.
2. Security issues are always a concern with that much cash being held outside a bank account.
3. Many marijuana businesses must pay their bills, including payroll, with money orders and cash.

**Risk of engaging in an illegal activity**

Although marijuana business might be legal at the state level in which an accountant practices, the accountant has to be concerned about the federal illegality and its impact on the accountant's reputation, ethics, and legal exposure.

1. Under federal law, a person who aids, abets, counsels, commands, induces or procures the commission of a federal offense is punishable as a principal.
2. What has not been determined is whether rendering tax advice or preparing tax returns, or performing accounting services qualifies as aiding or abetting an illegal activity.

**Note:** The Obama administration and the Justice Department have taken a hands-off approach to addressing the illegal nature of the marijuana business that is legal is certain statements. That approach has continued and there are no signs that the Justice Department is likely to change its focus. What is unknown is what would happen under the next administration in 2017.

3. There is the risk that CPAs (and lawyers) who service clients in legal states such as Colorado, Washington and others, could receive cancellation notices for their professional liability insurance.
4. Contracts can be deemed unenforceable for being against public policy and involving an illegal activity at the federal level.

5. There is the ongoing risk of dealing in a cash business including the risk of embezzlement and underreporting income.

**Marijuana ethics issues for the CPA**

In January 2015, the AICPA issued a white paper entitled, *An Issue Brief on State Marijuana Laws and the CPA Profession*.

In the Brief, the AICPA addresses some of the ethical issues surrounding accountants who choose to service clients in the marijuana business.

The AICPA notes the following:

1. CPAs should check with their State Board of Accountancy when they consider providing services to a marijuana-related business due to the fact that the business is illegal at the federal level.

   According to the AICPA:

   "It is possible that a CPA from a state that allows marijuana use who has provided services to a ‘marijuana business’ could face licensing difficulties if he or she seeks a reciprocal license in a state where marijuana is illegal. It’s not yet clear how State Boards of Accountancy will apply "good moral character" requirements or impose discipline when it comes to supporting marijuana-related businesses, or if they will take a position at all."

2. CPAs who are contemplating providing services to marijuana-related businesses should consider whether a State Board would consider it to be an "act discreditable" when a CPA provides services to businesses that violate federal drug laws, even in a state that allows those businesses to operate legally.

   **Note:** The AICPA Brief observes that in the states that have passed laws or referendums allowing medicinal or recreational marijuana use, State Boards of Accountancy have not yet provided any guidance for CPAs looking to provide services to businesses that grow/sell marijuana. This dynamic puts CPAs in a gray legal area. They need to satisfy the requirements of their State Boards of Accountancy for ‘good moral character’ and the ‘acts discreditable’ requirements in their respective states, while at the same time considering the potential business opportunities."

**Tax risks**
One of the greatest risks that an accountant can encounter with a marijuana client is the risk from IRS and state audits and the misapplication of Section 280E of the Internal Revenue Code.

1. IRC Section 280E *denies tax credits and deductions* to businesses who traffic *in controlled substances* such as marijuana.

   a. The exception is that such businesses *may deduct cost of goods* sold for growing and selling marijuana under 280E but *cannot deduct other expenses*.

      **Note:** Costs are capitalized to inventory (and deductible as cost of goods sold) under Section 471 (inventory) and 263A (uniform capitalization rules). Companies are incentivized to fully capitalize costs as these sections using full absorption so that such costs are ultimately deductible as part of cost of goods sold.

   b. Other costs for selling, marketing and G&A (that are not capitalized under 263A) are not deductible under 280E.

   **Note:** In January 2015, the IRS issued an internal legal memorandum that addresses how Section 280E should be applied to the marijuana industry. Its focus is to explain how the IRS should determine cost of goods sold for purposes of Section 280E deductibility.

   In the memorandum, the IRS noted that marijuana retailers and producers must compute cost of goods sold under the pre-Section 280E inventory rules (e.g., pre 263A). Those rules mean that the business is permitted to deduct the purchase price of the marijuana (net of discounts), plus transportation and other costs necessarily as part of the acquisition. In addition, the producer may include in cost of goods sold any direct costs such as seeds, direct labor related to planting, harvesting, sorting, and cultivating the plants. Certain indirect costs may be included in cost of goods sold provided they are "incidental and necessary to production", along with depreciation, factory insurance, and other factory costs.

   Such businesses may not allocate to cost of goods sold any costs associated with purchasing, handling, storage, and administrative costs to COGS.

2. There is a difficulty paying certain taxes electronically due to lack of a bank account or credit cards.

   **Note:** The IRS requires certain taxes to be paid electronically such as C corporation estimates. However, it is difficult for marijuana businesses to get bank accounts or utilize credit cards from which to pay the taxes. The IRS has tried to impose substantial penalties on marijuana businesses that tried to pay their taxes in cash, even though the businesses state that that they could not file electronically.

   Allgreens LLC sued the IRS in Tax Court challenging the IRS’s determination that the inability to get a bank account did not excuse the failure to pay employee withholding taxes
electronically. In a settlement of the case, the IRS agreed to abate the penalties, but stated that the settlement should not be viewed as precedent for future cases.

3. No medical expense deduction:
   a. For the individual utilizing marijuana for medical purposes, the federal law treatment of marijuana also creates problems for the medical expense deduction. Revenue Ruling 97-9 determined that amounts paid for marijuana for medicinal use are not deductible, even if permitted under state law, since they were not legally procured under federal law. A similar analysis would probably apply to health flexible spending accounts, health savings accounts, health reimbursement accounts, and Archer Medical Savings Accounts.

4. The difficulties of performing a complete and accurate tax return:
   a. With a pure cash business, there is the risk of:
      - Failure to issue 1099s
      - Having underreported income
      - Client underreporting sales tax due to missing cash deposits
      - Client taking deductions that should not be taken under 280E

**Accounting and auditing issues**

If an accountant is required to audit, review or compile the financial statements of a marijuana retailer or producer, there are certain issues that are peculiar to the engagement as follows:

1. Planning and client acceptance:
   a. Because the marijuana business is an emerging market, it is important for the accountant/auditor to do the following:
      - **Client acceptance**: Evaluate the reputation risk, professional liability and overall risk of performing the engagement.
      - **Understand the entity and business**: Including the legal and regulatory environment, uncertainties and estimates, cash issues, and financing issues.
      - **Scope limitations**: If an audit, any scope limitations particularly with respect to inventory and revenue.

2. Accounting issues:
   a. The financial statements should have the following disclosures:
• Nature of business including a description that the business is legal at the state level, but illegal at the federal level.

• Concentration of risks and uncertainties related to:
  o The illegal nature of the business and regulatory environment in which it operates, and
  o The fact that the business is a cash business
  o The fact that the business has no bank account yet has a concentration of cash that is not protected and deposited in a bank.

• Contingency- reasonably possible that the business could be shut down by the federal government due to its illegal nature.

3. Reporting issues:
   a. Noncompliance with laws and regulations: The accountant or auditor should address the issue as to whether the business is in compliance with laws and regulations and its impact on the financial statements.
   b. Emphasis of matter or other matter paragraph. The accountant or auditor may wish to include an emphasis-of-matter or other-matter paragraph in his or her report describing the business.

4. Management representation letter:
   a. If a review or audit is performed, the accountant or auditor should obtain a representation letter from management that specifically confirms that the business is not in compliance with laws and regulations, it is engaged in an illegal activity, revenues and inventories are complete, etc.

5. Engagement letter:
   a. In the accountant's/auditor's engagement letter, the letter should have language that indemnifies the accountant for known misrepresentations by management.

6. Possible scope limitations: Because of the cash business, it might be difficult to:
   a. Measure the completeness of revenue.
   b. Determining the completeness of inventory.

7. Going concern
a. In limited cases, due to the fact that the entity is engaged in an illegal activity, going concern could be an issue because the business could be shut down at any point in time.

_**Is an accountant or auditor permitted to issue a report on an illegal activity?**_

Nothing in compilation, review or auditing standards precludes an accountant from performing an engagement and issuing a report on an illegal activity as long as there is no scope limitation.
REVIEW QUESTIONS

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

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

1. According to the author, which of the following would be an impact of lowering the corporate tax rate:
   a. Deferred tax assets would be adjusted downward
   b. Deferred tax assets would be adjusted upward
   c. There would be no effect on deferred tax assets, but there is an impact on the accrued federal tax liability
   d. A larger valuation account would be required for deferred tax assets

2. Richard Gere is a CPA and his client is Redundant Inc. Redundant has recorded deferred tax asset on an unused NOL carryforward using the statutory rate of 35%. Congress passes a law in which the statutory rate declines to 25% effective January 1, 2017. What should Redundant do to its deferred tax asset:
   a. Nothing. It must retain the original NOL until it ultimately reverses
   b. The company must adjust the NOL to a revised deferred tax asset based on the lower rate of 25%.
   c. The company must adjust the NOL over a four-year phase-in period.
   d. The company must record a tax allowance for the 10% rate differential.

3. Julio is a CPA and has a new client, a marijuana grower and seller in the state of Washington. Which of the following is correct with respect to the new client:
   a. The new client’s business is illegal is both Washington and for federal purposes
   b. The business is illegal for federal purposes
   c. The new business is legal for federal purposes but illegal in the state of Washington
   d. The business is illegal at both the state and federal level
SUGGESTED SOLUTIONS

1. According to the author, which of the following would be an impact of lowering the corporate tax rate:
   a. Correct. If the federal rate were to be reduced, all deferred tax assets that were previously recorded at a higher 35% tax rate would have to be adjusted downward to reflect the lower tax benefit that would be received in future years.
   b. Incorrect. Deferred tax assets would be adjusted downward, not upward. If rates increase, the deferred tax assets would be adjusted upward.
   c. Incorrect. The deferred tax assets would be reduced making the statement incorrect.
   d. Incorrect. Reducing the deferred tax asset would affect the asset directly and not the valuation account.

2. Richard Gere is a CPA and his client is Redundant Inc. Redundant has recorded deferred tax asset on an unused NOL carryforward using the statutory rate of 35%. Congress passes a law in which the statutory rate declines to 25% effective January 1, 2017. What should Redundant do to its deferred tax asset:
   a. Incorrect. The asset must be adjusted. Otherwise it is overstated by 10%. Thus the answer is incorrect.
   b. Correct. GAAP states that when there is a change in tax law or rate, the deferred tax asset must be adjusted to the new lower rate with the offset being tax expense as part of income from continuing operations.
   c. Incorrect. GAAP does not provide for a four-year phase-in period.
   d. Incorrect. GAAP requires that the deferred tax asset be adjusted directly so that use of a tax allowance account is not warranted.

3. Julio is a CPA and has a new client, a marijuana grower and seller in the state of Washington. Which of the following is correct with respect to the new client:
   a. Incorrect. The state of Washington is one of the states which makes the sale of marijuana legal making the answer incorrect.
   b. Correct. It is still illegal to sell marijuana under the federal Controlled Substances Act of 1970 making the answer correct.
   c. Incorrect. The answer is the opposite in that the new business is illegal for federal purposes but legal at the state of Washington level making the answer incorrect.
   d. Incorrect. It is legal in the state of Washington making the answer incorrect.
**Discount rate for the lease:** For a lessee, the rate implicit in the lease unless that rate cannot be readily determined. In that case, the lessee is required to use its incremental borrowing rate. For a lessor, the discount rate for the lease is the rate implicit in the lease.

**Economic life:** Either the period over which an asset is expected to be economically usable by one or more users or the number of production or similar units expected to be obtained from an asset by one or more users.

**Equity security:** Any security representing an ownership interest in an entity (for example, common, preferred, or other capital stock) or the right to acquire (for example, warrants, rights, forward purchase contracts, and call options) or dispose of (for example, put options and forward sale contracts) an ownership interest in an entity at fixed or determinable prices. However, the term does not include convertible debt or preferred stock that by its terms either must be redeemed by the issuing entity or is redeemable at the option of the investor.

**Fair value:** The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

**Incremental borrowing rate:** The rate of interest that a lessee would have to pay to borrow on a collateralized basis over a similar term an amount equal to the lease payments in a similar economic environment.

**Initial direct costs:** Incremental costs of a lease that would not have been incurred if the lease had not been obtained.

**Lease:** A contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration.

**Lease liability:** A lessee’s obligation to make the lease payments arising from a lease, measured on a discounted basis.

**Lease modification:** A change to the terms and conditions of a contract that results in a change in the scope of or the consideration for a lease (for example, a change to the terms and conditions of the contract that adds or terminates the right to use one or more underlying assets or extends or shortens the contractual lease term).

**Lease term:** The noncancellable period for which a lessee has the right to use an underlying asset, together with all of the following a) Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option, b) Periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option, and c) Periods covered by an option to extend (or not to terminate) the lease in which exercise of the option is controlled by the lessor.
**Lessee:** An entity that enters into a contract to obtain the right to use an underlying asset for a period of time in exchange for consideration.

**Lessor:** An entity that enters into a contract to provide the right to use an underlying asset for a period of time in exchange for consideration.

**Management Discussion and Analysis (MD&A):** Consists of various disclosures that provide a narrative explanation of the financial statements that enhance disclosures and provide information about the quality of, and potential variability of earnings and cash flow. Such disclosures includes known trends, events, demands, commitments, and uncertainties that are reasonably likely to have a material effect on financial condition or operating performance.

**Operating lease:** From the perspective of a lessee, any lease other than a finance lease. From the perspective of a lessor, any lease other than a sales-type lease or a direct financing lease.

**Private company:** An entity other than a public business entity, a not-for-profit entity, or an employee benefit plan.

**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, or 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.

**Right-of-use asset:** An asset that represents a lessee’s right to use an underlying asset for the lease term.

**Risk factors:** In accordance with Item 503 if Regulation S-K, consists of the most significant factors that make an investment in the registrant speculative or risky.

**Tax position:** A position in a previously filed tax return or a position expected to be taken in a future tax return that is reflected in measuring current or deferred income tax assets or liabilities for interim or annual periods.”
Final Exam

1. Under existing GAAP for debt issuance costs prior to the effective date of ASU 2015-03, how are such costs accounted for:
   a. Expensed as incurred
   b. Capitalized as an asset and amortized
   c. Netted against debt
   d. Recorded as an asset and not amortized until the debt is repaid in full

2. With respect to ASU 2015-03 and debt issuance costs, the ASU does not apply to which of the following:
   a. Debt issuance costs of liabilities that are reported at cost
   b. Debt issuance costs of liabilities that are reported at fair value
   c. Debt issuance costs of liabilities that have maturity dates in excess of five years
   d. The amortization of a premium and discount of assets reported at cost

3. Facts: Brad Pitt CPA has to decide how to account for debt issuance costs under ASU 2015-03 for his client. Which of the following is the way in which such costs should be accounted for:
   a. Amortized to amortization expense
   b. Amortized to interest expense
   c. Not amortized but capitalized while the debt is outstanding
   d. Amortized and presented in other expense, net of tax

4. Which of the following must be disclosed regarding debt:
   a. Effective interest rate
   b. Market interest rate
   c. Replacement interest rate
   d. Risk-free interest rate

5. Julia Roberts CPA is the accountant for Ashford Cosmetics. Ashford seeks to implement ASU 2015-03 for its debt issuance costs. How should Ashford apply the new ASU:
   a. Proactively
   b. Prospectively
   c. Retroactively
   d. Retrospectively

6. Big John’s Fried Steak obtains a $5,000,000 line of credit from a local bank. The Company pays $100,000 for debt issuance costs related to the line of credit. How should the Company account for the costs under ASC 2015-15:
   a. Expense them as incurred
   b. Capitalize them and present them as an asset
   c. Capitalize them and net them against the line of credit liability balance
   d. Present them as a reduction of stockholder’s equity
7. Which of the following does ASU 2015-04 apply to:
   a. Employers who sponsor 401k plans
   b. Employee benefit plans
   c. Employers who sponsor defined benefit pension plans
   d. Health insurance plans

8. Which of the following is an example of a cloud computing arrangements:
   a. Software as a service
   b. Hardware for business use
   c. Software to be installed on an individual’s laptop
   d. Scanning services

9. Company L has internal-use software. How should L account for that software:
   a. Capitalize it but do not amortize it
   b. Amortize it on an accelerated basis
   c. Amortize it on a straight-line basis
   d. Expense it as incurred

10. Company X has signed a contract and obtains access to software in a hosting arrangement. In accordance with ASU 2015-05, which of the following is one of the criteria that must be met in order for X to treat it as internal-use software:
    a. X is not permitted to run the software on its own hardware
    b. X has the contractual right to take possession of the software without significant penalty
    c. X is permitted to take possession of the software by paying a significant penalty
    d. X is not permitted to have another party unrelated to the vendor to host the software

11. Company M has signed a contract and obtains access to software in a hosting arrangement. In accordance with ASU 2015-05, which of the following is one of the criteria that must be met in order for M to treat it as internal-use software:
    a. M can run the software on its own hardware
    b. M must develop the software internally
    c. M must be able to sell the software to a third party
    d. It is not feasible for M to run any software within its own hardware

12. Implications of a drastic change in the format of financial statements would include all of the following except:
    Tax return M-1 reconciliation would differ
    Contract formulas for bonuses would have to be rewritten
    The cost would be significant
    The use of the term cash equivalents would remain in tact
13. Which of the following is a reason why U.S. convergence with international standards has not occurred:
   a. It would require issuing financial statements in more than one language
   b. The cost to change would be significant
   c. It would require all companies to adopt LIFO
   d. International standards would be superior to U.S. standards thereby requiring more disclosures

14. Under the newly issued ASU 2016-01, which of the following is eliminated:
   Available-for-sale category for equity investments
   Held to maturity category for equity investments
   Trading category for equity investments
   Lower of cost or market category for all investments

15. One key change under the lease standard is:
   a. A small portion of operating leases, but not capital leases, would be brought onto the balance sheet
   b. Capital leases, but not operating leases, would be brought onto the balance sheet
   c. No leases would be capitalized
   d. Most existing operating leases would be brought onto the balance sheet

16. Under the lease standard, the lessee recognizes the liability at the present value of the lease payments discounted at which of the following permitted rates:
   a. The lessor’s borrowing rate
   b. The interest rate for similar obligations in the market
   c. The lessee’s incremental borrowing rate
   d. 110% of the applicable federal rate

17. Under the lease standard, which of the following is true as it relates to the lessee:
   a. An asset is recognized representing the sum of the lease payments over the lease term
   b. An asset is recognized representing its right to use the leased asset for the lease term
   c. An asset is not recognized
   d. An asset is recognized only if four criteria are met

18. How does a lessee account for initial direct costs incurred in connection with a lease, under the lease standard:
   a. Initial direct costs are included in the lease asset that is recorded at the commencement date
   b. Initial direct costs are not part of the lease asset
   c. Initial direct costs are expensed as period costs
   d. The lease standard is silent as to how to account for initial direct costs
19. Which of the following is \textit{not} considered part of lease payments under the lease standard:  
   a. Fixed payments  
   b. Amortization on the underlying leased asset  
   c. Exercise price of a purchase option  
   d. Payments for penalties for terminating the lease  

20. What happens to existing leases on the date of adoption of the lease standard:  
   a. Existing operating leases are grandfathered but capital leases are not  
   b. Existing capital leases are grandfathered but operating leases are not  
   c. The lease standard does not grandfather any existing leases  
   d. Existing leases are phased into the new standard over a four-year period  

21. Under the lease standard, which of the following is true:  
   a. Lease terms are likely to shorten to decrease the amount of the lease obligation  
   b. Lease terms are likely to get longer to reduce the amount of the lease obligation  
   c. Lease terms are likely to shorten to increase the amount of the lease asset recorded  
   d. Lease terms are likely to get longer to reduce the amount of the lease asset recorded  

22. The lease standard will likely result in which of the following occurring for existing leases:  
   a. Total lease expense for tax purposes will be greater than total GAAP expense  
   b. Total GAAP expense will be greater than lease expense for tax purposes  
   c. GAAP and tax expense will be identical  
   d. There will be no change in the total expense for GAAP or tax purposes from current practice  

23. Under the lease standard:  
   a. Deferred tax assets will likely be created  
   b. Deferred tax assets will likely be reduced  
   c. Deferred tax liabilities will likely be created  
   d. Deferred tax liabilities will likely be reduced  

24. One potential impact from the lease standard for finance (Type A) leases may be that EBITDA will have a/an:  
   a. Favorable impact because interest will decrease while rental expense will increase  
   b. Unfavorable impact because depreciation will increase while rental expense will decrease  
   c. Favorable impact because interest and amortization expense will increase while rental expense will decrease  
   d. Unfavorable impact because interest, depreciation and rental expense will all increase  

25. One potential impact from the lease standard may be that the debt-equity ratio will be:  
   a. Higher  
   b. Lower  
   c. The same  
   d. Either higher or lower depending on several factors
26. With respect to the Big-GAAP, Little-GAAP issue, accountants and their clients have defaulted to several techniques to avoid the burdensome task of having to comply with recently issued difficult and irrelevant accounting standards. Such techniques include all of the following except:
   a. Ignore the new GAAP standards
   b. Include a GAAP exception in the accountant’s/auditor’s report
   c. Issue tax-basis financial statements
   d. Issue standard GAAP statements

27. If a company uses the AICPA’s FRF for SMEs, that company may have a challenge in its use which may be that this framework:
   a. Is too complex to follow
   b. Is nonauthoritative
   c. Lacks core disclosures required by third parties
   d. Is too costly to implement

28. Which of the following is a key difference between IFRS for SMEs and IFRS:
   a. IFRS for SMEs is more complex than full IFRS
   b. IFRS for SMEs has simpler reporting needs
   c. IFRS for SMEs applies to large companies while IFRS applies to small to medium-sized companies
   d. IFRS for SMEs has more disclosures than IFRS

29. Which of the following is an example of an attribute found in the IFRS for SMEs:
   a. Topics that are not relevant to larger, public companies, have been omitted
   b. Revisions to the IFRS for SMEs are limited to once every decade
   c. There are thousands of pages in the IFRS for SMEs
   d. IFRS for SMEs is organized by topic within 35 sections

30. Which of the following is true as it relates to U.S. companies and their use of IFRS for SMEs:
   a. U.S. private companies are not yet permitted to adopt IFRS for SMEs
   b. U.S. private companies are required to adopt IFRS for SMEs
   c. U.S. public companies may adopt IFRS for SMEs
   d. U.S. private companies are permitted to adopt IFRS for SMEs

31. In accordance with the FASB’s ASU 2014-15 related to going concern, management's evaluation of going concern runs for what period of time:
   a. One year
   b. Six months
   c. A reasonable period of time that is not quantified
   d. Eighteen months
32. Under GAAP, a disclosure is required if, among other requirements, a concentration makes the entity vulnerable to the risk of _________________:
   a. A short-term negative impact
   b. A near-term severe impact
   c. A long-term disruptive impact
   d. A prospective loss

33. Company X has various concentrations in its business. X wants to know which concentrations might require disclosure. Under ASC 275, which of the following is not likely to be a type of concentration to which a disclosure might be required:
   a. Concentration of trucks
   b. Concentration in the volume with a particular customer
   c. Concentration in the available sources of materials
   d. Concentration in available labor

34. Which of the following thresholds does ASC 740 use for evaluating a liability for a tax position under FIN 48:
   a. More likely than not
   b. Probable
   c. Remote
   d. Reasonably possible

35. Company X is a nonpublic entity that has no uncertain tax positions liability. Which of the following is true:
   a. X must disclose the number of tax years open for tax examination
   b. X must include an abbreviated disclosure of the number of tax years open for examination
   c. The exclusion of the disclosure only applies if X is SEC registered and not a nonpublic entity
   d. X is not required to disclose the number of tax years open for examination

36. In considering whether to accept a client who grows and sells marijuana, which of the following is true:
   a. Most marijuana businesses have to work on a literal cash basis
   b. Credit card companies now accept payments for the purchases of marijuana
   c. Security is no longer an issue because banks will accept deposits from marijuana businesses
   d. Marijuana businesses are permitted to make payroll tax deposits by check instead of cash