Changes You Need to Know – The 2017 FASB REVIEW

(Item #30 and 30E)

16 CPE Hours

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2017 FASB REVIEW

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

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

- Recognize a key change made to GAAP by the new lease standard
- Identify a type of lease that exists for a lessee under ASU 2016-02
- Recall a type of lease for which the ASU 2016-02 rules do not apply
- Recognize some of the criteria that determine whether a contract is or is not a lease
- Identify a threshold for a lease term to be considered a major part of an asset's remaining economic life
- Identify how a lessee should account for initial direct costs
- Recall how a lessor should initially account for initial direct costs for a lease in certain instances
- Identify how a lessor should account for lease payments received on the income statement for an operating lease
- Recognize how certain existing leases are accounted for on the implementation date of ASU 2016-02
- Recall the potential impact that the new lease standard might have on a lessee's EBITDA and debt-equity ratios, and

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

- Identify the category of securities for which ASU 2016-01 retains the three categories under existing GAAP
- Recall one of the changes to existing GAAP for financial instruments made by ASU 2016-01
- Recall how available for sale debt securities are measured on an entity's balance sheet
- Identify how held to maturity securities are measured on the balance sheet
- Recognize how an entity should account for a temporary impairment.
- Recall how an entity should present an unrealized gain or loss on an equity security under ASU 2016-01
- Identify how a mutual fund that invests in debt and equity securities should classify the investment
- Recall a change made to the exemption for fair value disclosures with respect to trade receivables and payables
- Recognize the model that ASU 23016-13 uses to deal with credit losses
- Identify how credit losses should be recorded under new ASU 2016-13

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

- Identify one of the five steps required in applying the new revenue standard
- Recall the general rule that determines whether an entity should record revenue gross or net

- Recognize the requirement that must be met for a company be considered a principal in a revenue transaction
- Recall one of the indicators that ASU 2016-08 removes from the revenue model in determining gross versus net treatment of revenue
- Identify the general rule for determining whether an entity should record revenue gross or net
- Recognize an example of a prepaid stored-value product
- Recall how an entity should implement ASU 2016-04 related to prepaid stored-value products
- Recognize some of the changes made to the five steps of the new revenue standard by ASU 2016-12 amendments
- Identify a type of intellectual property that has significant standalone functionality
- Recognize how an entity should record revenue related to a license

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

- Recall one of the reasons why U.S. convergence with international standards has not occurred
- Recognize some of the differences between IFRS for SMEs and IFRS
- Identify a technique that accountants have defaulted to avoid GAAP
- Recognize the disclosure requirements when a nonpublic entity has no uncertain tax positions
- Recognize the classification of certain cash flow transactions addressed by ASU 2016-15
- Identify the expense account to which amortization of debt issuance costs should be recorded
- Recall the rate that an entity should use to amortize debt issuance costs

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

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

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

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

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

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CHAPTER 1:

ASU 2016-02:
Leases (Topic 842)

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ASU 2016-02: Leases (Topic 842)

Accounting for the New Lease Standard

Issued: February 2016

Effective Date:

The amendments in ASU 2016-02 are effective for fiscal years *beginning after December 15, 2018*, including interim periods within those fiscal years, for any of the following:

1. A public business entity
2. 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
3. An employee benefit plan that files financial statements with the U.S. Securities and Exchange Commission (SEC).

For all other entities (including non-public entities), the amendments in ASU 2016-02 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 ASU 2016-02 is permitted for all entities.

Objective:

The objective of ASU 2016-02 is to specify the accounting for leases and to establish the principles that lessees and lessors shall apply to report useful information to users of financial statements about the amount, timing, and uncertainty of cash flows arising from a lease.

I. 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. 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: 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

The changes made to lease accounting by ASU 2016-02 were instigated by Enron's collapse. The demise of Enron and a few other entities such as WorldCom, lead to the passage of the Sarbanes-Oxley Act of 2002. Within Sarbanes Oxley, Congress included a requirement that the SEC perform a study and issue a report on the extent to which public companies had significant off-balance sheet transactions.

In its 2005 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 resulted in significant liabilities being off-balance sheet.

Per the SEC Report and a U.S. Chamber of Commerce report:

a. 63% of companies record operating leases while 22% 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 operating lease obligations.

Moreover, 73 percent of all leases held by U.S. public companies ($1.1 trillion) involve the leasing of real estate.[1]

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 have completely changed the accounting (capital versus operating) for leases.

Keeping leases off-balance sheet while still retaining tax benefits, has been an industry unto itself. So-called "synthetic" leases have commonly been 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.

[1] CFO.com

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

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 to replace existing lease accounting rules found in ASC 840 (formerly FASB No. 13) and its counterpart in Europe, IASB No. 17. The FASB and IASB started deliberations on the project in 2007, and issued a discussion memorandum in 2009, following by the issuance of an exposure draft in 2010 entitled, *Leases (ASC 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 (ASC 840).*

Ultimately, in February 2016, the FASB issued a final standard in ASU 2016-02.

ASU 2016-02 replaces existing lease accounting rules found in ASC 840, *Leases*, with newly issued ASC 842, *Leases*.

The new ASC 842 affects any entity that enters into a lease with a few specified scope exemptions.

The main differences between previous GAAP in ASC 840 and new ASC 842 are:

- Most operating leases previously kept off balance sheet under ASC 840 are now capitalized under the new ASC 842.

- In ASC 842, all leases with a lease term more than 12 months must be capitalized, even if those leases have been expensed as operating leases in existing ASC 840.

ASC 842 retains a distinction between finance leases and operating leases. The classification criteria for distinguishing between finance leases and operating leases are substantially similar to the classification criteria for distinguishing between capital leases and operating leases in the previous leases guidance.

The result of retaining a distinction between finance leases and operating leases is that under the lessee accounting model in ASC 842, the effect of leases in the statement of income and the statement of cash flows is largely unchanged from previous GAAP in ASC 840.

II. Basic Concepts of ASU 2016-02

A. General Rules

1. Core principle in ASU 2016-02:

The core principle of ASU 2016-02 is that:

> *An entity should use the right-of-use model to account for leases which requires an entity to recognize assets and liabilities arising from a lease.*

This represents a significant change from existing lease requirements, which do not require lease assets and lease liabilities to be recognized for many leases, particularly those classified as operating leases.

In accordance with ASU 2016-02's *right-of-use model*:

a. A lessee recognizes assets and liabilities for all leases that have a maximum possible lease term of *more than 12 months*.

b. A lessee that has a lease with a term of *12 months or less*, may use a short-term lease option to either keep the lease off balance sheet, or recording a lease asset and liability.[2]

2. Lessee's side of the lease transaction- ASU 2016-02:

From the lessee's perspective, ASU 2016-02 makes significant changes to the accounting for leases, contrary to the existing GAAP's capital versus operating lease approach.

Under the new rules:

a. A lessee recognizes a liability to make lease payments (the lease liability) and a corresponding right-of-use asset representing its right to use the leased asset (the underlying asset) for the lease term.

   - The lease liability is the present value of the lease payments during the lease term.

   - The right-of-use asset is recorded at the amount of the lease liability plus certain initial direct costs.

b. The lessee's recognition, measurement, and presentation of expenses and cash flows arising from a lease depend on whether the lessee is *expected to consume a major part of the economic benefits* of the underlying leased asset.

c. Two types of leases for the lessee: ASU 2016-02 provides *two categories of leases* for the lessee.

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[2] Under the short-term lease option, the lease also must not have an option where it is reasonably possible that the option will be exercised at the commencement date.

- Finance leases (Type A): Interest and amortization expense are measured on an accelerated basis and recorded and presented as two separate expenses on the income statement, and

- Operating leases (Type B): Lease expense is recorded and measured on a straight-line basis and presented as one line item on the income statement- as combination of interest and amortization

Note: The only difference between the two types of leases is how total expense is recorded. Otherwise, the initial measurement and recording of the lease liability and asset is the same for both types of leases.

3. Lessor's side of the lease transaction:

From the lessor's perspective, ASU 2016-02 amendments provide for three potential types of leases:

- Sales-type lease
- Direct financing lease, or
- Operating lease

4. Other key elements found in ASU 2016-02:

There are several other important elements in the ASU that affect both lessees and lessors:

- The ASU exempts from the new standard any short-term leases with a lease term (including option periods) of 12 months or less and that have no option to purchase.

- Option payments and option lease terms are included in the present value calculation if it is *reasonably certain* that the lessee will exercise the lease extension or lease purchase option.

- The lease standard does not provide for the grandfathering of existing leases on the lease implementation date. Thus, on the implementation date, active leases must be adjusted to the new standard.

- The ASU includes numerous new disclosures related to leases.

5. Confusion over the use of the term "operating lease" and the use of Type A and B leases:

ASU 2016-02 has several nuances that are likely to confuse the reader. One of them is the use of the term "operating lease" to define leases on both the lessee and lessor side. The operating lease term is a holdover from existing lease rules found in ASU 840. Under the new ASU 2016-02 amendments, a lessee's lease classified as an operating lease is capitalized while an operating lease classified by a lessor is not.

Recall that under existing, pre-ASU 2016-02 authority (found in ASC 840) and lessee's operating lease is not recorded on the balance sheet. Instead, the lease is kept off-balance sheet with the lessee recording rent expense on a straight-line basis over the lease term.

With respect to ASU 2016-02, the term "operating lease" is used on both the lessee and lessor sides of the lease transaction as follows:

Lessee's operating lease: Lease is capitalized with a right-of-use asset and lease obligation, with total lease expense recognized on a straight-line basis over the lease term.

Lessor's operating lease: Lease is not recorded. Underlying asset is retained on the lessor's books with rental income recorded on a straight-line basis over the lease term.

The author suggests that the FASB, in creating ASU 2016-02, should have used new descriptions of leases under the new standard to differential from the terms used in previous ASC 840. One of those lease descriptions that should not have been used in ASU 2016-02 is the use of the term "operating lease." That term is linked to previous GAAP and should have been retired.

6. Effective date:

The ASU is effective for calendar Year 2019 for public companies, and for calendar Year 2020 for all other entities (including non-public entities). Early application of the amendments in ASU 2016-02 is permitted for all entities.

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.

1. Which of the following models does the new ASU 2016-02 lease standard use:
   a. Right-of-use model
   b. Operating lease model
   c. Capital lease model
   d. True lease model

2. Under the new lease standard, which one of the following leases is exempt from being recorded on the balance sheet:
   a. Capital leases
   b. Leases with a term of 12 months or less
   c. Related party leases
   d. Finance leases

3. How are options accounted for under the new lease standard:
   a. Option payments and option lease terms are included in the present value calculation in certain instances
   b. The lease term includes lease options only once they are exercised
   c. Options are ignored altogether in determining lease term
   d. Options are considered in the lease payments but not the lease term

SUGGESTED SOLUTIONS

1. Which of the following models does the new ASU 2016-02 lease standard use:
   a. **Correct. The new lease standard uses the right-of-use model under which assets and liabilities arising from the lease are recorded on the balance sheet.**
   b. Incorrect. Although certain leases under the new model are called operating leases, the model is not referred to as an operating lease model.
   c. Incorrect. The term "capital lease" is part of existing GAAP and is not used in the new 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.

2. Under the new lease standard, which one of the following leases is exempt from being recorded on the balance sheet:
   a. Incorrect. The term "capital leases" is part of existing GAAP and is not used in the new lease standards.
   b. Correct. ASU 2016-02 allows leases with a term of 12 months to be kept off balance sheet.
   c. Incorrect. ASU 2016-02 does not provide any special rules for related-party leases. Instead, such leases are treated like any other leases.
   d. Incorrect. Finance leases are one type of lease that must be capitalized by a lessee under ASU 2016-02, making the answer incorrect.

3. How are options accounted for under the new lease standard:
   a. **Correct. Option payments and option lease terms are included in the present value calculation if it is reasonably certain that the lessee will exercise the lease extension or lease purchase option.**
   b. Incorrect. The new standard does not provide for lease options being considered in the lease term only once the option is exercised. Both the lease term and payment are reflected in the lease calculations in certain instances.
   c. Incorrect. The new standard states that options are considered in lease calculations in certain instances making the answer incorrect.
   d. Incorrect. Options are considered in both the lease payments and lease term in certain instances, making the answer incorrect.

III. Scope and Scope Exceptions

1. An entity shall apply ASU 2016-02 to *all leases*, including subleases.

2. The ASU *does not apply* to the following:

   a. Leases of intangible assets, covered by ASC 350, *Intangibles—Goodwill and Other*

   b. Leases to explore for or use minerals, oil, natural gas, and similar non-regenerative resources, covered by ASC 930, *Extractive Activities— Mining, and 932, Extractive Activities—Oil and Gas*

   c. Leases of biological assets, including timber covered by ASC 905, *Agriculture*

   d. Leases of inventory per ASC 330, *Inventory*

   e. Leases of assets under construction, covered by ASC 360, *Property, Plant, and Equipment*

   Note: The exclusion of leases of intangible assets encompasses intangible rights to explore related to natural resources and rights to use land that contains those natural resources. The exclusion does not apply to rights of use where the right includes more than the right to explore for natural resources. The exclusion also does not extend to any equipment used to explore for the natural resources.

IV. Identifying a Lease

1. At inception of a contract, an entity (lessee and lessor) shall determine *whether that contract is or contains a lease*.

2. A contract is or contains a lease if the contract:

   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.

   a. A period of time may be described in terms of the amount of use of an identified asset (for example, the number of production units that an item of equipment will be used to produce).

3. In assessing whether a contract has a lease, there must be the following *two elements*:

   ELEMENT 1: There must be an *identified asset*, and

   ELEMENT 2: The lessee must have a *right to control the use* of the identified asset for a period of time

4. An entity shall reassess whether a contract is, or contains a lease only if the terms and conditions of the contract are changed.

5. In making the determination about whether a contract is, or contains a lease, an entity shall consider all relevant facts and circumstances.

6. Contract combinations

   a. An entity shall combine two or more contracts, at least one of which is, or contains a lease, entered into at or near the same time with the same counterparty (or related parties) and consider the contracts as a single transaction if any of the following criteria are met:

      1) The contracts are negotiated as a package with the same commercial objective(s).

      2) The amount of consideration to be paid in one contract depends on the price or performance of the other contract, or

      3) The rights to use underlying assets conveyed in the contracts (or some of the rights of use conveyed in the contracts) are a single lease component.

Element 1: There must be an identified asset

1. A lease must have an identified asset:

   a. If there is no identified asset, there is no lease.

   b. To be an identified asset, the asset must be either property, plant or equipment.

2. An asset typically is identified by being:

   a. *Explicitly specified in a contract*, *or*

   b. *Implicitly specified* at the time that the asset is made available for use by the lessee (customer).

3. There is no identified asset if the lessor (lessor (supplier) has the *substantive right to substitute the asset (substantive substitution rights)* throughout the period of use, even if the asset is specified.

   a. A lessor's (supplier's) *right to substitute an asset is substantive* only if *both* of the following conditions exist:

      1) The lessor (supplier) has the *practical ability to substitute alternative assets* throughout the period of use.

         a) The lessor (supplier) *has the practical ability* if:

            - A lessee (customer) cannot prevent the lessor (supplier) from substituting an asset, and

            - Alternative assets are readily available to the lessor (supplier) or could be sourced by the lessor (supplier) within a reasonable period of time.

b) If the lessor (supplier) has a right or an obligation to substitute the asset *only on or after either a particular date or the occurrence of a specified event*, the lessor (supplier) *does not have the practical ability to substitute* alternative assets throughout the period of use.

c) A lessor (supplier) *does not have the practical ability to substitute alternative assets* if the lessor (supplier) is required to substitute an asset:

- For repairs or maintenance, if the leased asset is not operating properly, or
- For a technical upgrade that is available.

2) The lessor (supplier) *would benefit economically* from the exercise of its right to substitute the asset.

a) A lessor (supplier) benefits economically if the expected benefits *exceed the costs* of substituting the asset.

Note: If the asset is located at the lessee's (customer's) premises or elsewhere, the costs associated with substitution are generally higher than when located at the lessor's (supplier's) premises and, therefore, are more likely to exceed the benefits associated with substituting the asset. Thus, it is more difficult to justify that the lessor (supplier) would benefit economically from substitution where the asset is located other than on the lessor's (supplier's) premises. The exception might be where the contract requires that the lessee pay some or all of the substitution costs thereby mitigating the costs of substitution incurred by the lessor (supplier).

b. An entity's evaluation of whether a lessor's (supplier's) substitution right is substantive is based on *facts and circumstances at inception* of the contract and shall *exclude consideration of future events that, at inception, are not considered likely to occur*.

c. If the lessee (customer) cannot readily determine whether the lessor (supplier) has a substantive substitution right, the lessee (customer) shall presume that any substitution right is not substantive.

4. A capacity portion of an asset *is an identified asset* if it is physically distinct such as a floor of a building or a segment of a pipeline that connects a single lessee (customer) to the larger pipeline.

a. A capacity or other portion of an asset that is not physically distinct (for example, a capacity portion of a fiber optic cable) is not an identified asset, unless it represents substantially all of the capacity of the asset and thereby provides the lessee (customer) with the right to obtain substantially all of the economic benefits from use of the asset.

Element 2: The lessee must have the right to control the use of the identified asset for a period of time

1. To have a lease, the second element that must be satisfied is that the lessee must have the *right to control the use of the identified asset* for a period of time.

2. An entity has the right to *control the use* of the identified asset if it has:

   a. The *right to obtain substantially all of the economic benefits* from use of the identified asset

   b. The *right to direct the use of the identified asset*

3. Right to obtain substantially all of the economic benefits from the use of the identified asset

   a. To *control the use* of an identified asset, a lessee (customer) is required to have the *right to obtain substantially all of the economic benefits* from use of the asset throughout the period of use (for example, by having exclusive use of the asset throughout that period).

   b. A lessee (customer) can *obtain economic benefits* from use of a leased asset directly or indirectly in many ways, such as by:

      - Using the asset
      - Holding the asset
      - Subleasing the asset

   c. The economic benefits from use of an asset include its primary output and by-products (including potential cash flows derived from these items) and other economic benefits from using the asset that could be realized from a commercial transaction with a third party.

   d. When assessing the right to obtain substantially all of the economic benefits from use of an asset, an entity shall consider the economic benefits that result from use of the asset within the defined scope of a lessee (customer)'s right to use the asset in the contract.

   e. If a contract requires a lessee (customer) to pay the lessor (supplier) or another party a portion of the cash flows derived from use of an asset as consideration, those cash flows paid as consideration shall be considered to be part of the economic benefits that the lessee (customer) obtains from use of the asset.

4. Right to direct the use of the identified asset

   a. To *control the use* of an identified asset, a lessee must have the *right to direct the use of an identified asset* throughout the period of use in *either* of the following situations:

      1) The lessee (customer) must have the *right to direct how and for what purpose the asset is used* throughout the period of use, or

      2) If the relevant decisions about *how and for what purpose the asset is used* are *predetermined*, at least one of the following two conditions must exist:

         a) The lessee has the right to operate the asset (or to direct others to operate the asset in a manner that it determines) throughout the period of use without the lessor (supplier) having the right to change those operating instructions.

b) The lessee designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

Note: In assessing whether a lessee (customer) has the right to direct the use of an asset, an entity shall consider *only rights to make decisions about the use of the asset* during the period of use unless the lessee (customer) designed the asset (or specific aspects of the asset).

An entity shall not consider decisions that are predetermined before the period of use. For example, if a lessee (customer) is able only to specify the output of an asset before the period of use, the lessee (customer) does not have the right to direct the use of that asset.

The relevant decisions about how and for what purpose an asset is used can be predetermined in a number of ways. For example, the relevant decisions can be predetermined by the design of the asset or by contractual restrictions on the use of the asset.

b. A lessee (customer) has *the right to direct how and for what purpose an asset is used* throughout the period of use if, within the scope of its right of use defined in the contract, it can change how and for what purpose the asset is used throughout that period.

1) In making this assessment, a lessee (customer) considers the decision-making rights that are *most relevant* to changing how and for what purpose an asset is used throughout the period of use.

a) Decision-making rights *are relevant* when they affect the economic benefits to be derived from use. The decision-making rights that are most relevant are likely to be different for different contracts, depending on the nature of the asset and the terms and conditions of the contract.

b) Examples of decision-making rights that generally *grant the right to direct how and for what purpose an asset is used*, within the defined scope of the lessee's (customer's) right of use, include the following:

- The right to change the type of output that is produced by the asset (for example, deciding whether to use a shipping container to transport goods for storage, or deciding on the mix of products sold from a retail unit)

- The right to change when the output is produced (for example, deciding when an item of machinery or a power plant will be used)

- The right to change where the output is produced (for example, deciding on the destination of a truck or a ship or deciding where a piece of equipment is used or deployed)

- The right to change whether the output is produced and the quantity of that output (for example, deciding whether to produce energy from a power plant and how much energy to produce from that power plant).

c) Examples of decision-making rights that *do not grant the right to direct how and for what purpose an asset is used* include rights that are limited to operating or maintaining the asset.

c. Protective rights of the lessor (supplier) *do not prevent the lessee from having the right to direct the use* of an identified asset.

1) Protective rights are typically terms and conditions in a contract designed to protect certain rights of a lessor (supplier) including:

- The lessor's (supplier's) interest in the asset or other assets
- Its personnel
- Compliance with laws or regulations

2) Examples of protective rights include:

- A contract provision that requires a lessee to follow particular operating practices or inform the lessor (supplier) of changes in how the asset will be used, or
- A contract provision that specifies the maximum amount of use of an asset or limit where or when the lessee can use the asset

5. Other issues related to right to control the leased asset:

a. If the lessee (customer) in the contract is a joint operation or a joint arrangement, an entity shall consider whether the joint operation or joint arrangement has the right to control the use of an identified asset throughout the period of use.

b. If the lessee (customer) has the right to control the use of an identified asset for only a portion of the term of the contract, the contract contains a lease for that portion of the term.

Illustrations of Identifying a Lease

Source: ASU 2016-02, as modified by the author.

Example 1—Contract for Rail Cars

- A contract between Lessee and a freight carrier (Lessor) provides Lessee with the use of 10 rail cars of a particular type for five years.
- The contract contains leases of rail cars. Lessee has the right to use 10 rail cars for five years.
- The contract *specifies the rail cars*; the cars are owned by Lessor.
- There are 10 identified cars. The cars are explicitly specified in the contract.
- Lessee determines when, where, and which goods are to be transported using the cars.
- When the cars are not in use, they are kept at Lessee's premises.
- Lessee can use the cars for another purpose (for example, storage) if it so chooses.
- However, the contract has a protective right which specifies that Lessee cannot transport particular types of cargo, such as explosives.
- Once delivered to Lessee, the cars *can be substituted only when they need to be serviced or repaired*. Otherwise, and other than on default by Lessee, the Lessor cannot retrieve the cars during the five-year period.
- The contract also has a *service component*:
  - The contract also requires Lessor to provide an engine and a driver when requested by Lessee.
  - Lessor keeps the engines at its premises and provides instructions to the driver detailing Lessee's requests to transport goods.
  - The engine used to transport the rail cars is not an identified asset because it is neither explicitly specified nor implicitly specified in the contract.
  - Lessor can choose to use any one of a number of engines to fulfill each of Lessee's requests, and one engine could be used to transport not only Lessee's goods, but also the goods of other lessees (customers) (for example, if other lessees require the transport of goods to destinations close to the destination requested by Lessee and within a similar timeframe, Lessor can choose to attach up to 100 rail cars to the engine).

Conclusion:

The contract satisfies the two elements to be considered a lease.

Element 1: The contract provides for an *identified asset.*

a. Lessor *cannot substitute assets* except being serviced or repaired.

Element 2: Lessee has the *right to control the use of the 10 rail cars* throughout the five-year period of use because:

a. Lessee has the right to *obtain substantially all of the economic benefits* from use of the cars over the five-year period of use, and

b. Lessee has the right to *direct the use of the cars* throughout the period of use, including when they are not being used to transport Lessee's goods.

- The contractual restrictions on the cargo that can be transported by the cars are protective rights of Lessor and merely define (but do not restrict) the scope of the Lessee's right to use the cars.
- Lessee makes all relevant decisions about how and for what purpose the cars are used by being able to decide when and where the rail cars will be used and which goods are transported using the cars.
- Lessee also determines whether and how the cars will be used when not being used to transport its goods such as whether and when they will be used for storage.
- Lessee has the right to change these decisions during the five-year period of use.

Although having an engine and driver, controlled by Lessor, to transport the rail cars is essential to the efficient use of the cars, Lessor's decisions in this regard do not give it the right to direct how and for what purpose the rail cars are used. Consequently, Lessor does not control the use of the cars during the period of use.

Separating Components of a Contract

1. After determining that a contract contains a lease, an entity shall *identify the separate lease components* within the contract.

2. Components can consist of:

   - Lease components: each evaluated and measured separately under the lease standard, and
   - Non-lease components: Those components excluded from the application of ASU 2016-02 such as service and management service contracts, and certain reimbursements of expenses to suppliers.

3. An entity shall consider the right to use an underlying asset to be a *separate lease component* (that is, separate from any other lease components of the contract) if *both of the following criteria* are met:

   a. The lessee *can benefit from the right of use either on its own or together with other resources* that are readily available to the lessee.

      - Readily available resources are goods or services that are sold or leased separately by the lessor or other lessors or resources that the lessee already has obtained from the lessor or from other transactions or events.

   b. The right of use is *neither highly dependent on nor highly interrelated with the other right(s)* to use underlying assets in the contract.

      - A lessee's right to use an underlying asset is highly dependent on or highly interrelated with another right to use an underlying asset if each right of use significantly affects the other.

4. To classify and account for a lease of land and other assets, an entity shall account for the right to use land as a separate lease component unless the accounting effect of doing so would be insignificant (for example, separating the land element would have no effect on lease classification of any lease component or the amount recognized for the land lease component would be insignificant).

5. The consideration in the contract shall be allocated to each separate lease component and non-lease component of the contract.

   a. Components of a contract include only those items or activities that *transfer a good or service to the lessee.*

   b. If an item or activity does not transfer a good or service to a lessee, it is not considered a component of the contract.

      - Activities that do not transfer a good or service to the lessee or amounts paid solely to reimburse costs of the lessor are not components in a contract and are not allocated any of the consideration in the contract.

   c. Components of a contract include:

      - Common area maintenance (CAM) charges because they transfer a service to the lessee:

        Example: CAM charges for cleaning of the lobby, snow removal and utilities are costs that are components as they transfer a service to the lessee and would otherwise have to be undertaken or paid for by the lessee.

   d. The following are *not separate components of a contract and do not receive an allocation of the consideration* in the contract:

      - Administrative tasks to set up a contract or initiate the lease that do not transfer a good or service to the lessee

- Reimbursement or payment of the lessor's costs, such as reimbursement of real estate taxes and insurance charges.

  Example: A lessor may incur various costs in its role as a lessor or as owner of the underlying asset. A requirement for the lessee to pay those costs, whether directly to a third party or as a reimbursement to the lessor, does not transfer a good or service to the lessee separate from the right to use the underlying asset.

6. An entity shall account for each separate lease component separately from the nonlease components of the contract unless the lessee makes an accounting policy election in (7) below.

7. Accounting policy election- Practical expedient:

   a. As a practical expedient, a lessee may, as an accounting policy election by class of underlying asset, choose *not to separate nonlease components from lease components* and instead to account for each separate lease component and the nonlease components associated with that lease component as a single lease component.

8. Below are examples of the application of the ASU 2016-02 rules to separate components of a contract.

Example: Separating Components of a Contract

Source: ASU 2016-02, as modified by author

Example 1: Activities or Costs That Are Not Components of a Contract Payments for Taxes and Insurance Are Variable

- Lessor and Lessee enter into a five-year lease of a building.
- The contract requires the Lessee to pay for the costs relating to the asset, including the real estate taxes and the insurance on the building.
- The real estate taxes would be owed by Lessor regardless of whether the Lessee leased the building and who the Lessee is.
- Lessor is the named insured on the building insurance policy (that is, the insurance protects Lessor's investment in the building, and Lessor will receive the proceeds from any claim).
- The annual lease payments are fixed at $10,000 per year, plus the annual real estate taxes and insurance premium will vary and be billed to Lessee each year.

Conclusion:

The real estate taxes and the building insurance are not separate components of the contract. The contract includes a single lease component, the right to use the building, which is included in lease payments at the fixed amount of $10,000.

Lessee's payments of those amounts solely represent a reimbursement of Lessor's costs and do not represent payments for the transfer of goods or services in addition to the right to use the building. The real estate taxes and insurance expenses would be incurred by the Lessor regardless of whether the building was leased to the Lessee.

The real estate taxes and insurance premiums paid by Lessee during the lease term are variable and are recognized as a variable lease payment as incurred. They are excluded from the measurement of the lease liability and recognized in profit or loss on the lease.

8. Lessee allocation rules

a. Unless a lessee makes an accounting policy election in accordance with Paragraph (6) above, a lessee shall allocate the *consideration in the contract* to the *separate lease components* and the *nonlease components* as follows:

1) The lessee shall determine the relative *standalone price* of the separate lease components and the nonlease components based on their observable standalone prices.

- If observable standalone prices are not readily available, the lessee shall estimate the standalone prices, maximizing the use of *observable* information. A residual estimation approach may be appropriate if the standalone price for a component is highly variable or uncertain.

2) The lessee shall allocate the consideration in the contract on a relative standalone price basis to the separate lease components and the nonlease components of the contract.

Note: A price is observable if it is the price that either the lessor or similar lessor (supplier)s sell similar lease or nonlease components on a standalone basis.

3) The consideration in the contract for a lessee includes *all of the lease payments*, as well as all of the following payments that will be made during the lease term:

- Any fixed payments (such as monthly service charges) or in-substance fixed payments, less any incentives paid or payable to the lessee, other than those included as part of lease payments.

- Any other variable payments that depend on an index or a rate, initially measured using the index or rate at the commencement date.

4) Initial direct costs should be allocated to the separate lease components on the same basis as the lease payments.

b. A lessee shall remeasure and reallocate the consideration in the contract upon either of the following:

   1) A remeasurement of the lease liability (for example, a remeasurement resulting from a change in the lease term or a change in the assessment of whether a lessee is or is not reasonably certain to exercise an option to purchase the underlying asset), or

   2) The effective date of a contract modification that is not accounted for as a separate contract.

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.

1. Which of the following is an element that must exist for there to be a lease:
   a. There must be a description of an asset
   b. The lessee must have the right to retain physical custody of the asset on a regular basis
   c. The asset must be identified explicitly in the contract
   d. The asset must be property, plant or equipment

2. Company J has two contracts with a company that leases equipment. One of the contracts contains a lease. J should combine the two contracts and treat them as a single transaction if which one of the following criteria is met:
   a. The contracts are negotiated within one year of each other
   b. The amount of consideration to be paid in one contract is independent of the price of the other contract
   c. The rights to use the underlying assets are treated as a single component
   d. The two contracts have consideration which is similar in value to each other

3. A lessor has the practice ability to substitute alternative assets in which of the following instances:
   a. To repair the leased asset
   b. For maintenance of the leased asset
   c. For a technical upgrade that is available
   d. So that the lessor can benefit from selling the leased asset

4. Which of the following would be considered a protective right found in a lease contract: A contract provision that does which of the following:
   a. Requires the lessee to follow particular operating practices
   b. Defines the lease term
   c. Requires the lessee to make a specific payment by a prescribed date
   d. Defines the leased asset

5. Wally Gator is a CPA and getting a headache from reviewing the new ASU 2016-02 rules. In reviewing certain lease contracts, Wally notices that the contracts might have several components. Wally would rather be fishing and does not want to work that hard to separate the components. What is Wally's perfect solution:
   a. Elect not to capitalize any of the components
   b. Consolidate the components into one non-lease component
   c. Elect not to separate the components
   d. There is no solution as ASU 2016-02 requires that components be separated

SUGGESTED SOLUTIONS

1. Which of the following is an element that must exist for there to be a lease:
   a. Incorrect. There must be an identified asset and not just a description of an asset.
   b. Incorrect. The lessee must have the right to control the use of the asset, not merely retain physical custody of the asset on a regular basis
   c. Incorrect. Although the asset might be identified explicitly in the contract, it can also be implicitly specified at the time the asset is made available to the lessee. Thus, the answer is incorrect.
   d. Correct. A leased must involve use of either property, plant or equipment. Other types of assets, including intangible assets, do not qualify under the lease standard.

2. Company J has two contracts with a company that leases equipment. One of the contracts contains a lease. J should combine the two contracts and treat them as a single transaction if which one of the following criteria is met:
   a. Incorrect. ASU 2015-02 requires that the contracts are negotiated as a package with the same commercial objective. Negotiating as a package suggests they are negotiated at approximately the same time, and not within one year of each other.
   b. Incorrect. The ASU states that the amount of consideration in one contract must depend on the price or performance of the other contract. Thus, the contracts are interdependent, and not independent, making the answer incorrect.
   c. Correct. One of the criteria that ASU 2016-02 requires to combine the contracts into a single transaction is that the rights to use the underlying assets or the some or all of the rights in the contracts must be treated as a single component.
   d. Incorrect. The ASU does not provide a requirement that the consideration between the two contracts be similar in value to each other.

3. A lessor has the practice ability to substitute alternative assets in which of the following instances:
   a. Incorrect. The general rule is that a lessor does not have the ability to substitute alternative assets if the lessor must do so to accommodate a needed repair, particularly if the leased asset is not working properly.
   b. Incorrect. If a lessor substitutes the leased asset to perform maintenance of the leased asset, that action does not demonstrate the lessor's practical ability to substitute assets.
   c. Incorrect. The ASU states that a technical upgrade to the substituted asset that is available, is not deemed to show the lessor's practical ability to substitute alternative assets.
   d. Correct. On element that demonstrates that a lessor has the practical ability to substitute assets is if the lessor benefits economically from the substitution. In general, that occurs if the expected benefits from the substitution exceed the costs of doing so.

4. Which of the following would be considered a protective right found in a lease contract: A contract provision that does which of the following:
   a. Correct. A protective right is one that is designed to protect certain rights of the lessor. Such a protective right would be one that requires the lessee to follow particular operating practices, particularly those that might protect the underlying leased asset.
   b. Incorrect. Although defining the lease term would typically be included in the lease contract, such an element is not a protective clause as it does not protect a right of the lessor (supplier) in the leased asset.

c. Incorrect. A clause that requires the lessee to make a specific payment by a prescribed date is a contract term but not categorized as a protective clause as it does not protect the lessor's interest in the leased asset.
d. Incorrect. Defining the leased asset is not a protective clause as it does not protect the lessor's interest in the leased asset.

5. Wally Gator is a CPA and getting a headache from reviewing the new ASU 2016-02 rules. In reviewing certain lease contracts, Wally notices that the contracts might have several components. Wally would rather be fishing and does not want to work that hard to separate the components. What is Wally's perfect solution:
   a. Incorrect. ASU 2016-02 provides guidance on separating components but does not permit an entity not to capitalize any of the components. The separation of components has nothing to do with overriding the general concept that most leases must be capitalized.
   b. Incorrect. If components are combined, they are combined into one lease component. Nothing in the ASU permits establishing one non-lease component.
   c. Correct. ASU 2016-02 offers a practical expedient under which a lessee may make an accounting policy election to choose not to separate nonlease components from lease components. Instead, the components are combined into one single lease component.
   d. Incorrect. The solution is the practical expedient which allows for the combining of components into one single component. Thus, the answer is incorrect.

V. Lessee Rules

A. Lease Classification - Lessee

1. ASU 2016-02 requires an entity to classify each separate lease component at the commencement date. In most cases, there is one lease component per lease.

2. Once the classification is done, an entity shall not reassess the lease classification after the commencement date unless:

   a. The lease contract is modified and the modification is not accounted for as a separate contract.

   b. There is a change in the lease term or the assessment of whether the lessee is reasonably certain to exercise an option to purchase the underlying leased asset.

3. A lessee shall classify a lease as either a(an):

   Finance lease (Type A lease)- Lessee *expects to* consume a *major part* of the economic benefits of the leased asset:

   Operating lease (Type B lease)- Lessee *does not expect* to consume a *major part* of the economic benefits of the leased asset. An operating lease is defined as any lease that does not qualify as a finance lease.

4. Finance lease- lessee

   a. A lease is a *finance lease* if the lessee expects to *consume a major part of the economic benefits* of the leased asset when the lease meets any one of the following *five criteria* at the lease commencement date:

      Criterion 1: The lease *transfers ownership of the underlying asset* to the lessee by the end of the lease term.

      Criterion 2: The lease grants the lessee an *option to purchase* the underlying asset that the lessee is *reasonably certain* to exercise.

      Criterion 3: The lease term is for the major part of the remaining economic life of the underlying asset.

      1) *75% or more* of the remaining economic life of the underlying asset is a major part of the remaining economic life of that underlying asset.

         Exception: If the commencement date falls within the last 25% of the total economic life of the underlying leased asset, the 75% criterion (Criterion 3) cannot be used for purposes of classifying the lease.

Note: If a single lease component contains the right to use more than one underlying asset, an entity shall consider the remaining economic life of the predominant asset in the lease component in computing the 75% test.

Criterion 4: 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.

1) *90% or more of the fair value* of the underlying asset amounts to substantially all the fair value of the underlying asset.

   a) The ASU is silent as to which interest rate a lessee should use to apply the 90% test. Absent authority, the lessee should use rates authorized elsewhere within the ASU:

      First, use the rate implicit in the lease, if available
      Then, use the lessee's incremental borrowing rate.

   Note: The ASU states that in some cases, it may not be practicable for an entity to determine the fair value of an underlying asset for purposes of performing the 90% test (Criterion 4). The term "practicable" means that a reasonable estimate of fair value can be made without undue cost or effort. In situations in which it is not practicable for a lessee to determine the fair value of an underlying asset, the lease classification should be determined based on the other four criteria without consideration to the 90% test (Criterion 4).

Criterion 5: The underlying asset is of such a *specialized nature* that it is *expected to have no alternative use to the lessor* at the end of the lease term.

Below is a brief discussion of each of the five criteria.

Criterion 1: Transfer of ownership criterion

The transfer of ownership criterion (Criterion 1) is met in leases that have language that:

a. States that upon the lessee's performance in accordance with the terms of the lease, that the lessor should execute and deliver to the lessee such documents (including, if applicable, a bill of sale) as may be required to release the underlying asset from the lease and to transfer ownership to the lessee.

b. Requires the payment by the lessee of a *nominal amount* (for example, the minimum fee required by the statutory regulation to transfer ownership) in connection with the transfer of ownership.

Criterion 2: The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise

ASU 2016-02 provides that if a lease has an option to purchase the underlying leased asset and it is *reasonably certain* that the lessee will exercise the option, Criterion 2 is met and the lease is categorized as a finance lease (Type A) lease.

a. The determination of whether the lessee is reasonably certain to exercise the option is made at the commencement date, and not subsequent to the commencement date.

Criterion 3: Lease term is a major part of the remaining economic life of the underlying leased asset

In Criterion 3, ASU 2016-02 applies a 75 percent rule in determining whether the lease term is a major part of the remaining economic life.

It states that:

> "If the lease term is 75 percent or more of the remaining economic life of the underlying asset, the lease term is considered a major part of the remaining economic life of the asset. In such a case, Criterion 3 is satisfied and the lease is a finance lease from the lessee's perspective."

In determining the lease term, there are a few rules:

a. The lessee should include any options to extend the lease if it *reasonably certain* the lessee will exercise its option to extend the lease.

b. If the commencement date is within the last 25 percent of the total economic life of the leased asset, Criterion 3 cannot be used to test whether there is a finance lease. Instead, a lessee must use one of the other four criteria.

c. If a lease has several lease components with different remaining economic lives, the lessee should use the remaining economic life of the most predominant asset within the lease, to apply to the calculation of the entire lease.

Criterion 4: Present value is 90% or more of the fair value

Criterion 4 states that if the present value of the lease payments (and any residual value not already reflected in the lease payments) is 90 percent or more of the fair value of the leased asset, the lease consumes a major part of the economic benefit of the leased asset. Thus, Criterion 4 is satisfied and the lease is considered a finance (Type A) lease.

a. In determining the present value, lease payments should include the payments of any lease option periods and any option to purchase, if it is reasonably certain that the lessee will exercise those options.

b. The present value calculation should include a residual value at the end of the lease term.

What interest rate should a lessee use in making the 90% present value calculation in Criterion 4?

The ASU does not require that the lessee use the implicit interest rate to make the 90% calculation, although use of the implicit rate is required by the lessor. Absent the requirement to use the implicit interest rate, the author believes it is appropriate to follow the guidance found in the ASU in calculating the lease obligation which is to first use the implicit rate in the lease, if available. If the implicit rate is not available, use the lessee's incremental borrowing rate. Although the ASU permits use of a risk-free

rate (such as the U.S. Treasury rate) for non-public lessees in computing the lease obligation (discussed further on in this course), the author does not believe that use of that risk-free rate to perform the 90% test is appropriate and is likely to result in a distorted result. The sole purpose of using a risk-free rate in the lease obligation calculation is to simplify the calculation for the non-public entity even though, theoretically, the risk-free rate is not commensurate with a market rate.

Criterion 5: Alternative use

Criterion 5 states that that for a lessee, a lease is classified as a finance lease (Type A lease) if the leased asset is of such a specialized nature that it is expected to have *no alternative use to the lessor at the end of the lease term.*

ASU 2016-02 states that in assessing whether an underlying asset has an alternative use to the lessor at the end of the lease term and the lessor' ability to *readily direct that asset for another use* (such as sell it or lease it to an entity other than the lessee), a lessee should consider the effects of:

- Contractual restrictions, and
- Practical limitations.

The ASU provides the following guidance in making the assessment of alternative use:

a. A contractual restriction on a lessor's ability to direct an underlying asset for another use must be substantive (e.g., enforceable) for the asset not to have an alternative use to the lessor.

b. A practical limitation on a lessor's ability to direct an underlying asset for another use exists if the lessor would incur significant economic losses to direct the underlying asset for another use.

    - A significant economic loss could arise because the lessor either would incur significant costs to rework the asset or would only be able to sell or re-lease the asset at a significant loss.

      For example, a lessor may be practically limited from redirecting assets that either have design specifications that are unique to the lessee or that are located in remote areas.

ASU 2016-02 states that the possibility of the contract with the lessee (customer) being terminated is not a relevant consideration in assessing whether the lessor would be able to readily direct the underlying asset for another use.

5. Operating lease (Type B lease)- lessee

a. When none of the five criteria to classify a lease as a finance (Type A) lease are met, a lessee shall classify the lease as an *operating (Type B) lease*.

   That means an operating lease *fails all of the five criteria* related to a finance lease:

   - *Fails Criterion 1*: The lease does not transfer ownership of the underlying asset to the lessee at the end of the lease term.

- *Fails Criterion 2*: The lease does not grant the lessee an option to purchase the leased asset or there is an option to purchase and it is not reasonably certain that the lessee will exercise it at the commencement date.

- *Fails Criterion 3*: The lease term is not 75% or more of the remaining economic life of the leased asset.

- *Fails Criterion 4*: The present value of the lease payments (and any residual value guaranteed by the lessee) is less than 90% of the fair value of the leased asset, and

- *Fails Criterion 5*: The underlying asset is not of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

COMPARISON OF FIVE CRITERIA-
LESSEE LEASE CLASSIFICATION
FINANCE LEASE (TYPE A) VERSUS OPERATING LEASE (TYPE B)

Operating Lease (Type B) **[None of the Five Criteria]**	**FIVE CRITERIA**	**Finance Lease (Type A)** **[Any One of the Five Criteria]**
No transfer of ownership	**CRITERION 1** **Ownership transfer**	Transfer of Ownership
No option to purchase or Option to purchase and lessee is not reasonable certain to exercise	**CRITERION 2** **Option to Purchase**	Option to Purchase – lessee reasonably certain to exercise
< 75%	**CRITERION 3** **Lease term as % economic life**	75% or more **significant**
< 90%	**CRITERION 4** **PV lease payments- % of fair value**	90% or more **significant**
Leased asset: – Not specialized in nature – Expect <u>to have</u> alternative use to lessor	**CRITERION 5** **Specialized nature- alternative use**	Leased asset: – Is specialized in nature – Expected <u>not to have</u> alternative use to the lessor

Below are examples illustrating the classification of leases from the lessee's perspective.

Examples: Classification of Leases- Lessee

Source: The author.

Example 1: Criterion 1- Transfer of Ownership

Company X is a lessee who executes a five-year lease. The lease states that, at the end of the lease, the leased asset ownership transfers to X by X paying a nominal amount of $1.

Conclusion:

Because the lease calls for transfer of ownership at the end of the lease for a nominal amount of $1.00, Criterion 1 is satisfied and the lease is classified as a finance lease.

Example 2: Criterion 2- Lease Grants Lessee Option to Purchase

Company X is a lessee that executes a five-year lease that has an option to purchase the leased asset at the end of the lease at a defined price.

At the commencement date, it is reasonably certain that X will exercise the option to purchase the leased asset at the end of the lease.

Conclusion:

Criterion 2 is met and the lease is categorized as a finance lease (Type A) lease. The reason is because it is reasonably certain X will exercise the option to purchase at the commencement date.

Example 3: Criterion 3- Lease Term is 75% or More of Remaining Economic Life

Company X is a lessee that executes a lease effective January 1, 20X1, the commencement date.

The lease has a term of five years, plus two, five-year options to extend (total of 15 years).

The leased asset has a remaining economic life at January 1, 20X1 of 20 years.

Company X states that it is reasonably certain to exercise both options because X has extensive amount of funds invested in leasehold improvements that it cannot take with it once the lease ends.

Conclusion:

The lease term for determining Criterion 3 is 15 years (the base five-year lease plus two, five-year options that X is *reasonably certain* to exercise based on facts in place at the January 1, 20X1 commencement date).

Thus, the lease term is 75% of the remaining economic life of the leased asset calculated as:

Lease term at commencement date:	
Base lease	5 years
Options to extend where it is reasonably certain to exercise (5 years x 2 option periods)	10 years
Total lease term	15 years
Remaining economic life	20 years
%	75%

Because the lease term, at the commencement date, is 75% or more of the remaining economic life of the leased asset, the lease term is deemed to be a major part of the remaining economic life of the underlying leased asset.

The result is that Criterion 3 is satisfied and the lease is classified as a finance (Type A) lease.

Change the facts: Assume it is *not reasonably certain* that the lessee will exercise either of the lease options.

Conclusion:

The lease term for determining Criterion 3 is five years (the base five-year lease only at the January 1, 20X1 commencement date).

Thus, the lease term is only 25% of the remaining economic life of the leased asset calculated as:

Lease term at commencement date:	
Base lease	5 years
Options to extend (1)	NONE
Total lease term	5 years
Remaining economic life	20 years
%	25%:

(1): Option periods are not included in the lease term because the lessee is not reasonable certain to exercise the options.

Because the lease term is only 25 percent of the remaining economic life, Criterion 3 is not satisfied. Therefore, unless the lease satisfies one of the other four criteria, the lease is classified as an operating lease (Type B lease), and not a finance lease (Type A lease).

6. Other considerations in determining lessee lease classification

a. Subleases

1) When classifying a sublease, an entity shall classify the sublease with reference to the underlying asset (for example, the item of property, plant, or equipment that is the subject of the lease) rather than with reference to the right of-use asset.

b. Leases between related parties

1) Leases between related parties should be classified in accordance with the lease classification criteria applicable to all other leases based on the legally enforceable terms and conditions of the lease. In the separate financial statements of the related parties, the classification and accounting for the leases should be the same as for leases between unrelated parties.

c. Lessee indemnification for environmental contamination

1) A provision that requires lessee indemnification for environmental contamination, whether for environmental contamination caused by the lessee during its use of the underlying asset over the lease term or for preexisting environmental contamination, should not affect the classification of the lease.

B. Initial Measurement of Lease- Lessee

1. At the commencement date, a lessee shall measure and recognize a:

- Lease liability, and a
- Right-of-use asset

2. Lease liability

a. The lease liability shall be measured at the *present value of the lease payments* not yet paid, discounted using the discount rate for the lease at lease commencement.

b. The *discount rate used* to determine the present value of the lease payments for a lessee is basis of information available at the commencement date.

1) A lessee should use the *rate implicit in the lease* whenever that rate is readily determinable.

2) If the rate implicit in the lease is not readily determinable, a lessee uses its *incremental borrowing rate.*

- *Incremental borrowing rate* is 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.

3) A lessee that is not a public business entity is permitted to use a *risk-free discount rate* (U.S. Treasury Rate) for the lease, determined using a period comparable with that of the lease term, as an accounting policy election for all leases.

   Note: The rate implicit in the lease is the rate that, when used to present value the lease payments, results in a present value equal to the fair value of the leased asset.

What is the implicit rate in the lease?

ASU 2016-02 requires a lessee to use the implicit rate in the lease as the discount rate in present value calculation to determine the lease obligation. If that rate is *not readily determinable*, the lessee should use its incremental borrowing rate. There is also the option for a non-public entity to elect to use the risk-free rate of return, such as the U.S. Treasury rate applicable to the lease term.

ASU 2016-02 defines the rate implicit in the lease as:

> "The rate of interest that, at a given date, causes the aggregate present value of (a) the lease payments and (b) the amount that a lessor expects to derive from the underlying asset following the end of the lease term to equal the sum of (1) the fair value of the underlying asset minus any related investment tax credit retained and expected to be realized by the lessor and (2) any deferred initial direct costs of the lessor."

In layman's terms, the rate implicit in the lease is the internal rate of return (IRR) that equates the present value of the lease payments to the fair value of the leased asset, at the commencement date.

Lease payments x PV factor at ___% discount rate = Fair value of leased asset

Why shouldn't a lessee simply use the risk-free rate to compute the present value of lease payments?

If an entity is a non-public entity, ASU 2016-02 permits that entity to use the risk-free rate of return in the present value computation, to arrive at the lease obligation. The risk-free rate of return is the U.S. Treasury rate for the lease term.

So, why wouldn't a lessee use the U.S. Treasury rate all the time?

The reason is that the U.S. Treasury rate is significantly lower than the incremental borrowing rate.

For example, in 2017, the U.S. treasury rate for a five-year note is hovering around 2% while the incremental borrowing rate is in the 4% to 6% range. If a non-public entity elects to use the risk-free rate of return to compute the present value of lease payments, the lease obligation and related right-of-use asset are likely to be significantly higher than if the entity has used its incremental borrowing rate. The lower the rate, the higher the present value result and higher lease obligation. The higher the lease obligation, the higher right-of-use asset.

Rarely will an entity use the risk-free rate of return as the penalty to do so is too night.

3. Right-of-use asset

a. At the commencement date, the lessee should measure and record a right-of-use asset.

b. The cost of the right-of-use asset shall be measured and recorded based on the sum of following elements:

   1) The amount of the initial measurement of the lease liability

   2) Any lease payments made to the lessor at or before the commencement date, minus any lease incentives received

   3) Any initial direct costs incurred by the lessee

c. Initial direct costs

   1) At the commencement date, initial direct costs for a lessee are included as part of the cost of the right-of-use asset.

   2) Initial direct costs are defined as:

      "Incremental costs of a lease that would not have been incurred if the lease had not been obtained (executed)."

   3) Examples of initial direct costs include:

      a) Commissions

      b) Payments made to an existing tenant to incentivize that tenant to terminate its lease.

   4) The following items are examples of costs that are *not initial direct costs*:

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

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

      c) Costs related to activities that occur before the lease is obtained, such as costs of obtaining tax or *legal advice*, *negotiating lease terms and conditions*, or evaluating a prospective lessee's financial condition.

Example 1: Initial Direct Costs- Lessee

Lessee and Lessor enter into an operating lease.

The following costs are incurred by the lessee in connection with the lease:

External legal costs	$15,000
Allocation of employee costs for time negotiating lease terms and conditions	7,000
Commissions to broker representing lessee	10,000
Payments made to existing tenants to obtain the lease	[3]20,000
Total costs- lessee	$52,000

Conclusion: Lessee includes $30,000 of initial direct costs in the initial measurement of the right-of-use asset. The $30,000 consists of the $10,000 of commissions and $20,000 payments made to existing tenants to obtain the lease.

Both expenses represent incremental costs that would not have been incurred if the lease had not been obtained (executed) by the parties. That is, if the lessee had not executed the lease, the lessee would not have incurred the $10,000 of commissions and $20,000 of payments to existing tenants.

The external legal costs do not qualify as initial direct costs because these costs would be incurred even if both parties fail to consummate a final lease. Similarly, internal employment costs are not initial direct costs because these costs would have been incurred, regardless of whether a lease is executed.

Example 2: Computation of Right-of-Use Asset

Company X enters into a five-year lease that commences of January 1, 20X1.

The lease liability is calculated at the present value of five years of monthly lease payments of $10,000, discounted using a 4% incremental borrowing rate is $543,000.

Commissions paid on the lease are $10,000.

Prior to the lease commencement date of January 1, 20X1, X paid $20,000 to use the leased facilities.

Conclusion: The right-of-use asset is recorded at $573,000 consisting of:

Lease liability	$543,000
Initial direct costs- commissions	10,000
Lease payments made prior to commencement date	20,000
	$573,000

The initial entry by the lessee to record a lease on the January 1, 20X1 commencement date is as follows:

[3] ASU 2016-02 does not differentiate between whether the lessee or lessor makes payments to existing tenants. Typically, this cost would be incurred by the lessor to vacate premises for a new tenant/lessee. However, because the ASU is silent as to who pays this cost, it could conceivably be paid by the lessee as well.

Entry at January 1, 20X1 commencement date	dr	cr
Right-of use asset	573,000	
Lease obligation- PV lease payments		543,000
AP- commissions on lease		10,000
AP- lease payments before commencement date		20,000

C. Lease Modifications - Lessee

ASU 2016-02 differentiates between a lease modification that is accounted for as a separate contract as compared with one that is not.

1. Modification accounted for as a separate contract

a. An entity shall account for a modification to a contract *as a separate contract* (that is, separate from the original contract) when *both of the following conditions* are present:

1) The modification *grants the lessee an additional right of use not included in the original lease, such as:*

- The right to use an additional asset, or
- The right to use additional space such as expanding the retail space.

2) The lease payments *increase commensurate with the standalone price for the additional right of use*, adjusted for the circumstances of the particular contract.

For example, the standalone price for the lease of one floor of an office building in which the lessee already leases other floors in that building may be different from the standalone price of a similar floor in a different office building, because it was not necessary for a lessor to incur costs that it would have incurred for a new lessee.

2. Modification not accounted for as a separate contract

a. If a lease is modified and that modification is *not accounted for as a separate contract*, the entity shall do the following:

1) Reassess the classification of the existing lease (finance versus operating lease) as of the *effective date of the modification* based on its modified terms and conditions and the facts and circumstances as of that date such as:

- Fair value, and
- Remaining economic life of the underlying leased asset

2) Account for initial direct costs, lease incentives, and any other payments made to or by the entity in connection with a modification to a lease in the same manner as those items would be accounted for in connection with a new lease.

b. If the lease is modified and not accounted for as a separate contract, the lessee should *reallocate the remaining consideration in the contract* and remeasure the lease liability using a discount rate for the lease determined at the effective date of the modification if a contract modification does any of the following:

1) Grants the lessee an additional right of use not included in the original contract

2) Extends or reduces the term of an existing lease other than through the exercise of a contractual option to extend or terminate the lease:

Example: The lease term from five to ten years or vice versa

3) Fully or partially terminates an existing lease (such as reducing the assets subject to the lease, or

4) Changes the consideration in the contract only.

Special rule for change in classification from finance to operating lease

If a finance (Type A) lease is modified and the modified lease is classified as an operating (Type B) lease, any difference between the carrying amount of the right-of use asset after recording the adjustment required and the carrying amount of the right-of-use asset that would result from applying the initial operating right-of-use asset measurement to the modified lease, shall be accounted for in the same manner as a rent prepayment or a lease incentive.

D. Lease Payments - Lessee

At the commencement date, a lessee must capture the amount and timing of lease payments used in the present value computation to arrive at the lease obligation.

1. ASU 2016-02 provides that lease payments *consist of the following payments* relating to the use of the leased asset during the lease term:

a. *Fixed payments*, including in-substance fixed payments, less any lease incentives paid or payable to the lessee.

b. *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.

c. The *exercise price of an option to purchase* the underlying asset if the lessee is *reasonably certain to exercise that option.*

d. *Payments for penalties for terminating the lease* if the lease term reflects the lessee exercising an option to terminate the lease.

Note: For the lease term to reflect a reduction for exercising an option to terminate the lease, the lessee must be *reasonably certain* to exercise the option to terminate.

e. Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction.

Note: Such fees shall not be included in the fair value of the underlying asset for purposes of applying the 90% present value calculation (Criterion 4) for determining the lease classification.

f. *Residual value guarantees*- amounts that are *probable of being owed* by the lessee under *residual value guarantees*

Note: Generally, there is no residual value guarantee amount if there is an option to purchase and it is reasonably certain the lessee will exercise that option to purchase.

2. The calculation of the present value of lease payments at the commencement date is as follows:

An assumed 4% discount rate (incremental borrowing rate) has been inserted as a place holder.

----------LEASE PAYMENTS----------					**PV factor 4%**	**Present value of lease payments**
Year	**Fixed annual lease payments**	**Variable payments based on index/rate**	**Exercise price of option to purchase (a)**	**Total lease payments**		
1	$XX	$XX	$0	$XX	1.000	$XX
2	XX	XX	0	XX	.96154	XX
3	XX	XX	0	XX	.92456	XX
4	XX	XX	0	XX	.88900	XX
5	XX	XX	XX	XX	.85480	XX
					Present value- lease obligation	**$XX**

Note: The above formula does not reflect additional lease payment amounts for payment of penalties to terminate a lease, fees paid to owners of a special-purpose entity, and any residual value guarantee amounts.

(a): Exercise price of option to purchase is included in lease payments only if, at the commencement date, it is reasonably certain the lessee will exercise the option.

3. Fixed payments as part of lease payments

a. Fixed payments are part of total lease payments used in the present value computation of the lease liability.

1) The term fixed payments is defined in ASU 2016-02 as the sum of:

a) Fixed payments (defined payments in the lease contract)

b) In substance fixed payments, and

c) A reduction for any lease incentives paid or payable to the lessee

2) In substance fixed payments are defined as payments that may appear to be variable but are, in effect, fixed and unavoidable, and may include, for example, any of the following:

a) Payments that do not create genuine variability (such as those that result from clauses that do not have economic substance), and

b) The lower of the payments to be made when a lessee has a choice about which set of payments it makes, although it must make at least one set of payments.

3) Fixed payments are reduced by any lease incentives payable to the lessee.

a) Lease incentives include *both of the following*:

- Payments made to or on behalf of the lessee
- Losses incurred by the lessor as a result of assuming a lessee's preexisting lease with a third party.

4. Variable lease payments[4]

a. ASU 2016-02 states that variable lease payments are *included as part of total lease payments* if the *payments depend on an index or a rate* (such as a Consumer Price Index or a market interest rate).

b. If there is an index or rate, variable lease payments are initially measured using the index or rate at the commencement date.

c. If the variable lease payments are not dependent on an index or rate, the variable payments are not included as part of lease payments in computing the present value of the lease obligation.

d. Variable lease payments are included in lease payments used to calculation the lease liability if:

- The lease payments *depend on an index or rate*, such as a CPI index. Each year, the lessee must adjust the lease obligation to reflect the present value of the remaining lease payments using latest index in effect at the end of that year, or
- The lease payments are in-substance, fixed payments, such as minimum annual increase of 2% per year.

[4] The ASU notes that some leases contain indemnification clauses that indemnify lessors on an after-tax basis for certain tax benefits that the lessor may lose if a change in the tax law precludes realization of those tax benefits. Although the indemnification payments may appear to meet the definition of variable lease payments, those payments are not of the nature normally expected to arise under variable lease payment provisions.

e. Lease payments based on performance (such as a percentage of sales, with no minimum) are not reflected in the lease payments in computing the lease obligation. Instead, such payments are recorded annually as part of lease expense as actual sales are generated.

Example: Company X is a lessee of retail space. The lease calls for monthly fixed lease payments of $5,000, plus 2% of sales over $2,000,000. The 2% override payment is made after year end once actual final sales are calculated for the previous year.

Conclusion: The monthly payments of $5,000 are fixed payments and included in the present value of lease payments to compute the lease obligation. The 2% of sales is a variable payment that is not based on a rate or index and is not included as part of lease payments in the present value computation. Instead, such variable payments are recorded annually as part of lease expense once actual sales are computed.

5. Exercise price of an option to purchase- lease payments

a. ASU 2016-02 adds into its amendments a requirement that a lessee must perform an assessment to determine whether the amount of a purchase option should be included in the lease payments that are part of the present value computation of the lease obligation.

b. **Rule:** At the commencement date of the lease, if it is *reasonably certain* that the lessee will exercise the option to purchase the leased asset at the end of the lease, the amount of the purchase price is included as part of lease payments.

c. *Reasonably certain assessment*:

1) In making the *reasonably certain assessment*, the lessee should consider *all economic factors* relevant to that assessment including:

- Contract-based,
- Asset-based,
- Market-based, and
- Entity-based factors.

2) Examples of economic factors to consider in performing the reasonably certain assessment, include, but are not limited to, any of the following:

a) *Contractual terms and conditions compared with current market rates*, such as:

- The amount of lease payments in any optional period

- The amount of any variable lease payments or other contingent payments, such as payments under termination penalties and residual value guarantees, and

- The terms and conditions of any options that are exercisable after the initial optional periods as compared with the market rates (e.g., option price as compared with the estimated residual value at the end of the lease).

b) *Significant leasehold improvements* that are expected to have significant economic value for the lessee when the option to extend or terminate the lease or to purchase the underlying asset becomes exercisable.

c) *Costs relating to the termination of the lease and the signing of a new lease*, such as negotiation costs, relocation costs, costs of identifying another underlying asset suitable for the lessee's operations, or costs associated with returning the underlying asset in a contractually specified condition or to a contractually specified location.

d) *The importance of that underlying asset to the lessee's operations*, considering, for example, whether the underlying asset is a specialized asset and the location of the underlying asset.

What if the option to purchase is at a market rate or right-of-first-refusal basis?

Many leases have option to purchase provisions that do not offer a fixed option price. Instead, the option to purchase might be at a market rate in effect at the option date. Alternatively, there might be an option in the form of a right-of-first-refusal under which the lessee has the right to match any prospective buyer's offer to purchase.

In either case, it is difficult, if not impossible, for the reasonably certain threshold to be met. Thus, the exercise price of the purchase option should not be reflected in the lease payments because it cannot be measured at the commencement date.

Examples: Option to Purchase- Lease Payments

Example 1: Including Option to Purchase as Part of Lease Payments

Company X is a lessee and enters into a five-year lease of equipment with annual lease payments of $100,000 due on the first day of each year.

X has an option to purchase the equipment at the end of the lease for $10,000. X estimates the residual value at the end of the lease will be about $25,000.

The initial direct costs related to the lease is $5,000 for a commission paid.

Because the option price of $10,000 is significantly lower than the estimated residual value of $25,000 at the end of the lease, X believes it is *reasonably certain* it will exercise its purchase option at the end of the lease.

Conclusion:

Because it is *reasonably certain* that X will exercise its option to purchase at the end of the lease, X should include the $10,000 cost to purchase in the computation of lease payments used in the present value computation.

Assume the discount rate (incremental borrowing rate) is 4%.

The stream of lease payments and the present value computation is as follows:

Year	Fixed annual lease payments	Payment of lease option to purchase	Total lease payments	PV factor 4%	Present value
Beg- 1	$100,000	$0	$100,000	1.000	$100,000
Beg- 2	100,000	0	100,000	.96154	96,154
Beg- 3	100,000	0	100,000	.92456	92,456
Beg- 4	100,000	0	100,000	.88900	88,900
Beg- 5	100,000	0	100,000	.85480	85,480
End- 5	0	**10,000**	10,000	.82193	8,219
					$471,209

Because it is reasonably certain that the lease option will be exercised at the end of the lease, the payment of the lease purchase option of $10,000 is included in the stream of lease payments and used in the present value calculation.

The result is that present value of lease payments of $471,209 is the lease obligation and the right-of-use asset is $476,209 computed as follow:

PV of lease payments	$471,209
Initial direct costs- commissions	5,000
	$476,209

Entry at commencement date**:**

	dr	Cr
Right-of-use asset	476,209	
AP- commissions		5,000
Lease liability		471,209

Example 2: Including Option to Purchase as Part of Lease Payments

Company Z enters into a five-year lease for specialized equipment with an annual lease payment of $65,000 due at the end of year.

Z has a purchase option to purchase the specialized equipment for $90,000 at the end of the five years, which is expected to be the fair value at that time.

The equipment was constructed specifically for the lessee and is vital to the lessee's business.

Z concludes that it is *reasonably certain* it will exercise the purchase option due to numerous factors among which, the specialization of the equipment, and the importance of the equipment to the lessee's operations.

Conclusion:

Z should include the $90,000 payment to for the purchase option in its lease payments in computing the present value. The reason is because it is reasonably certain that Z will exercise that option.

6. Payments for penalties for terminating the lease- lease payments

a. ASU 2016-02 states that lease payments include payments for penalties for terminating the lease if the lease term also reflects the lessee exercising an option to terminate the lease.

b. In order for the lease term to reflect a reduction for exercising an option to terminate the lease prior to the end of the lease term, the lessee must be *reasonably certain* to exercise the option to terminate.

Example:

Company Y enters into a 10-year lease of an asset, which it can terminate at the end of each year beginning at the end of Year 6.

Lease payments are $50,000 per year during the 10-year term, payable at the beginning of each year.

If Lessee terminates the lease at the end of Year 6, Lessee must pay penalty to Lessor of $20,000. The termination penalty decreases by $5,000 in each successive year.

At the commencement date, Lessee concludes that it is *reasonably certain* to exercise the option to terminate. That is, Lessee will not continue to use the underlying asset after Year 6.

In making the determination, the Lessee considered all relevant factors, including the significance of the termination penalty and other factors (contract-based, asset-based, entity-based, and market-based)

Accordingly, the lease term is six years.

Conclusion: At the commencement date, Lessee determines lease payments as follows:

Fixed lease payments: $50,000 x 6 years	$300,000
Termination penalty due at the end of Year 6	20,000
	$320,000

7. Residual value guarantees as part of lease payments

a. ASU 2016-02 requires that a lessee must include in lease payments certain amounts owed by the lessee under residual value guarantees under the following rules:

1) Amounts for residual value guarantees are included in lease payments only if it is *probable of being owed* by the lessee.

2) If the lessor has the right to require the lessee to purchase the underlying asset by the end of the lease term, the stated purchase price is included in lease payments as a guaranteed residual value that the lessee is obligated to pay based on circumstances outside its control.

b. The following items are *excluded from residual value guarantees* and *are not included as part of lease payments* used in the present value computation:

1) A lease provision requiring the lessee to make up a residual value deficiency that is attributable to damage, extraordinary wear and tear, or excessive usage.

- Such amounts are treated as variable lease payments not linked to an index or rate in that the amount is not determinable at the commencement date.

- Payments for a residual value deficiency at the end of the lease is recorded as part of lease expense once incurred.

2) Amounts paid in consideration for a guarantee by an unrelated third party, are executory costs and are not included in the lessee's lease payments.

3) A residual value guarantee obtained by the lessee from an unrelated third party for the benefit of the lessor

- Such amounts should not be used to reduce the amount of the lessee's lease payments except to the extent that the lessor explicitly releases the lessee from obligation, including the secondary obligation, which is if the guarantor defaults, a residual value deficiency must be made up.

8. Payments excluded from lease payments:

a. Lease payments *do not include* any of the following:

1) Variable lease payments that do not depend on an index or a rate

2) Any guarantee by the lessee of the lessor's debt

3) Amounts allocated to non-lease components

4) Residual value deficiency that is attributable to damage, extraordinary wear and tear, or excessive usage

5) Obligations to return or restore a leased asset to its original condition

9. Obligations to restore an underlying leased asset to its original condition

a. ASU 2016-02 provides guidance on dealing with lease agreement obligations to restore or return the leased asset to its original condition at the end of the lease.

b. Obligations that require a lessee to return an underlying asset to its original condition if it has been modified by the lessee *do not meet the definition of lease payments* or variable lease payments.

1) Such payments should be accounted for as an asset retirement and environmental obligations under ASC 410-20, *Asset Retirement and Environmental Obligations*.

c. Costs that are incurred by the lessee at the end of the lease and used to dismantle and remove an underlying asset at the end of the lease term are generally considered lease payments or variable lease payments.

Example: Obligations to restore an underlying leased asset to its original condition- lease payments

Company X is a lessee and executes a five-year lease.

X plans to make significant improvements to the leased premised to customize the facility for its own use.

The lease requires that X remove the lessee-installed leasehold improvements and restore the premises to its original condition at the end of the lease.

X estimates it will cost it about $50,000 to restore the premises at the end of the lease.

Conclusion:

The obligation to restore the premises at the end of the lease is *not part of the lease payments*. Instead, it should be accounted for as an asset retirement and environmental obligations under ASC 410-20, *Asset Retirement and Environmental Obligations*.

Change the facts:

The lease requires that the lessee pay $50,000 at the end of the lease to *remove the leasehold improvements* from the premises.

Conclusion:

Costs to dismantle or remove an underlying asset at the end of the lease term are generally *considered lease payments*. Because the amount to be paid is fixed, the $50,000 should be included as part of lease payments used in the present value calculation.

E. Lease Term and Purchase Options- Lessee

In computing the lease obligation, a lessee must compute the present value of lease payments over the lease term.

ASU 2016-02 expands the lease term to include not only the noncancellable term within the lease, but also terms related to lease extensions.

1. The lease term begins at the commencement date and includes any rent-free periods provided to the lessee by the lessor.

2. Under ASU 2016-02, at the commencement date, a lessee shall determine the lease term that is used in the present value calculation.

3. The lease term consists of the following components:

    a. The *noncancellable period* of the lease

b. Periods covered by an *option to extend the lease* if the lessee is *reasonably certain* to exercise that option

c. Periods covered by an *option to terminate* the lease if the lessee is *reasonably certain not to exercise that option*, and

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

4. At the commencement date, an entity shall assess the periods in 3(a) through (d) above in the lease term and shall consider all relevant factors that create an economic incentive for the lessee such as:

- Contract-based
- Asset-based
- Entity-based, and
- Market-based.

a. These factors shall be considered together, and the existence of any one factor does not necessarily signify that a lessee is reasonably certain to exercise or not to exercise an option.

5. Noncancellable period in the lease term

a. The starting point in determining the lease term is the noncancellable period which should be easily defined by the lease contract.

Example: If a lease has a five-year term, with two, five-year options to extend, the noncancellable period is likely to be the first five-year period.

b. An entity should determine the noncancellable period of a lease when determining the lease term.

1) When assessing the length of the noncancellable period of a lease, an entity should apply the definition of a contract and determine the period for which the contract is *enforceable.*

2) A lease is no longer enforceable when *both the lessee and the lessor each have the right to terminate the lease without permission* from the other party with no more than an insignificant penalty.

6. Option to extend the lease term and the reasonably certain assessment

a. The lease term includes any option to extend the lease if certain criteria are met:

1) At the commencement date of the lease, if it is *reasonably certain* that the lessee will exercise the option to extend the lease, the extension period is included as part of the lease term. ASU 2016-02 uses the same definition of "reasonably certain" used to evaluate options to purchase as part of the assessment of lease payments.

2) *Reasonably certain assessment*:

a) In making the *reasonably certain assessment*, the lessee should consider *all economic factors* relevant to that assessment including:

- Contract-based,
- Asset-based,
- Market-based, and
- Entity-based factors.

b) Examples of economic factors to consider in making the reasonable certain assessment include, but are not limited to, any of the following:

i) *Contractual terms and conditions for the optional periods compared with current market rates*, such as:

- The amount of lease payments in any optional period

- The amount of any variable lease payments or other contingent payments, such as payments under termination penalties and residual value guarantees

- The terms and conditions of any options that are exercisable after the initial optional periods as compared with the market rates (e.g., option price as compared with the estimated residual value at the end of the lease)

ii) *Significant leasehold improvements* that are expected to have significant economic value for the lessee when the option to extend or terminate the lease or to purchase the underlying asset becomes exercisable.

iii) *Costs relating to the termination of the lease and the signing of a new lease*, such as negotiation costs, relocation costs, costs of identifying another underlying asset suitable for the lessee's operations, or costs associated with returning the underlying asset in a contractually specified condition or to a contractually specified location.

iv) *The importance of that underlying asset to the lessee's operations*, considering, for example, whether the underlying asset is a specialized asset and the location of the underlying asset.

Example:

Effective January 1, 20X1, Company X, a lessee, executes a five-year lease that has two, five-year options (a total of 15 years).

X is a restaurant located in downtown Boston in a key location.

X expects to spend approximately $2 million on leasehold improvements none of which can be removed from the premises at the end of the lease.

At the commencement date, January 1, 20X1, X needs to determine the lease term to be used to compute the present value of lease payments, and the lease obligation.

Because X is spending a significant amount on leasehold improvements ($2 million), X is *reasonably certain* it will exercise at least one of the five-year options, but not reasonably certain about the second option.

Conclusion:

In determining the lease term, X should include the first five-year option in the lease term so that the lease term is 10 years for purposes of computing lease payments and the present value of lease payments. The first five-year option is included in the lease term because it is reasonably certain that X will exercise the five-year option given the extensive leasehold improvements spent by the Lessee.

7. Option to terminate a lease- lease term

a. At the commencement date, a lease term is adjusted (reduced) for an *option to terminate* the lease if the lessee is *reasonably certain* to exercise that option to terminate.

1) In order for an option to terminate the lease to be considered an adjustment (reduction) to the lease term, the lessee only must have the right to terminate the lease.

2) If only a lessor has the right to terminate a lease, the noncancellable period of the lease includes the period covered by the option to terminate the lease, and no adjustment to the lease term is made to reflect the potential reduction for the termination period.

8. Lease term- commencement date of lease

a. The lease term begins on the commencement date.

1) ASU 2016-02 defines the commencement date as:

> *"The date on which a lessor makes an underlying asset available for use by a lessee."*

b. The timing of when lease payments begin under the contract does not affect the commencement date of the lease.

c. Commencement date for a master lease

Note: There may be multiple commencement dates resulting from a master lease agreement. That is because a master lease agreement may cover a significant number of underlying assets, each of which are made available for use by the lessee on different dates. Although a master lease agreement may specify that the lessee must take a minimum number of units or dollar value of equipment, there will be multiple commencement dates unless all of the underlying assets subject to that minimum are made available for use by the lessee on the same date.

F. Subsequent Reassessment of Lease Elements- Lessee

The general rule is that once a lease is measured and recorded at the commencement date, it is not reassessed or remeasured throughout the lease term.

However, ASU 2016-02 provides guidance under which a lessee is *required to reassess* any of the following:

- Lease term
- Option to purchase, extend or terminate a lease, and
- Lease payments.

1. Reassessing the lease term or options

a. A lessee shall reassess the *lease term or a lessee option to purchase* the underlying asset only if and at the point in time that certain events occur.

b. A reassessment of the lease term or a lessee option to purchase is required in any of the following instances:

1) 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:

a) Exercise or not to exercise an option to extend or terminate the lease, or

b) Purchase the underlying asset.

2) 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.

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

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

c. Examples of *significant events or significant changes in circumstances* that a lessee should consider in reassessing the lease term or lessee's option to purchase include, but are not limited to, the following:

1) Constructing significant leasehold improvements that are expected to have significant economic value for the lessee when the option becomes exercisable

2) Making significant modifications or customizations to the underlying asset

3) Making a business decision that is directly relevant to the lessee's ability to exercise or not to exercise an option (for example, extending the lease of a complementary asset or disposing of an alternative asset)

4) Subleasing the underlying asset for a period beyond the exercise date of the option.

d. A change in market-based factors (such as market rates to lease or purchase a comparable asset) should not, in isolation, trigger reassessment of the lease term or a lessee option to purchase the underlying asset.

2. Reassessing lease payments

a. A lessee shall *remeasure the lease payments* if any of the following occur:

1) The terms of the lease are modified, and that modification is not accounted for as a separate contract.

2) A contingency upon which some or all of the variable lease payments that will be paid over the remainder of the lease term are based is resolved such that those payments now meet the definition of lease payments.

Example: An event occurs that results in variable lease payments that were linked to the performance or use of the underlying asset becoming fixed payments for the remainder of the lease term.

Note: When a lessee remeasures the lease payments in accordance with paragraph, variable lease payments that depend on an index or a rate shall be measured using the index or rate at the remeasurement date.

3) There is a change in any of the following:

a) The *lease term is reassessed*.

- If the lessee revises the lease term, the lease payments should be revised based on the revised lease term.

b) The assessment of whether the lessee is reasonably certain to exercise or not to exercise an option to purchase the underlying asset.

- A lessee shall determine the revised lease payments to reflect the change in the assessment of the purchase option.

c) Amounts *probable* of being owed by the lessee under residual value guarantees**.**

- A lessee shall determine the revised lease payments to reflect the change in amounts probable of being owed by the lessee under residual value guarantees.

3. Remeasurement of the lease liability- lessee

a. After the commencement date, a lessee shall remeasure the lease liability *if there are changes in lease payments.*

b. A lessee shall recognize the amount of the remeasurement of the lease liability as an adjustment to the right-of-use asset.

Exception: If the carrying amount of the right-of-use asset is reduced to zero, a lessee shall recognize any remaining amount of the remeasurement in profit or loss.

c. Updating the discount rate:

1) If there is a remeasurement of the lease liability, the lessee shall *update the discount rate* for the lease at the date of remeasurement based on the remaining lease term and the remaining lease payments *unless* the remeasurement of the lease liability is the result of one of the following:

a) A change in the lease term or the assessment of whether the lessee will exercise an option to purchase the underlying asset and the discount rate for the lease already reflects that the lessee has an option to extend or terminate the lease or to purchase the underlying asset.

b) A change in amounts probable of being owed by the lessee under a residual value guarantee

c) A change in the lease payments resulting from the resolution of a contingency upon which some or all of the variable lease payments that will be paid over the remainder of the lease term are based

Example 1: Reassessment:

Company X executes a five-year lease that has a five-year option to extend and is effective January 1, 20X1.

At the January 1, 20X1 commencement date, it is *not reasonably certain* that X will exercise the option to extend.

Therefore, X measures and records a finance (Type A) lease based on the five-year term without considering the five-year option in the lease payments and lease term.

On January 1, 20X4, X exercises the option to extend the lease. On that date, there is now two years left on the original lease and five years on the option (a total of seven years).

Conclusion:

On January 1, 20X4, ASU 2016-02 requires that the lease to be reassessed if a lessee elects to exercise an option even though the entity had previously determined that the lessee was not reasonably certain to do so.

X is required to reassess both the lease term and lease payments and recompute the lease obligation as follows at January 1, 20X4:

1. Remeasure the lease obligation: compute a new present value using:

   - Seven-years of lease payments
   - A seven-year lease term
   - A discount rate at January 1, 20X4

2. Recognize the amount of the remeasurement of the lease liability as an adjustment to the right-of-use asset.

3. The right-of-use asset should revise its amortization life to reflect the new seven-year life.

G. Short-Term Leases - Lessee

A lessee may elect not to capitalize certain *short-term leases* and, instead, account for them the same way in which operating leases are accounted for under existing lease standards.

1. ASU 2016-02 defines a short-term lease as a lease that, at the commencement date:

   a. Has a *lease term of 12 months or less*, and

   b. *Does not include an option to purchase* the underlying asset that the lessee is reasonably certain to exercise.

2. Under the short-term lease rules:

   a. As an accounting policy, a lessee may elect not to apply the recognition requirements in ASU 2016-02 to short-term leases.

   b. Instead, a lessee may do the following:

      1) Recognize the lease payments in the income statement as *rent expense on a straight-line basis* over the lease term and variable lease payments in the period in which the obligation for those payments is incurred.

   c. The accounting policy election for short-term leases shall be made by class of underlying asset to which the right of use relates.

   d. If the lease term or the assessment of a lessee option to purchase the underlying asset changes such that, after the change, the remaining lease term extends more than 12 months from the end of the previously determined lease term or the lessee is reasonably certain to exercise its option to purchase the underlying asset, the lease no longer meets the definition of a short-term lease and the lessee shall apply the ASU 2016-02 immediately as if the date of the change in circumstances is the commencement date.

Example 1: Short-Term Lease

Lessee enters into a 12-month lease of a vehicle, with an option to purchase the asset at the end of the lease. Monthly payments are $5,000 (total of $60,000 for the 12-month lease period).

Lessee has considered all relevant factors and determined that it is *not reasonably certain to exercise the option* to purchase.

Lessee seeks to make an accounting policy election not to recognize a right-of-use asset and lease obligation that arise from short-term lease.

Conclusion:

Lessee can make the short-term lease policy election not to recognize the right-of-use asset and liability obligation.

The lease qualifies as a short-term lease for two reasons:

a. At the lease commencement, it is *not reasonably certain that the lessee will exercise the option* to purchase, and

b. The lease term is 12 months or less.

The lease meets the definition of a short-term lease because the lease term is 12 months or less and it is not reasonably certain that any option to purchase will be exercised.

Consequently, consistent with Lessee's accounting policy election, Lessee does not recognize the right-of-use asset and the lease liability arising from this lease. Instead, each month, Lessee makes the following entry:

Entry each month:	dr	cr
Rent expense	5,000	
Cash, AP		5,000
To record monthly rent		

H. Subsequent Measurement and Accounting for Leases- Lessee

Once a lease is measured and recorded at the commencement date, the lessee is required to follow certain rules to account for the lease after the commencement date. Those rules pertain to how measure the right-of-use asset and lease obligation, including recording lease expense.

1. After the commencement date, a lessee shall measure the lease liability and right-of-use asset as follows:

2. Lease obligation- subsequent measurement and accounting

a. After the initial measurement of the lease liability on the commencement date, the lease obligation shall be adjusted by the following:

- Increased to reflect the recognition of interest using the effective interest method, and

- Reduced to reflect the lease payments made during the period.

b. *Interest is recorded using the effective interest method*:

- The lessee shall record interest expense related to the lease obligation using the *effective interest method.*

- The amount of interest shall be reflective of the unwinding of the discount on the lease liability in each period during the lease term as the amount that produces a constant periodic discount rate on the remaining balance of the liability, taking into consideration the reassessment.

3. Right-of-use asset- subsequent measurement and accounting

a. The right-of-use asset shall be measured at cost less any accumulated amortization and any accumulated impairment losses, taking into consideration the reassessment requirements.

4. Recognition of lease expense- finance (Type A) and operating (Type B) leases

a. After the commencement date, a lessee shall recognize in expense all of the following, unless the costs are included in the carrying amount of another asset:

Finance (Type A) lease:

A finance lease (Type A lease) has *two recurring expense elements*:

- Interest expense: recorded through the lease obligation using the effective interest method, and

- Amortization expense: recorded on the right-of-use asset, computed on a straight-line basis.

Operating (Type B) lease:

An operating (Type B lease) has *one single lease cost*, based on *combining two recurring expense elements*:

- Interest expense: recorded through the lease obligation using the effective interest method, and

- Amortization expense: calculated at an amount that brings the total combined lease cost to a straight-line expense based on the remaining cost and lease term, at the beginning of each period.

Note: For an operating (Type B) lease, the periodic lease cost shall not be less than interest expense computed using the effective interest method.

b. In addition to interest and amortization expense computed for finance (Type A) or operating (Type B) leases, a lessee should include in expense the following nonrecurring elements:

   1) Any *variable lease payments* that were not included in the lease liability in the period in which the obligation for those payments is incurred,[5] and

   2) Any *impairment losses* related to the right-of-use asset.

c. Regardless of whether there is a finance (Type A) or operating (Type B) lease, lease expense elements consist of the following:

   Recurring elements:
   - Interest expense
   - Amortization expense

   Non-recurring elements:
   - Variable lease payments not tied to an index or rate, and
   - Impairment losses, if any

5. Interest expense

a. The amount of interest expense is the same for both types of leases in that it is computed on the lease obligation, using the effective interest method.

6. Amortization expense on the right-of-use asset

a. A lessee shall amortize the right-of-use asset from the commencement date to the earlier of the end of the useful life of the right-of-use asset or the end of the lease term.

   1) If the lease transfers ownership of the underlying asset to the lessee or the lessee is reasonably certain to exercise an option to purchase the underlying asset, the lessee shall amortize the right-of use asset to the end of the useful life of the underlying asset.

b. As for amortization expense, the amount recognized differences between a finance lease versus an operating lease.

   1) Finance lease: Records amortization expense on the right-of-use asset on a straight-line basis.

[5] Variable lease payments included in the computation of the lease liability include those linked to an index or rate, such as a CPI index. All other variable lease payments are not included in the computation of the lease obligation and are recorded as part of lease expense as incurred. Examples include lease payments due as a percentage of sales or another performance achievement.

2) Operating lease: Records amortization expense at an amount needed to bring the total lease expense (interest and amortization) equal to a straight-line amount of the total cost of the lease over the lease term.

c. Details on computing amortization expense follow:

Finance (Type A) lease: A lessee shall amortize the right-of-use asset on a straight-line basis, unless another systematic basis is more representative of the pattern in which the lessee expects to consume the right-of-use asset‘s future economic benefits.

1) A lessee shall amortize the right-of-use asset from the commencement date to the earlier of: a) the end of the useful life of the right-of-use asset, or b) the end of the lease term.

2) If the lessee is reasonably certain to exercise a purchase option, the lessee shall amortize the right-of-use asset over that asset’s useful life.

Operating (Type B) lease: For an operating (Type B) lease, a lessee shall determine the amortization of the right-of-use asset for the period as the following:

Annual straight-line lease expense:

$$\frac{\text{Total remaining lease cost at the beginning of year}}{\text{Remaining life}} = \text{Annual straight-line cost}$$

Compute the amount of amortization for the year:

Annual straight-line cost[6] Less: Interest expense from the lease obligation (effective interest method) Equals: Amount of amortization expense recorded on the right-of-use asset

Example 1: Operating Lease

Company X signs a 10-year lease with annual lease payments ranging from $100,000 in Year 1 to $130,000 in the last year. Total payments over the 10 years is $1,200,000.

The lease is classified as an operating (Type B) lease.

X records a right-of-use asset and lease obligation for $900,000, the present value of the lease payments at the incremental borrowing rate.

[6] Paragraph 842-20-25-6 provides that the total expense (interest and amortization) should consist of the remaining lease cost allocated over the remaining lease term on a straight-line basis. The ASU also permits use of another method, other than straight-line, where another systematic and rational basis is more representative of the pattern in which benefit is expected to be derived from the right-of-use asset. There are also special rules for the period after which there is an impairment of the leased asset.

Entry at commencement date:	dr	cr
Right of use asset	900,000	
Lease obligation		900,000
To record lease		

For Year 1, interest expense on the lease obligation is $36,000.

Entry- Year 1:	dr	cr
Interest expense (given)	***36,000***	
Lease obligation	64,000	
Cash		100,000
To record Year 1 lease payment and interest computed using the effective interest method.		

Conclusion: Amortization expense on the right-of-use asset is $84,000 in Year 1, computed as follows:

Total lease cost (10 years)	$1,200,000
Remaining number of years	10
Annual straight-line expense	120,000
Less: interest recorded in Year 1	(36,000)
Amortization expense- Year 1	$84,000

Entry- Year 1:	dr	cr
Amortization expense	84,000	
Right-of-use asset		84,000
To amortize right-of-use asset		

Total lease expense consists of interest on the lease obligation plus amortization expense on the right-of-use asset. Because the lease is an operating (Type B) lease, annual lease expense is the straight-line amount of the total lease cost over the entire lease term. In this example, total lease cost over 10 years is $1,200,000. That means that annual expense in Year 1 is $120,000 ($1,200,000 divided by 10 years). Interest expense is $36,000 so that the amount of amortization recorded in Year 1 is $84,000, the amount to bring the total expense to $120,000.

Example 2: Finance Lease

Same facts as Example 1, except the lease is a finance (Type A) lease.

Conclusion:

Total lease expense is computed as follows:

For Year 1, interest expense on the lease obligation is $36,000.

Entry- Year 1:	dr	cr
Interest expense (given)	***36,000***	
Lease obligation	64,000	
Cash		100,000
To record Year 1 lease payment and interest computed using the effective interest method.		

Amortization is computed on a straight-line basis over the ten-year lease term as follows:

Right-of-use asset- cost	$900,000
Lease term	10
Amortization expense- Year 1	$90,000

Entry- Year 1:	dr	cr
Amortization expense	90,000	
Right-of-use asset		90,000
To amortize right-of-use asset		

Total lease expense in Year 1 for the finance (Type A) lease is as follows:

Interest expense	$36,000
Amortization expense	90,000
Total lease expense- Year 1- finance lease	$126,000

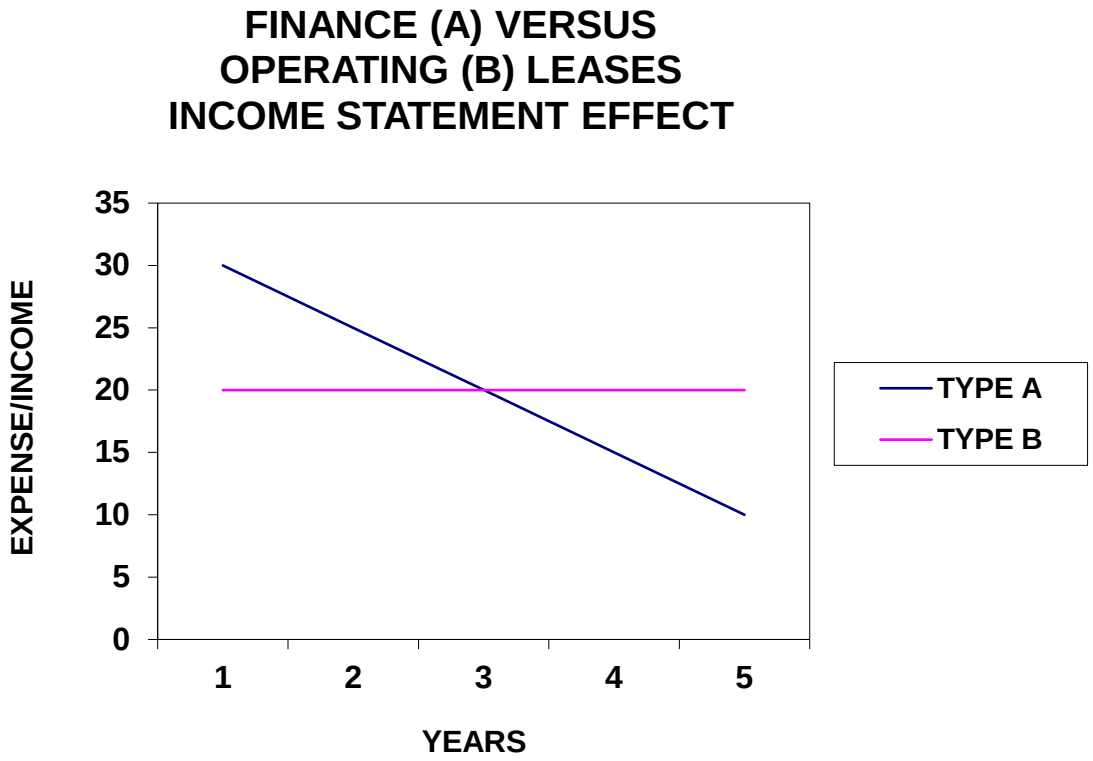
A comparison of lease expense for the operating lease (Example 1) versus finance lease (Example 2) follows:

	Operating (Type B) Lease Example 1	Finance (Type A) Lease Example 2
Interest expense	$36,000	$36,000
Amortization expense	84,000	90,000
Total lease expense- Year 1- finance lease	$120,000	$126,000

Observation: The above examples illustrate the fact that total lease expense for a finance (Type A) lease is higher than lease expense for an operating (Type B) at the front-end of the lease and reverses in the later years. The reason is because lease expense for a finance lease is accelerated while lease expense for an operating lease is recorded on a straight-line basis.

The following chart illustrates lease expense for the two types of leases.

Comparison of Lease Expense: Finance (Type A) versus Operating (Type B) Lease



Observation: The above chart illustrates the difference between total lease expense for a finance (Type A) lease and an operating (Type B) lease. With respect to a finance (Type A) lease, total lease expense is accelerated consisting of accelerated interest expense and straight-line amortization. With respect to an operating (Type B) lease, total expense is recorded on a straight-line basis consisting of two components. First, there is interest expense which is recorded on an accelerated basis using the effective interest method.

The second component of expense, amortization, is recorded at an amount so that the total lease expense for the year is a straight-line amount of total expense for the entire lease term.

I. Other Recognition and Measurement Issues- Lessees

1. Impairment of a right-of-use leased asset

a. A lessee shall determine whether the right-of-use asset is impaired and, in certain instances, shall recognize any impairment loss in accordance with ASC 360, *Property, Plant and Equipment*.

b. If a right-of-use asset is impaired, after the impairment, it shall be measured at its carrying amount immediately after the impairment less any accumulated amortization. A lessee shall amortize the right-of-use asset from the date of the impairment to the earlier of the end of the useful life of the right-of-use asset or the end of the lease term.

2. Amortization of Leasehold Improvements

a. Leasehold improvements shall be amortized by a lessee over the *shorter of:*

- The useful life of those leasehold improvements, and
- The remaining lease term,

b. **Exception:** If the lease transfers ownership of the leased asset to the lessee or the lessee is *reasonably certain to exercise an option to purchase* the underlying asset, the lessee *shall amortize the leasehold improvements over their estimated useful life*.

c. Leasehold improvements acquired in a business combination or an acquisition by a not-for-profit entity shall be amortized over the shorter of the useful life of the assets and the remaining lease term at the date of acquisition.

In amortizing leasehold improvements, should options to extend the lease be included in the remaining lease term?

Yes. Although ASU 2016-02 does not address it, in determining the remaining lease term, the lessee should include any options to extend where it is reasonably certain that the lessee will exercise its option to extend the lease.

Example 1:

Company B installs leasehold improvements that have a useful life of 20 years.

The remaining lease term is five years. There is an option to extend the lease for an additional 5 years (total of 10 years) and it is reasonably certain that B will exercise the option to extend.

Conclusion:

The leasehold improvements should be amortized over the shorter of the useful life of the leasehold improvements and the remaining lease term.

In this case, the remaining lease term is 10 years consisting of the five years remaining plus the additional five-year extension period as it is reasonably certain to be extended. The leasehold improvements are amortized over 10 years, the shorter of 10 years remaining lease term and 20 years useful life.

Example 2:

Same facts as Example 1, except that there is an option to purchase the leased asset at the end of the lease and it is reasonably certain that the lessee will exercise the option.

Conclusion:

ASU 2016-02 states that if the lease transfers ownership of the leased asset to the lessee or the *lessee is reasonably certain to exercise an option to purchase the underlying asset*, the lessee shall amortize the leasehold improvements over their estimated useful life.

In this case, there is an option to purchase and it is reasonably certain that the lessee will exercise its option to purchase. Therefore, the leasehold improvements should be amortized over their useful life of 20 years.

3. Subleases

a. If the nature of a sublease is such that the original lessee is not relieved of the primary obligation under the original lease, the original lessee (as sub lessor) shall continue to account for the original lease in one of the following ways:

1) If the sublease is classified as an operating (Type B) lease, the original lessee shall continue to account for the original lease as it did before commencement of the sublease.

- If the lease cost for the term of the sublease exceeds the anticipated sublease income for that same period, the original lessee shall treat that circumstance as an indicator that the carrying amount of the right-of-use asset associated with the original lease may not be recoverable

2) If the original lease is classified as a finance (Type A) lease and the sublease is classified as a sales-type lease or a direct financing lease, the original lessee shall derecognize the original right-of-use asset and continue to account for the original lease liability as it did before commencement of the sublease.

- The original lessee shall evaluate its investment in the sublease for impairment

3) If the original lease is classified as an operating (Type B) lease and the sublease is classified as a sales-type lease or a direct financing lease, the original lessee shall derecognize the original right-of-use asset and, from the sublease commencement date, account for the original lease liability.

- The original lessee shall evaluate its investment in the sublease for impairment.

b. The original lessee (as sublessor) in a sublease shall use the rate implicit in the lease to determine the classification of the sublease and to measure the net investment in the sublease if the sublease is classified as a sales-type or a direct financing lease unless that rate cannot be readily determined. If the rate implicit in the lease cannot be readily determined, the original lessee may use the discount rate for the lease established for the original (or head) lease.

4. Derecognition

a. A lessee must account for the derecognition (removal) of a lease when certain events occur.

b. Examples of such events include:

- Lease termination
- Purchase of the underlying leased asset
- Sublease

c. Lease Termination

1) A termination of a lease before the expiration of the lease term shall be accounted for by the lessee by removing the right-of-use asset and the lease liability, with *profit or loss recognized* for the difference.

Example:

Company X is a lessee who has recorded a finance lease. The lease term expires on December 31, 20X9.

At December 31, 20X3, the right-of-use asset has an amortized balance of $1,300,000 and the lease obligation has a balance of $1,150,000.

On January 1, 20X4, X terminates the lease early without an early termination penalty.

Conclusion:

Because the lease is being terminated before the expiration of the lease term, the lessee should account for the termination by removing the right-of-use asset and the lease liability, with the difference being recorded on the income statement as a profit or loss on the transaction.

In this example, the difference between the carrying amount of the right-of-use asset ($1,300,000) and the lease obligation ($1,150,000) is $150,000 and is recorded as a loss on termination on the income statement.

On January 1, 20X4, X should make the following entry:

Entry: January 1, 20X4	dr	cr
Lease obligation	1,150,000	
Loss on termination of lease (income statement)	***150,000***	
Right-of-use asset		1,300,000
To record early termination of lease.		

d. Purchase of the Underlying Asset

1) The termination of a lease that results from the purchase of an underlying asset by the lessee is not considered a lease termination.

   a) The transaction is considered an integral part of the purchase of the underlying asset.

b) If the lessee purchases the underlying asset, any difference between the purchase price and the carrying amount of the lease liability immediately before the purchase shall be recorded by the lessee as an adjustment of the carrying amount of the asset.

Example:

Company X is a lessee who has recorded a finance lease. The lease term expires on December 31, 20X9.

At December 31, 20X3, the right-of-use asset has an amortized balance of $1,300,000 and the lease obligation has a balance of $1,150,000.

On January 1, 20X4, X purchases the leased asset at a price of $700,000.

Conclusion:

ASU 2016-02 states that a termination of a lease as a result of a purchase of the underlying leased asset is not a lease termination.

The lease transaction is considered part of the purchase of the leased asset with any difference between the purchase price and the carrying amount of the lease liability being recorded as an adjustment of the carrying amount of the asset.

Right of use asset	$1,300,000
Lease obligation	(1,150,000)
Adjustment	$150,000
Purchase price of leased asset	700,000
Carrying amount of purchased asset	$850,000

On January 1, 20X4, X should make the following entry:

Entry: January 1, 20X4	dr	cr
Lease obligation	1,150,000	
Right-of-use asset		1,300,000
Fixed asset	$850,000	
Cash		700,000
To record purchased of leased asset.		

e. Subleases

1) If the nature of a sublease is such that the original lessee is relieved of the primary obligation under the original lease, the transaction shall be considered a termination of the original lease.

a) Any consideration paid or received upon termination that was not already included in the lease payments (for example, a termination payment that was not included in the lease payments based on the lease term) shall be included in the determination of profit or loss to be recognized.

2) If a sublease is a termination of the original lease and the original lessee is secondarily liable, the guarantee obligation shall be recognized by the lessee.

J. Financial Statement Presentation Matters- Lessee

Once leases are classified, measured and recorded on the balance sheet, the next issue is how the leases should be presented in the lessee's financial statements.

Statement of Financial Position

1. A lessee shall either present in the statement of financial position or disclose in the notes all of the following:

   a. Right-of-use assets separately from other assets

   b. Lease liabilities separately from other liabilities

   c. Finance (Type A) lease right-of-use assets presented separately from operating (Type B) right-of-use assets

   d. Finance (Type A) lease obligations presented separately from operating (Type B) lease obligations

2. If a lessee does not present finance and operating lease right-of-use assets and lease liabilities separately in the statement of financial position, the lessee shall do the following:

   a. Disclose which line items in the statement of financial position include right-of-use assets and lease liabilities.

3. Right-of-use assets and lease liabilities shall be subject to the same considerations as other assets and liabilities in classifying them as current and noncurrent in classified statements of financial position.

4. In the statement of financial position, a lessee is prohibited from presenting both of the following:

   a. Finance lease right-of-use assets in the same line item as operating lease right-of-use assets

   b. Finance lease liabilities in the same line item as operating lease liabilities.

Statement of Comprehensive Income (Income Statement)

1. In the statement of comprehensive income (income), a lessee shall present both of the following:

a. For finance leases, the interest expense and amortization expense shall be presented in a manner consistent with how other interest and amortization expense is presented.

Note: The interest and amortization are not required to be presented as separate line items and shall be presented in a manner consistent with how the entity presents other interest expense and amortization of similar assets, respectively. ASU 2016-02 requires that interest expense and amortization expense be disclosed somewhere, either on the face of the statement of income or in the notes to financial statements.

b. For operating (Type B) leases, lease expense, consisting of combined interest and amortization expense, shall be included in the lessee's income from continuing operations

Observation: ASU 2016-02 does not require that an entity present lease expense components as separate line items on the statement of income. Instead, for finance leases, interest and amortization shall be presented separately the same way the entity presents other interest and amortization. In most cases, that will be to include interest and amortization expense as part of total operating expenses on the income statement. As for operating (Type B) leases, interest and amortization are combined into one amount called "lease expense" and included as part of income from continuing operations. Again, there is no requirement that a lessee present lease expense related to operating leases as a separate line item on the statement of income provided that lease expense is included as part of income from continuing operations.

Statement of Cash Flows

1. In the statement of cash flows, a lessee shall classify the following:

a. <u>Finance (Type A) leases</u>:

- Payments of the principal portion of the lease liability presented within financing activities.
- Interest expense related to the lease liability is presented in operating activities as part of net income (if the indirect method is used) and interest paid is disclosed.
- Amortization expense is an add back to net income in the operating activities section if the indirect method is used.

b. <u>Operating (Type B) lease</u>:

- Payments of principal portion of the lease liability presented in operating activities.
- Interest expense related to the lease liability is presented in operating activities as part of net income (if the indirect method is used) and interest paid is disclosed.
- Amortization expense is an add back to net income in the operating activities section if the indirect method is used.

c. Other items: both finance and operating leases:

- Any payments that represent costs to bring another asset to the condition and location necessary for its intended use, should be classified within investing activities.

- Variable lease payments and short-term lease payments not included in the lease liability within operating activities. Such payments are part of lease expense and included as part of net income in the operating activities section.

K. Disclosures by Lessees

ASU 2016-02 states that the objective of the ASU's disclosure requirements is to enable users of financial statements to understand the amount, timing, and uncertainty of cash flows arising from leases.

To achieve that objective, a lessee shall *disclose qualitative and quantitative information* about all of the following:

a. Its leases

b. The significant judgments made in applying the ASU 2016-02 requirements to those leases, and

c. The amounts recognized in the financial statements relating to those leases.

Note: A lessee shall consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of the various requirements. A lessee shall aggregate or disaggregate disclosures so that useful information is not obscured by including a large amount of insignificant detail or by aggregating items that have different characteristics.

1. ASU 2016-02 requires that a lessee shall disclose the following:

   a. Information about the nature of its leases, including:

      - A general description of those leases
      - The basis, and terms and conditions, on which variable lease payments are determined
      - The existence, and terms and conditions, of options to extend or terminate the lease. A lessee should provide narrative disclosure about the options that are recognized as part of the right-of-use asset and lease liability and those that are not
      - The existence, and terms and conditions, of residual value guarantees provided by the lessee
      - The restrictions or covenants imposed by leases, for example, those relating to dividends or incurring additional financial obligations

      Note: A lessee should identify the information relating to subleases included in the disclosures above.

   b. Information about leases that have not yet commenced but that create significant rights and obligations for the lessee.

   c. Information about significant assumptions and judgments made in applying the requirements of ASU 2016-02 (ASC 842), which may include the following:

- The determination of whether a contract contains a lease
- The allocation of the consideration in a contract between lease and non-lease components, and
- The determination of the discount rate for the lease

2. For each period presented in the financial statements, a lessee shall disclose the following amounts relating to a lessee's *total lease cost*, which includes both amounts recognized in the income statement during the period and any amounts capitalized as part of the cost of another asset in accordance with other GAAP, and the cash flows arising from lease transactions:

   a. Total lease cost- total leases

   b. Finance leases:

      - Lease cost, segregated between the amortization of the right-of-use assets and interest on the lease liabilities.

   c. Operating lease cost

      - Total lease cost (consisting of combined amortization and interest)

   d. Short-term lease cost, excluding expenses relating to leases with a lease term of one month or less

   e. Variable lease cost that is not part of the lease obligation

   f. Sublease income, disclosed on a gross basis, separate from the finance or operating lease expense.

   g. Net gain or loss recognized from sale and leaseback transactions

   h. Amounts segregated between those for finance and operating leases for the following items:

      - Cash paid for amounts included in the measurement of lease liabilities, segregated between operating and financing cash flows
      - Supplemental noncash information on lease liabilities arising from obtaining right-of-use assets
      - Weighted-average remaining lease term, and
      - Weighted-average discount rate.

      Note: The lessee should calculate the *weighted-average remaining lease term* based on the remaining lease term and the lease liability balance for each lease as of the reporting date.

      The lessee should calculate the *weighted-average discount rate* based on both of the following:

- The discount rate for the lease that was used to calculate the lease liability balance for each lease as of the reporting date

- The remaining balance of the lease payments for each lease as of the reporting date.

3. A lessee shall disclose:

   a. A maturity analysis of its finance lease liabilities and its operating lease liabilities separately, showing the undiscounted cash flows on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years.

   b. A reconciliation of the undiscounted cash flows to the finance lease liabilities and operating lease liabilities recognized in the statement of financial position.

   c. Lease transactions between related parties in accordance with ASC 850, *Related Party Disclosures.*

4. A lessee that accounts for short-term leases shall disclose that fact.

   Note: If the short-term lease expense for the period does not reasonably reflect the lessee's short-term lease commitments, a lessee shall disclose that fact and the amount of its short-term lease commitments.

5. A lessee that elects the practical expedient on not separating lease components from nonlease components shall disclose its accounting policy election and which class or classes of underlying assets it has elected to apply the practical expedient.

Observation: Some of the lease disclosures noted above overlap with existing disclosures required by other GAAP. Existing GAAP already requires disclosure of interest expense and amortization expense. Now, ASU 2016-02 requires disclosure of interest expense and amortization expense related to finance (Type A) leases. The disclosures required by ASU 2016-02 are in addition to disclosures required by other GAAP. For example, with respect to interest expense, an entity will be required to disclose total interest expense for the entity (existing GAAP) plus that interest expense portion related to finance leases. Similarly, an entity is required to disclose total amortization expense under existing GAAP, plus amortization expense related to finance leases.

As for operating (Type B) leases, ASU 2016-02 requires that total lease expense be disclosed with no requirement to disclose the individual interest and amortization expense components of lease expense.

Example:

Company X implements ASU 2016-02 for 20X1.

X has the following for 20X1:

Interest expense:	
Non-lease interest expense- various loans	$100,000
Interest expense- finance lease obligations	50,000
Interest expense- operating lease obligations	25,000
Total interest expense	$175,000
Amortization expense:	
Amortization expense- various non-lease intangible assets	$200,000
Amortization expense- finance lease right-of-use assets	60,000
Amortization expense- operating lease right-of-use assets	70,000
Total amortization expense	$330,000

Conclusion:

For 20X1, X must disclose the following items as required by existing GAAP along with additional disclosures required by ASU 2016-02:

Disclosures- Existing GAAP and New ASU 2016-02

Expense	**Authority**	**Disclosure**
Total interest expense	Existing GAAP	$175,000
Total amortization expense	Existing GAAP	$330,000
Total lease cost- all leases:		
Lease cost- finance leases:		
Interest expense portion	New- ASU 2016-02	$50,000
Amortization expense portion	New- ASU 2016-02	60,000
Total lease cost- finance leases	New- ASU 2016-02	110,000
Lease cost- operating leases	New- ASU 2016-02	(a) 95,000
Total lease cost- all leases	New- ASU 2016-02	$205,000

(a) For operating (Type B) leases, ASU 2016-02 requires disclosure of total lease cost (expense) without breaking out the amortization and interest components of that cost. In this case, the $95,000 consists of interest expense ($25,000) plus amortization expense ($70,000).

Below is a sample disclosure that presents the format that can be used to disclosure the items required by ASU 2016-02:

Sample Disclosure of Information Identified in (2)(a) through (h):

NOTE X: Lease Information

A summary of total lease cost, by component, and other lease information for the years ended December 31, 20X2 and 20X1, follows:

	20X2	20X1
Total lease cost:		
Finance lease cost:	$XX	$XX
Amortization of right-of-use assets	XX	XX
Interest on lease obligations	XX	XX
Operating lease cost	XX	XX
Short-term lease cost	XX	XX
Variable lease cost	XX	XX
Total	XX	XX
Sublease income	(XX)	(XX)
Total lease cost	$XX	$XX
Other lease information:		
(Gains) and losses on sale and leaseback transactions	$(XX)	$(XX)
Cash paid for amounts included in the measurement of lease liabilities:	XX	XX
Operating cash flows from finance leases	XX	XX
Operating cash flows from operating leases	XX	XX
Financing cash flows from finance leases	XX	XX
Right-of-use assets obtained in exchange for new finance lease liabilities	XX	XX
Right-of-use assets obtained in exchange for new operating lease liabilities	XX	XX
Weighted-average remaining lease term:		
Finance leases	XX years	XX years
Operating leases	XX years	XX years
Weighted-average discount rate:		
Finance leases	x.x%	x.x%
Operating leases	x.x%	x.x%

Source: ASU 2016-02, as modified by the Author.

Examples: Application of Lease Standard- Lessee

Following are examples that present the generally application of ASU 2016-02 as it relates to the lessee side of the transaction. Most of the following examples were extracted from ASU 2016-02 and have been modified by the author.

Example 1: Initial and Subsequent Measurement by a Lessee and Accounting for a Change in the Lease Term

Part 1: Initial and Subsequent Measurement of the Right-of-Use Asset and the Lease Liability

- On January 1, 20X1, a lessee enters into a 10-year lease of an asset, with an option to extend for five years.
- Lease payments are due on January 1 at $50,000 per year during the initial 10-year term, and $55,000 per year during the five-year optional period, all payable at the beginning of each year.
- The lessee makes the first $50,000 on January 1, 20X1.
- The lessee incurs initial direct costs of $15,000 related to commissions paid.
- At the commencement date, the lessee concludes that it *is not reasonably certain that the lessee will exercise the option* to extend and therefore determines the lease term to be 10 years.
- The rate that the lessor charges the lessee is not readily determinable. The lessee's incremental borrowing rate is 5.87 percent, which reflects the fixed rate at which the lessee could borrow a similar amount in the same currency, for the same term, and with similar collateral as in the lease.

Conclusion: At the January 1, 20X1 commencement date, the lessee incurs initial direct costs, and measures the lease liability at the present value of 10 payments of $50,000, discounted at the rate of 5.87 percent, which is $392,017. Then, the lessee makes the initial payment of $50,000.

Payment date	Annual lease payment	Present value factor (5.87%)	Present value
Jan 1, 20X1	$50,000	1.0000	$50,000
Jan 1, 20X2	50,000	.9445	47,227
Jan 1, 20X3	50,000	.8922	44,609
Jan 1, 20X4	50,000	.8427	42,136
Jan 1, 20X5	50,000	.7960	39,800
Jan 1, 20X6	50,000	.7518	37,592
Jan 1, 20X7	50,000	.7102	35,508
Jan 1, 20X8	50,000	.6708	33,540
Jan 1, 20X9	50,000	.6336	31,680
Jan 1, 20X10	50,000	.5985	29,925
	$500,000		$392,017

At January 1, 20X1 commencement date, the lessee records the right-of-use asset as follows:

Liability amount	$392,017
Initial direct costs	15,000
	$407,017

Entry: January 1, 20X1 inception:	dr	cr
Right-of-use asset	407,017	
Lease liability		392,017
Cash (initial direct costs)		15,000
To establish lease at inception		
Lease liability	50,000	
Cash		50,000
To record first lease payment		

Lease Amortization Schedule

Payment Date	Beginning Balance	Principal	Interest	Total	Ending Balance
Jan 1, 20X1	$392,017	$50,000	$ 0	$50,000	$342,017
Jan 1, 20X2	342,017	29,924	20,076	50,000	312,093
Jan 1, 20X3	312,093	31,680	18,320	50,000	280,413
Jan 1, 20X4	280,413	33,539	16,461	50,000	246,874
Jan 1, 20X5	246,874	35,509	14,491	50,000	211,365
Jan 1, 20X6	211,365	37,593	12,407	50,000	173,772
Jan 1, 20X7	173,772	39,799	10,201	50,000	133,972
Jan 1, 20X8	133,973	42,136	7,864	50,000	91,836
Jan 1, 20X9	91,837	44,609	5,391	50,000	47,229
Jan 1, 20X10	47,228	47,228	2,772	50,000	0
		$392,017	**$107,983**	**$500,000**	

Assume lease is a Finance lease (Type A):

The lessee expects to consume the right-of-use asset‘s future economic benefits evenly over the lease term and, thus, amortizes the right-of-use asset on a straight-line basis.

Entries: December 31, 20X1 (Year 1):	dr	cr
Interest expense	20,076	
Accrued interest		20,076
To record interest in Year 1		
Amortization expense	40,702	
Accumulated amortization- right-of-use asset		40,702
To amortize asset on a straight-line basis ($407,017/10 years)		

The balance sheet presentation at December 31, 20X1 follows:

Company X
Balance Sheet
December 31, 20X1
(FINANCE LEASE (TYPE A)

ASSETS:

Property, Plant and Equipment:	
Equipment	$XX
Less: Accumulated depreciation	XX
Total equipment	XX
Right-of-use lease assets- Finance leases (TYPE A) (a)	**407,017**
Less: accumulated amortization	**40,702**
Total right-to-use assets	**366,315**
Right-of-use lease assets- Operating Leases (TYPE B) (a)	XX
Less: accumulated amortization	XX
Total right-to-use assets	XX
Total plant and equipment	XX

LIABILITIES:

Current liabilities:	
Current portion of long-term debt	XX
Current portion of lease obligation- Finance leases (TYPE A) (b)	**29,924**
Current portion of lease obligations- Operating Leases (TYPE B) (b)	XX
Long-term liabilities:	
Long-term debt	
Long-term lease obligation- Finance leases (Type A) (b) (c)	**312,093**
Long-term lease obligations- Operating Leases (Type B) (b)	XX

(a) ASU 2016-02 requires that the right-to-use asset be presented separately from owned assets within the property, plant and equipment section. In addition, right-of-use assets for finance leases (Type A) must be presented separately from right-of-use assets for operating leases (Type B).

(b) ASU 2016-02 requires that the lease obligation be presented separate from other debt on the balance sheet, and separated between Financing (Type A) and Operating (Type B) leases.

(c) $392,017 – principal payment at inception $(50,000) = $342,017 - current portion ($29,924) = $312,093.

Company X
Statement of Income
For the Year Ended December 31, 20X1
(FINANCE LEASE (TYPE A))

Net sales	$XX
Cost of goods sold	XX
Gross profit on sales	XX
Operating expenses:	
Interest expense	XX
Interest expense- lease obligations (a)	**20,076**
Depreciation and amortization	XX
Amortization expense- right-of-use lease assets (a)	**40,702**
Payroll and payroll-related expenses	XX
Utilities	XX
Rent	XX
Office expenses	XX
Sundry other expenses	XX
Total operating expenses	XX
Net operating income	$XX

(a): ASU 2016-02 requires that for a Finance lease (Type A), interest expense from the lease obligation and amortization expense related to right-of-use leased assets be separated from other interest and amortization expense.

Company X
Statement of Cash Flows
For the Year Ended December 31, 20X1
(FINANCE LEASE (TYPE A))

Cash flow from operating activities:	
Net income (a)	$XX
Adjustments to reconcile net income to cash from operating activities:	
	XX
Depreciation and amortization	XX
Amortization expense- right-of-use leased assets (a)	**40,702**
Investing activities:	
Financing activities:	
Repayments of long-term debt	
Repayments of right-of-use lease obligations (principal)	**(50,000)**

(a): Includes a deduction for interest expense ($20,076) and ($40,702) of amortization expense.

Assume lease is an <u>Operating Lease (Type B)</u>:

If it is an operating lease (Type B), total expense (interest and amortization) is recorded on a straight-line basis over the lease term.

In this example, total annual lease payments are as follows:

Lease payments $50,000 x 10	$500,000
Initial direct costs	15,000
Total lease payments	$515,000
Annual expense $515,000/ 10 years =	$51,500

Computation of Straight-Line Expense

Year	Interest Expense	**Amortization of lease asset (PLUG) (a)**	Total lease expense **(b)**
20X1	$20,076	**$31,424**	$51,500
20X2	18,320	**33,180**	51,500
20X3	16,461	**35,039**	51,500
20X4	14,491	**37,009**	51,500
20X5	12,407	**39,093**	51,500
20X6	10,201	**41,299**	51,500
20X7	7,864	**43,636**	51,500
20X8	5,391	**46,109**	51,500
20X9	2,772	**48,728**	51,500
20X10	0	**51,500**	51,500
	$107,983	**$407,017**	**$515,000**

(a) Right-of-use (leased) asset is amortized as a "balancing figure" so that total lease expense is measured on a straight-line basis.
(b) Shown as lease expense in the statement of income.

Entries: December 31, 20X1 (Year 1)	dr	cr
Interest expense	20,076	
Accrued interest		20,076
To record interest in Year 1		
Amortization expense	**31,424**	
Accumulated amortization- right-of-use asset		**31,424**
To amortize right-of-use asset per the schedule.		

Company X
Balance Sheet
December 31, 20X1
(OPERATING LEASE (TYPE B))

ASSETS:

Property, Plant and Equipment:	
Equipment	$XX
Less: Accumulated depreciation	XX
Total equipment	XX
Right-of-use lease assets- finance lease (Type A) (a)	$XX
Less: accumulated amortization	XX
Total right-to-use assets	XX
Right-of-use lease assets- operating lease (Type B) (a)	**407,017**
Less: accumulated amortization	**31,424**
Total right-to-use assets	**375,593**
Total plant and equipment	XX

LIABILITIES:

Current liabilities:	
Current portion of long-term debt	XX
Current portion of lease obligation- finance lease (Type A) (b)	XX
Current portion of lease obligation- operating lease (Type B) (b)	**29,924**
Long-term liabilities:	
Long-term debt	XX
Long-term lease obligation- finance lease (Type A) (b) (c)	XX
Long-term lease obligation- operating lease (Type B) (b) (c)	**312,093**

(a) ASU 2016-02 requires that the right-to-use asset be presented separately from owned assets within the property, plant and equipment section. In addition, right-of-use assets related to finance leases (Type A) must be presented separately from those related to operating leases (Type B).

(b) ASU 2016-02 requires that the lease obligation be presented separate from other debt on the balance sheet, and separated between financing (Type A) and operating (Type B) leases.

(c) $392,017 – principal payment at inception $(50,000) = $342,017 - current portion ($29,924) = $312,093.

Company X
Statement of Income
For the Year Ended December 31, 20X1
(OPERATING LEASE (TYPE B))

Net sales	$XX
Cost of goods sold	XX
Gross profit on sales	XX
Operating expenses:	
Interest expense	XX
Lease expense (1)	**51,500**
Depreciation and amortization	XX
Payroll and payroll-related expenses	XX
Utilities	XX
Rent	XX
Office expenses	XX
Sundry other expenses	XX
Total operating expenses	XX
Net operating income	$XX

(1) Under an operating lease (Type B), interest expense and amortization expense are presented as "lease expense" as a single line item on the income statement. Breakout is: interest $20,076 plus amortization $31,424 equals $51,500.

Company X
Statement of Cash Flows
For the Year Ended December 31, 20X1
(OPERATING LEASE (TYPE B))

Cash flow from operating activities:	
Net income (a)	$XX
Adjustments to reconcile net income to cash from operating activities:	XX
Depreciation and amortization	XX
Amortization expense- right-of-use leased assets – operating lease (Type B)	**31,424**
Repayments of right-of-use lease obligations- operating lease (Type B) (b)	**(50,000)**
Net cash flow from operating activities	XX
Investing activities:	
Financing activities:	
Repayments of long-term debt	XX

(a): Includes a deduction for lease expense of $51,500.
(b): For operating leases (Type B), all lease payments are part of operating activities.

A comparison of total expense for a finance lease (Type A) versus operating lease (Type B) follows:

COMPARISON OF EXPENSE - LESSEE
FINANCE LEASE (TYPE A) VERSUS OPERATING LEASE (TYPE B) LEASES

	FINANCE LEASE (TYPE A)			OPERATING LEASE (TYPE B)			DIFF A>B (B>A)
Year	**Interest**	**Amortization**	**Total**	**Interest**	**Amortization**	**Total**	
20X1	$20,076	$40,702	$60,778	$20,076	$31,424	$51,500	**$9,278**
20X2	18,320	40,702	59,022	18,320	33,180	51,500	**7,522**
20X3	16,461	40,702	57,163	16,461	35,039	51,500	**5,663**
20X4	14,491	40,702	55,193	14,491	37,009	51,500	**3,693**
20X5	12,407	40,702	53,109	12,407	39,093	51,500	**1,609**
20X6	10,201	40,702	50,903	10,201	41,299	51,500	**(597)**
20X7	7,864	40,702	48,566	7,864	43,636	51,500	**(2,934)**
20X8	5,391	40,702	46,093	5,391	46,109	51,500	**(5,407)**
20X9	2,772	40,702	43,474	2,772	48,728	51,500	**(8,026)**
20X10	0	40,699	40,699	0	51,500	51,500	**(10,801)**
	$107,983	**$407,017**	**$515,000**	**$107,983**	**$407,017**	**$515,000**	**$ 0**

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.

1. Company Y is a lessee and must classify a new lease under ASU 2016-02. Which of the following is a criterion that must be met for the lease to be classified as an operating (Type B) lease:
   a. Lease does not transfer ownership of the leased asset
   b. The lease grants lessee the option to purchase the asset
   c. The lease term is 75% or more of the remaining economic life
   d. The present value of the lease payments is 90% or more of the fair value of the leased asset

2. Big Lou's Insurance Company is a nonpublic lessee and has just signed a new lease. In computing the lease obligation, which of the following discount rates can Big Lou use in ASU 2016-02:
   a. Lessor's borrowing rate
   b. Only the rate implicit in the lease
   c. Only the lessee's incremental borrowing rate
   d. Risk-free discount rate

3. Which of the following elements should be included in lease payments for purposes of computing the lease obligation:
   a. Variable payments not dependent on an index
   b. Option to purchase if it is likely the lessee will exercise the option
   c. Payments for penalties to terminate the lease if the lease term does not reflect the lessee exercising the option to terminate
   d. In substance fixed payments

4. Alicia is a CPA whose client is a restaurant. The restaurant lease calls for five years of lease payments and there is a five-year option to extend the lease. In implementing ASU 2016-02, Alicia is trying to assess the lease term and payments in light of whether it is reasonably certain that the client will exercise the five-year option to extend the lease. Which of the following is a factor that is likely to persuade Alicia that it is reasonably certain the client will exercise the option to extend:
   a. The fact that the amount of the lease payments during the five-year lease period will be at a market rate
   b. The client spent more than $5 million of leasehold improvements that it cannot take with it once it leaves
   c. There are no costs of termination at the end of the five-year period
   d. The lease location is not critical to the operation as there are ample other locations nearby

5. Company M is a lessee and classifies its lease as an operating (Type B) lease under new ASU 2016-02. How should M record and present lease expense under its operating lease:
   a. Present as two separate expense components and record it on an accelerated expense basis
   b. Present as a single lease cost with total expense recorded on a straight-line basis
   c. Present as a single lease cost and record expense on an accelerated basis
   d. Present expense as two separate components and record it on a straight-line basis

SUGGESTED SOLUTIONS

1. Company Y is a lessee and must classify a new lease under ASU 2016-02. Which of the following is a criterion that must be met for the lease to be classified as an operating (Type B) lease:
   a. Correct. For a lease to be classified as an operating (Type B) lease, the lease must fail all five of the criteria for classification as a finance lease. One of those criteria is that the lease transfers ownership of the leased asset. Thus, an operating lease must fail that criterion by having a condition that the lease does not transfer ownership of the leased asset.
   b. Incorrect. Granting lessee the option to purchase the asset is a criterion of a finance lease. Not granting such an option is necessary for the lease to be an operating lease.
   c. Incorrect. Having a lease term of 75% or more of the remaining economic life is a criterion for a finance lease. Not meeting the 75% or more threshold is needed to classify the lease as an operating lease.
   d. Incorrect. A present value of the lease payments that is 90% or more of the fair value of the leased asset is a criterion for a finance lease. To have an operating lease, the threshold must be less than 90%.

2. Big Lou's Insurance Company is a nonpublic lessee and has just signed a new lease. In computing the lease obligation, which of the following discount rates can Big Lou use in ASU 2016-02:
   a. Incorrect. The lessor's borrowing rate is not relevant to the lessee and is not used per ASU 2016-02.
   b. Incorrect. Although use of the implicit rate in the lease is an acceptable rate, it is not the only rate making the answer incorrect. ASU 2016-02 states that a lessee should use the implicit rate in the lease, if available. If not, the lessee's incremental borrowing rate is used. There is also use of a risk-free rate of return for nonpublic entities.
   c. Incorrect. If the implicit rate in the lease is not available, the lessee's incremental borrowing rate is used. However, because Big Lou is a non-public entity, it may elect to use the risk-free rate of return. Thus, only using the incremental borrowing rate is incorrect.
   d. Correct. ASU 2016-02 permits a nonpublic entity to use the risk-free discount rate (e.g., U.S. Treasury rate) in lieu of using the incremental borrowing rate or implicit rate. Thus, Big Lou may elect to use the risk-free rate to compute the lease obligation.

3. Which of the following elements should be included in lease payments for purposes of computing the lease obligation:
   a. Incorrect. Variable payments that are dependent on an index or rate are included in lease payments, making the answer incorrect.
   b. Incorrect. A payment related to an option to purchase is included in lease payments if it is reasonably certain it will be exercised. The likely threshold is not correct.
   c. Incorrect. Payments for penalties to terminate the lease are included in lease payments if the lease term does reflect the lessee exercising the option to terminate. Thus, the answer is incorrect.
   d. Correct. In substance fixed payments along with regular fixed payments are included in lease payments per ASU 2016-02. The reason is because in-substance fixed payments do not have variability and therefore, act like fixed lease payments.

4. Alicia is a CPA whose client is a restaurant. The restaurant lease calls for five years of lease payments and there is a five-year option to extend the lease. In implementing ASU 2016-02, Alicia is trying to assess the lease term and payments in light of whether it is reasonably certain that the

client will exercise the five-year option to extend the lease. Which of the following is a factor that is likely to persuade Alicia that it is reasonably certain the client will exercise the option to extend:

a. Incorrect. In making the assessment, the amount of the payments in the five-year option period, relative to fair value, is considered. The fact that the amount of the lease payments during the five-year lease period will be at a market rate means there is not real barrier to leaving and less likely that the lessee is reasonably certain to exercise the option.
b. Correct. The significance of the leasehold improvements is a key factor to consider in determining whether a lessee is reasonably certain to exercise the option to extend. In this case, the client spent more than $5 million of leasehold improvements that it cannot take with it once it leaves. That fact is a positive one in concluding that the lessee is reasonably certain to exercise the option to extend the lease.
c. Incorrect. The fact that there are no costs of termination at the end of the five-year period means there is no barrier to leave.
d. Incorrect. A factor to consider is the importance of the location to the restaurant operations. In this case, the location is minimally important so that there is little need for the lessee to exercise the option to extend.

5. Company M is a lessee and classifies its lease as an operating (Type B) lease under new ASU 2016-02. How should M record and present lease expense under its operating lease:
   a. Incorrect. Recording and presenting expense as two separate components on an accelerated expense basis is the method used for a finance (Type A) lease, and not an operating (Type B) lease.
   b. Correct. ASU 2016-02 requires an operating (Type B) lease to present one single lease cost, by combining interest and amortization expense for an operating (Type B lease. Total lease expense is measured and recorded on a straight-line basis over the lease term.
   c. Incorrect. The answer is not quite correct. Presenting expense as a single lease cost is correct, but it is recorded on a straight-line basis, not an accelerated expense basis.
   d. Incorrect. An operating lease requires that total expense is presented as a single component (not two separate components) and recorded on a straight-line basis. Thus, the answer is partially incorrect.

VI. Lessor Rules

A. Lease Classification

1. From the lessor's perspective, the ASU 2016-01 provides three potential types of leases:

   - Sales-type lease
   - Direct financing lease, or
   - Operating lease

2. **Sales-type lease:**

   a. ASU 2016-02 uses the *same five criteria used by a lessee* to classify a finance (Type A) lease, in assessing whether a sales-type lease exists for a lessor.

   b. A lessor's lease is a sales-type lease if the lessee is expected to *consume a major part of the economic benefits* (life) of the leased asset when the lease meets any one of the following *five criteria* at the lease commencement date:

   Criterion 1: The lease *transfers ownership of the underlying asset* to the lessee by the end of the lease term.

   Criterion 2: The lease grants the lessee an option to purchase the underlying asset that the lessee is *reasonably certain* to exercise.

   Criterion 3: The lease term is for the major part of the remaining economic life of the underlying asset.

   1) *75% or more* of the remaining economic life of the underlying asset is a major part of the remaining economic life of that underlying asset.

      Exception: If the commencement date falls within the last 25% of the total economic life of the underlying leased asset, the 75% criterion shall not be used for purposes of classifying the lease.

      Note: If a single lease component contains the right to use more than one underlying asset, an entity shall consider the remaining economic life of the predominant asset in the lease component in computing the 75% test.

   Criterion 4: 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.

   1) *90% or more of the fair value* of the underlying asset amounts to substantially all the fair value of the underlying asset.

      - A lessor shall compute the present value using the rate implicit in the lease**.**

- A lessor shall assume that no initial direct costs will be deferred if, at the commencement date, the fair value of the underlying asset is different from its carrying amount.

Criterion 5: The underlying asset is of such a *specialized nature* that it is *expected to have no alternative use to the lessor* at the end of the lease term.

3. Direct financing lease:

a. When none of the five criteria to classify a lease as a sales-type lease are met, a lessor shall classify the lease as either a (an):

- Direct financing lease, or
- Operating lease.

b. If the lease is not a sales-type lease, it is classified as a direct financing lease if *two criteria* are met:

1) 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 *and/or any other third party unrelated to the lessor* equals or exceeds substantially all of the fair value of the underlying asset.

a) 90% or more of the fair value of the underlying asset amounts to substantially all the fair value of the underlying asset.

- A lessor shall compute the present value using the rate implicit in the lease.

2) It is probable that the lessor will collect the lease payments plus any amount necessary to satisfy a residual value guarantee.

Note: Unlike a lessee, a lessor is required to use the rate implicit in the lease to perform its 90% test. A lessee may use the implicit rate, if known, or its incremental borrowing rate.

c. In general, a direct financing lease is the same as a sales-type lease except for two differences that are summarized as follows:

1) A direct financing lease defers any selling profit and includes it in the measurement of the net investment in the lease. A sales-type lease recognizes selling profit into income at the commencement of the lease.

2) A direct financing lease defers initial direct costs and records them as part of the net investment in the lease while a sales-type lease expenses such costs in most cases.

Observation: There is a 90% present value test (Criterion 4) that is used to determine if a lease is a sales-type lease. If not a sales-type lease, it is either a direct financing lease or an operating lease. A lease is a direct financing lease if two conditions are met:

1) 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 *and/or any other third party unrelated to the lessor* equals or exceeds substantially all (90% or more) of the fair value of the underlying asset, and

2) It is probable that the lessor will collect the lease payments plus any amount necessary to satisfy a residual value guarantee.

Are the two 90% present value computations the same?

No. The 90% present value test used to determine if a lease is a direct financing lease computes present value using the sum of the lease payments and any residual value guaranteed by:

a. The lessee that is not already reflected in the lease payments, and/or

b. Any other third party unrelated to the lessor.

The 90% present value computation used to determine if there is a direct financing lease has part (b), which is to include the present value of any residual value guaranteed by "any third party unrelated to the lessor.

The 90% test for a sales-type lease does not include any residual value guaranteed by a third party unrelated to the lessor.

4. Operating lease:

a. From a lessor's perspective, if the lease does not qualify as a sales-type lease (Type A) and does qualify as a direct financing lease, it defaults to an operating lease.

b. Under the operating lease rules, a lessor:

1) Applies an approach *similar to existing operating lease* accounting in which the lessor does the following:

- Retains the leased asset on the lessor's balance sheet, and
- Recognizes lease (rental) income over the lease term typically on a straight-line basis.

5. Comparison of lease types- lessee versus lessor

Following is a chart that compares the types of leases between a lessee and a lessor.

Comparison of Lease Types: Lessee Versus Lessor
New ASU 2016-02

Requirement	**Lessee Side**	**Lessor Side**
Lease consumes a *major part* of the economic benefits of the leased asset: Any one of the following *five criteria* is met: 1. Transfer of ownership 2. Option to purchase that is reasonably expected to be exercised 3. Lease term is 75% or more of remaining asset life 4. Present value is 90% or more of the fair value of asset 5. Asset is specialized nature with no alternative use	Finance (Type A) lease	Sales-type lease
None of the five criteria are met	Operating (Type B) lease (1)	Either: a. Direct finance lease, or b. Operating lease (1)

(1) Operating (Type B) lease from the lessee's side is not the same as an operating lease from the lessor's side. An operating (Type B) lease from the lessee's side is capitalized. An operating lease from the lessor's side is not capitalized and, instead, the lessee records rental income on a straight-line basis over the lease term.

Observation: The common thread that links lease types between lessees and lessors is whether the lease is *expected to consume a major part of the economic benefits of the leased asset*. Satisfying the "major part" threshold is measured based on satisfying one of five criteria:

- Transfer of ownership
- Option to purchase that lessee is reasonably certain to exercise
- Lease term is 75% or more of remaining asset life
- Present value is 90% or more of the fair value of asset
- Asset is specialized nature with no alternative use

The same five criteria are used for the lessee and lessor.

From the lessee's side, if any one of the five criteria is met, the lease is a finance (Type A) lease, while, from the lessor's side the lease is classified as a sales-type lease.

Thus, a lease that is expected to consume a major part of the economic benefits of the leased asset is classified as a finance lease by the lessee and as a sales-type lease by the lessor.

What happens if the five criteria are not met?

In such a case, the lessee is classified as an operating (Type B) lease. From the lessor's side, the lease is classified as either a direct finance or operating lease.

Confusion over use of the term "operating lease"

As previous discussed in this course, the author suggests that the FASB made a glaring error in how it named the different types of leases found in ASU 2016-02. In particular, it uses the term "operating leases" to mean different types of leases, some capitalized and some not. The result is the reader is confused.

Let's look at how the term operating lease is used in multiple places within ASU 2016-02:

Existing GAAP:

> *Operating lease*: lease is not capitalized by lessor or lessee. Rents are recorded on straight-line basis.

New ASU 2016-02:

> *Operating lease (Type A) lease- lessee*: Lease is capitalized with a right-of-use asset and lease obligation.
>
> *Operating lease- lessor:* Lease is not capitalized. Lease asset is retained and rental income is recorded on a straight-line basis.

What this means is that a reader of ASU 2016-02 might be confused with use of the term "operating lease" and its definition depending on whether it is an operating lease from the lessee's perspective or from the lessor's perspective. A lessee capitalizes an operating lease (Type B lease) while a lessor does not record an operating lease.

Example:

Lessee and Lessor enter into a lease. Each does its own evaluation of the five criteria in ASU 2016-02 to classify the same lease.

	Lease Assessment	
Criteria for lease classification	**Lessee**	**Lessor**
1. Transfer of ownership?	No	No
2. Option to purchase that lessee is reasonably certain to exercise?	Yes	No
3. Lease term is 75% or more of remaining asset life?	Yes	No
4. Present value is 90% or more of the fair value of asset?	Yes	No
5. Asset is specialized nature with no alternative use?	No	No
Conclusion:	Three of five criteria met- **Finance (Type A) lease**	None of five criteria met- **Operating lease**

Conclusion: In the above example, the lessee and lessor perform their own independent analysis of the five criteria yet they each reach difference conclusion. For example, the lessee concludes that three of the five criteria are met, while the lessor concludes that none of the five are met. The differences in conclusions can be based on each side having imperfect information. For example, the lessee has better information as to whether it is reasonably certain to exercise the option to purchase the leased asset. Similarly, the lessor might have more accurate information about the fair value of the asset allowing it to perform a more accurate present value computation.

Thus, each party classifies the lease separate and distinct from the classification done by the other party.

B. Accounting for Sales-Type Lease- Lessor

Initial measurement of sales-type lease- lessor

1. At the commencement date, the lessor shall measure and recognize the following:

    a. Derecognize (remove) the underlying leased asset

    b. Recognize the following elements:

1) A net investment in the lease consisting of:
   - A lease receivable and
   - An unguaranteed residual asset

2) Selling profit or loss arising from the lease

3) Initial direct costs as an expense, if, at the commencement date, the fair value of the leased asset differs from the carrying amount.

2. Net investment in the lease:

   a. At the commencement date, the lessor shall measure and recognize an asset referred to as "net investment in the lease" consisting of two elements:

      1) Lease receivable, measured at the present value at the rate implicit in the lease of:

         a) The lease payments not yet received by the lessor,[7] and

         b) The *residual value guaranteed by the lessee* or third party, at the end of the lease.

      2) An unguaranteed residual asset:

         a) Calculated at the present value (using the implicit rate in the lease) of the amount the lessor expects to derived from the leased asset at the end of the lease, that is *not guaranteed by the lessee* or an unrelated third party.

3. Selling profit or loss- lessor

   a. At the commencement date, selling profit or loss equals the following:

Lower of: • The fair value of the underlying asset, or • The sum of (1) the lease receivable and (2) any lease payments prepaid by the lessee	$XX
Carrying amount of underlying asset net of unguaranteed residual asset	(XX)
Any deferred initial direct costs of the lessor	(XX)
Equals Selling profit or loss	$XX

4. Initial direct costs- lessor

[7] "Lease payments" is the same term used by lessees which includes fixed payments, plus variable payments tied to an index or rate, the price of a purchase option where it reasonably certain the lessee will exercise the option, and other payments.

a. Initial direct costs are the lessor's costs incurred and are recorded as an expense if, at the commencement date, the fair value of the leased asset differs from the carrying amount.

b. If the fair value of the leased asset equals its carrying amount, the initial direct costs are deferred at the commencement date and included in the measurement of the net investment in the lease.

c. Initial direct costs are defined as:

"Incremental costs of a lease that would not have been incurred if the lease had not been obtained (executed)"

d. Examples of initial direct costs <u>include:</u>

- Commissions, and
- Payments made to an existing tenant to incentivize that tenant to terminate its lease

e. Initial direct costs of the lessor exclude:

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

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

- Costs related to activities that occur before the lease is obtained, such as costs of obtaining tax or <u>*legal advice*</u>, <u>*negotiating lease terms and conditions*</u>, or evaluating a prospective lessee's financial condition.

Subsequent measurement- sales-type lease

1. After the commencement date, a lessor shall measure the net investment in the lease by doing the following:

   a. Reducing the carrying amount to reflect the lease payments collected during the period.

   b. Recognizing interest income on the net investment in the lease, measured as follows:

      - Increasing the carrying amount to reflect the interest income on the net investment in the lease, computed using the effective interest method.

      Note: A lessor shall determine the interest income on the net investment in the lease in each period during the lease term as the amount that produces a constant a periodic discount rate on the remaining balance of the net investment in the lease (e.g., using the effective interest method).

   c. Reducing the net investment in the lease for any impairment of the investment asset, if any.

2. Lessor shall record variable lease payments that are not included in the net investment in the lease as income in the income statement in the period when the changes in facts and circumstances on which the variable lease payments are based occur.

3. After the commencement date, a lessor shall not remeasure the net investment in the lease unless the lease is modified and that modification is not accounted for as a separate contract.

Other measurement issues- sales-type lease- lessor

1. Impairment of the net investment in the lease

   a. A lessor shall determine impairment related to the net investment in the lease and shall recognize any impairment in accordance with ASC 310, *Receivables*.

   b. When determining the loss allowance for a net investment in the lease, a lessor shall take into consideration the collateral relating to the net investment in the lease.

      Note: The collateral relating to the net investment in the lease represents the cash flows that the lessor would expect to derive from the underlying asset during the remaining lease term (for example, from sale of the asset or release of the asset for the remainder of the lease term), which excludes the cash flows that the lessor would expect to derive from the underlying asset following the end of the lease term (for example, cash flows from leasing the asset after the end of the lease term).

2. Sale of the lease receivable

   a. If a lessor sells the lease receivable associated with a sales-type lease and retains an interest in the unguaranteed residual asset, the lessor shall not continue to accrete the unguaranteed residual asset to its estimated value over the remaining lease term.

   b. The lessor shall report any remaining unguaranteed residual asset thereafter at its carrying amount at the date of the sale of the lease receivable and apply ASC 360 on property, plant, and equipment to determine whether the unguaranteed residual asset is impaired.

3. Accounting for the underlying asset at the end of the lease term

   a. At the end of the lease term, a lessor shall reclassify the net investment in the lease to the appropriate category of asset (for example, property, plant, and equipment) in accordance with other GAAP, measured at the carrying amount of the net investment in the lease. The lessor shall account for the underlying asset that was the subject of a lease in accordance with other GAAP.

4. Sales-type lease terminated

   a. If a sales-type lease is terminated before the end of the lease term, a lessor shall do all of the following:

      1) Test the net investment in the lease for impairment in accordance with ASC 310, *Receivables*, and recognize any impairment loss identified.

2) Reclassify the net investment in the lease to the appropriate category of asset in accordance with other GAAP, measured at the sum of the carrying amounts of the lease receivable (less any amounts still expected to be received by the lessor) and the residual asset, and

3) Account for the underlying asset that was the subject of the lease in accordance with other GAAP.

Derecognition – sales-type lease- lessor

1. At the commencement date, a lessor shall derecognize (remove) the carrying amount of the underlying asset (if previously recognized) unless the lease is a sales-type lease and *collectibility of the lease payments is not probable.*

2. Subleases

   a. If the original lease agreement is replaced by a new agreement with a new lessee, the lessor shall account for the termination of the original lease and shall classify and account for the new lease as a separate transaction.

Modifications- sales-type leases- lessor

1. A lessor shall not reassess the lease term or a lessee option to purchase the underlying asset unless the lease is modified and that modification is not accounted for as a separate contract.

2. When a lessee exercises an option to extend or terminate the lease or purchase the underlying asset, the lessor shall account for the exercise of that option in the same manner as a lease modification.

3. If a sales-type lease is modified and the modification is not accounted for as a separate contract, the lessor shall account for the modified lease as follows:

   a. If the modified lease is classified as a sales-type or a direct financing lease, the following rules apply:

      - The lessor shall adjust the discount rate for the modified lease so that the initial net investment in the modified lease equals the carrying amount of the net investment in the original lease immediately before the effective date of the modification.

   b. If the modified lease is classified as an operating lease:

      - The carrying amount of the underlying asset should equal the net investment in the original lease immediately before the effective date of the modification.

Collectibility of lease payments- sales-type lease- lessor

1. If collectibility of the lease payments, plus any amount necessary to satisfy a residual value guarantee provided by the lessee, is *not probable at the commencement date*, the lessor shall not derecognize (remove) the underlying asset but shall do the following:

a. Recognize lease payments received (including variable lease payments) as a *deposit liability* until the earlier of either of the following:

1) Collectibility of the lease payments, plus any amount necessary to satisfy a residual value guarantee provided by the lessee, *becomes probable*. If collectibility is not probable at the commencement date, a lessor shall continue to assess collectibility to determine whether the lease payments and any amount necessary to satisfy a residual value guarantee are probable of collection.

2) Either of the following events occurs:

a) The contract has been terminated, and the lease payments received from the lessee are nonrefundable.

b) The lessor has repossessed the underlying asset, it has no further obligation under the contract to the lessee, and the lease payments received from the lessee are nonrefundable.

2. When collectibility is not probable at the commencement date, at the date the collectability *becomes probable based on paragraph (a)(1)* above, the lessor shall do all of the following:

a. Derecognize the carrying amount of the underlying asset

b. Derecognize the carrying amount of any deposit liability recognized to date

c. Recognize a net investment in the lease based on the remaining lease payments and remaining lease term, using the rate implicit in the lease determined at the commencement date

d. Recognize selling profit or selling loss calculated as:

1) The lease receivable; plus

2) The carrying amount of the deposit liability; minus

3) The carrying amount of the underlying asset, net of the unguaranteed residual asset.

3. When collectibility is not probable at the commencement date, at the date the criterion in (a)(2) above are met, the lessor shall derecognize the carrying amount of any deposit liability recognized to date with the corresponding amount recognized as lease income.

Financial statement presentation sales-type leases

1. Statement of Financial Position

a. A lessor shall present lease assets (that is, the aggregate of the lessor's net investment in sales-type leases and direct financing leases) separately from other assets in the statement of financial position.

b. Lease assets shall be subject to the same considerations as other assets in classification as current or noncurrent assets in a classified balance sheet.

2. Statement of Comprehensive Income (Statement of Income)

a. A lessor shall either present in the statement of comprehensive income (statement of income) or disclose in the notes lease income arising from leases.

b. If a lessor does not separately present lease income in the statement of comprehensive income, the lessor shall disclose which line items include lease income in the statement of comprehensive income.

c. A lessor shall present any profit or loss on the lease recognized at the commencement date in a manner that best reflects the lessor's business model(s).

Examples of presentation include the following:

1) If a lessor uses leases as an alternative means of realizing value from the goods that it would otherwise sell, the lessor shall present revenue and cost of goods sold relating to its leasing activities in separate line items so that income and expenses from sold and leased items are presented consistently. Revenue recognized is the lesser of:

- The fair value of the underlying asset at the commencement date
- The sum of the lease receivable and any lease payments prepaid by the lessee.

Cost of goods sold is the carrying amount of the underlying asset at the commencement date minus the unguaranteed residual asset.

2) If a lessor uses leases for the purposes of providing finance, the lessor shall present the profit or loss in a single line item.

3. Statement of Cash Flows

a. In the statement of cash flows, a lessor shall classify cash receipts from leases within operating activities.

C. Accounting for a Direct Financing Lease

Categorizing a lease as a direct financing lease

1. When *none of the criteria* to classify a lease as a sales-type lease are met, a lessor shall classify the lease as either a (an):

- Direct financing lease, or
- Operating lease.

2. If the lease is not a sales-type lease, it is classified as a direct financing lease if *both of the following two criteria are met*:

   a. 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 and/or any other third party unrelated to the lessor equals or exceeds substantially all of the fair value of the underlying asset.

      1) 90% or more of the fair value of the underlying asset amounts to substantially all the fair value of the underlying asset. A lessor shall compute the present value using the *rate implicit in the lease*.

   b. It is probable that the lessor will collect the lease payments plus any amount necessary to satisfy a residual value guarantee.

Initial measurement of direct financing lease- lessor

1. At the commencement date, the lessor shall measure and recognize the following:

   a. Derecognize (remove) the underlying leased asset

   b. Recognize the following elements:

      1) A *net investment in the lease* consisting of the following, reduced by any selling profit.

         - A lease receivable and
         - An unguaranteed residual asset

      2) *Selling loss* arising from the lease, if any

2. Selling profit and initial direct costs are *deferred* at the commencement date and *included in the measurement of the net investment in the lease*. The rate implicit in the lease is defined in such a way that initial direct costs deferred in accordance with this paragraph are included automatically in the net investment in the lease; there is no need to add them separately.

3. Net investment in the lease:

   a. At the commencement date, the lessor shall measure and recognize an asset referred to as "net investment in the lease" consisting of two elements, reduced by any selling profit, if any.

      1) Lease receivable, measured at the present value at the rate implicit in the lease of:

         a) The lease payments not yet received by the lessor,[8] and

         b) The *residual value guaranteed by the lessee* or third party, at the end of the lease.

      2) An unguaranteed residual asset:

[8] Lease payments is the same term used for lessees which includes fixed payments, plus variable payments tied to an index or rate, the price of a purchase option where it reasonably certain the lessee will exercise the option, and other payments.

a) Calculated at the present value (using the implicit rate in the lease) of the amount the lessor expects to derived from the leased asset at the end of the lease, that is *not guaranteed by the lessee* or an unrelated third party.

Subsequent measurement- direct financing lease

1. After the commencement date, a lessor shall do the following:

   a. Measure the net investment in the lease by doing both of the following:

      1) Reduce the carrying amount to reflect the lease payments collected during the period.

      2) Recognize interest income on the net investment in the lease, measured as follows:

         - Increase the carrying amount to reflect the interest income on the net investment in the lease.

           Note: A lessor shall determine the interest income on the net investment in the lease in each period during the lease term as the amount that produces a constant a periodic discount rate on the remaining balance of the net investment in the lease.

   b. Record additional items as follows:

      1) Variable lease payments that are not included in the net investment in the lease as income in profit or loss in the period when the changes in facts and circumstances on which the variable lease payments are based occur.

      2) Impairment of the net investment in the lease.

2. After the commencement date, a lessor shall not remeasure the net investment in the lease unless the lease is modified and that modification is not accounted for as a separate contract.

What are the real differences between a sales-Type And direct financing lease accounting?

The differences between the two types of leases are not significant and are summarized as follows:

a. A direct financing lease defers any selling profit and includes it in the measurement of the net investment in the lease. A sales-type lease recognizes selling profit into income at the commencement of the lease.

b. A direct financing lease defers initial direct costs and records them as part of the net investment in the lease while a sales-type lease expenses such costs in most cases.

Modification- direct financing lease

1. If a direct financing lease is modified and the modification is not accounted for as a separate contract, the lessor shall account for the modified lease as follows:

a. If the modified lease is classified as a direct financing lease, the lessor shall adjust the discount rate for the modified lease so that the initial net investment in the modified lease equals the carrying amount of the net investment in the original lease immediately before the effective date of the modification.

b. If the modified lease is classified as a sales-type lease, the lessor shall account for the modified lease in accordance with the guidance applicable to sales-type leases, with the commencement date of the modified lease being the effective date of the modification.

- In calculating the selling profit or selling loss on the lease, the fair value of the underlying asset is its fair value at the effective date of the modification, and its carrying amount is the carrying amount of the net investment in the original lease immediately before the effective date of the modification.

c. If the modified lease is classified as an operating lease, the carrying amount of the underlying asset equals the net investment in the original lease immediately before the effective date of the modification.

Financial statement presentation - direct financing lease

The financial statement presentation for direct financing leases is the same as sales-type leases.

1. Statement of Financial Position

a. A lessor shall present lease assets (that is, the aggregate of the lessor's net investment in sales-type leases and direct financing leases) separately from other assets in the statement of financial position.

b. Lease assets shall be subject to the same considerations as other assets in classification as current or noncurrent assets in a classified balance sheet.

2. Statement of Comprehensive Income (Statement of Income)

a. A lessor shall either present in the statement of comprehensive income or disclose in the notes income arising from leases.

b. If a lessor does not separately present lease income in the statement of comprehensive income, the lessor shall disclose which line items include lease income in the statement of comprehensive income.

c. A lessor shall present any profit or loss on the lease recognized at the commencement date in a manner that best reflects the lessor's business model(s).

Examples of presentation include the following:

1) If a lessor uses leases as an alternative means of realizing value from the goods that it would otherwise sell, the lessor shall present revenue and cost of goods sold relating to its leasing

activities in separate line items so that income and expenses from sold and leased items are presented consistently. Revenue recognized is the lesser of:

- The fair value of the underlying asset at the commencement date
- The sum of the lease receivable and any lease payments prepaid by the lessee.

Cost of goods sold is the carrying amount of the underlying asset at the commencement date minus the unguaranteed residual asset.

2) If a lessor uses leases for the purposes of providing finance, the lessor shall present the profit or loss in a single line item.

3. Statement of Cash Flows

a. In the statement of cash flows, a lessor shall classify cash receipts from leases within operating activities.

D. Accounting for Operating Leases- Lessor

Categorizing a lease as an operating lease- lessor

1. If a lease does not qualify as a sales-type lease or a direct financing lease, a lessor categorizes it as an operating lease.

   a. For a lessor, the term "operating lease" is different than an operating lease (Type B) lease related to a lessee, which is capitalized.

Initial measurement- operating lease- lessor

1. At the commencement date:

   a. The leased asset is retained on the books and depreciated.

   b. The leased asset and liability is not recorded on the balance sheet.

   c. Lessor shall *defer initial direct costs*.

Subsequent measurement- operating lease- lessor

1. After the commencement date, a lessor shall recognize all of the following:

   a. The lease payments received as lease income on the income statement over the lease term on a *straight-line basis* unless another systematic and rational basis is more representative of the pattern in which benefit is expected to be derived from the use of the underlying asset.

b. *Variable lease payments* as income in profit or loss in the period in which the changes in facts and circumstances on which the variable lease payments are based occur

c. *Initial direct costs* as an expense over the lease term on the same basis as lease income

2. If collectibility of the lease payments plus any amount necessary to satisfy a residual value guarantee is *not probable* at the commencement date, lease income shall be limited to the lesser of:

   a. The income that would be recognized in (1)(a) and (b) above, or

   b. The lease payments, including variable lease payments, that have been collected from the lessee.

   Note: If the assessment of collectibility changes after the commencement date, any difference between the lease income that would have been recognized and the lease payments, including variable lease payments, that have been collected from the lessee shall be recognized as a current-period adjustment to lease income.

Example: Operating Lease

Lessor executes a five-year lease with a lessee calling for annual lease payments as follows:

Year	Annual lease payments
1	$50,000
2	52,000
3	54,000
4	56,000
5	58,000
	$270,000

The lessor categorizes the lease as an operating lease.

Conclusion:

The lessor should retain the leased asset on its books and depreciate it.

As annual lease payments are received, the lessor should recognize those lease payments in lease income on a straight-line basis in the amount of $54,000 annually as follows:

Total lease payments- 5 years	$270,000
Divided by	5
Straight line basis/year	$54,000

Entry: Year 1:		dr	cr
Cash		50,000	
	Lease income		54,000
Rent receivable		4,000	
To record Year 1 lease income on a straight-line basis			

Note: Under ASU 2016-02, a lessor lease classified as an operating lease requires the lease income to be recorded on a straight-line basis, unless another method is systematic and rational. Under this example, the total income over the five-year lease term is $270,000 resulting in income computed on a straight-line basis of $54,000 per year. In Year 1, lease income recorded on the income statement is $54,000 while the amount received is only $50,000 under the lease contract. The difference is $4,000, which is recorded as a rent receivable or similar asset.

Modification- operating lease- lessor

1. If an operating lease is modified and the modification is not accounted for as a separate contract, the lessor shall account for the modification as if it were a termination of the existing lease and the creation of a new lease that commences on the effective date of the modification as follows:

    a. If the modified lease is classified as an operating lease, the lessor shall consider any prepaid or accrued lease rentals relating to the original lease as a part of the lease payments for the modified lease.

    b. If the modified lease is classified as a direct financing lease or a sales-type lease, the lessor shall derecognize any deferred rent liability or accrued rent asset and adjust the selling profit or selling loss accordingly.

Financial statement presentation- operating leases

1. Statement of Financial Position

a. For an operating lease, a lessor shall continue to present the underlying asset on its balance sheet.

2. Statement of Comprehensive Income (Income Statement)

a. Lease payments are recorded as lease income on the income statement on a *straight-line basis* unless there is another systematic basis that is more representative of the pattern in which income is earned from the underlying asset.

3. Statement of Cash Flows

a. In the statement of cash flows, a lessor shall classify cash receipts from lease payments within operating activities.

E. Disclosure- Lessor Leases

The objective of the disclosure requirements in ASU 2016-02 is to enable users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases. ASU 2016-02 requires a lessor to disclose qualitative and quantitative information about all of the following:

a. Its leases

b. The significant judgments made in applying the requirements in ASU 2016-02 to those leases, and

c. The amounts recognized in the financial statements relating to those leases

A lessor shall consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of the various requirements.

A lessor shall aggregate or disaggregate disclosures so that useful information is not obscured by including a large amount of insignificant detail or by aggregating items that have different characteristics.

1. A lessor shall disclose both of the following:

   a. Information about the nature of its leases, including:

      1. A general description of those leases

      2. The basis and terms and conditions on which variable lease payments are determined

      3. The existence and terms and conditions of options to extend or terminate the lease

      4. The existence and terms and conditions of options for a lessee to purchase the underlying asset.

   b. Information about significant assumptions and judgments made in applying the requirements of ASC 842, which may include the following:

      1. The determination of whether a contract contains a lease

      2. The allocation of the consideration in a contract between lease and nonlease components

      3. The determination of the amount the lessor expects to derive from the underlying asset following the end of the lease term.

2. A lessor shall disclose any lease transactions between related parties.

3. A lessor shall disclose lease income recognized in each annual and interim reporting period, in a *tabular format*, to include the following:

a. For sales-type leases and direct financing leases:

- Profit or loss recognized at the commencement date (disclosed on a gross basis or a net basis)

- Interest income either in aggregate or separated by components of the net investment in the lease.

b. For operating leases, lease income relating to lease payments.

c. Lease income relating to variable lease payments not included in the measurement of the lease receivable.

4. A lessor shall disclose in the notes the components of its aggregate net investment in sales-Type And direct financing leases such as:

- The carrying amount of its lease receivables
- Its unguaranteed residual assets, and
- Any deferred selling profit on direct financing leases.

5. A lessor shall disclose information about how it manages its risk associated with the residual value of its leased assets. A lessor should disclose all of the following:

a. Its risk management strategy for residual assets

b. The carrying amount of residual assets covered by residual value guarantees (excluding guarantees considered to be lease payments for the lessor, and

c. Any other means by which the lessor reduces its residual asset risk (for example, buyback agreements or variable lease payments for use in excess of specified limits).

6. Sales-type and direct financing leases- additional disclosures

a. For sales-Type And direct financing leases, the lessor shall disclose the following addition information:

- An explanation of significant changes in the balance of its unguaranteed residual assets and deferred selling profit on direct financing leases

- A maturity analysis of its lease receivables, showing the undiscounted cash flows to be received on an annual basis for a *minimum of each of the first five years and a total* of the amounts for the remaining years

- A reconciliation of the undiscounted cash flows to the lease receivables recognized in the statement of financial position (or disclosed separately in the notes)

7. Operating leases- additional disclosures

a. For operating leases, the lessor shall disclose the following addition information:

- A maturity analysis of lease payments, showing the undiscounted cash flows to be received on an annual basis for a minimum of each of the *first five years* and a total of the amounts for the remaining years.

  Note: The maturity analysis should be shown separately from the maturity analysis required for sales-type leases and direct financing leases.

- Disclosures required by ASC 360 on property, plant, and equipment separately for underlying assets under operating leases from owned assets.

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.

1. Which of the following is a criterion that is used to determine whether a lessor's lease is a sales-type lease:
   a. There is no transfer of ownership
   b. There is an option to purchase
   c. The lease term is 80% or more of the remaining economic life of the leased asset
   d. The present value of the lease payments and residual value exceeds 60% of the carrying amount of the leased asset

2. Company X is a lessor and has classified a new lease as an operating lease. Which of the following is correct in terms of how X should account for the operating lease:
   a. X should record a lease asset and liability
   b. X should retain the leased asset on its balance sheet
   c. Lease should record interest income on the lease liability
   d. X should amortize the leased asset

3. Company Z is a lessor with a sales-type lease. At the commencement date, it is not probable that Z will collect lease payments from the lessee. How should Z account for the lease going forward:
   a. Record the lease payments received as interest and principal payments
   b. Record the lease payments received as a deposit liability
   c. Record the lease payments received as rental income
   d. Record the lease payments received against the net investment and defer the interest income

4. Which of the following is a disclosure required by a lessor under ASU 2016-02 requirements:
   a. A detailed description of the leases
   b. For sales-type leases, a maturity analysis of lease receivables for a minimum of each of the first ten years
   c. For operating leases, a maturity analysis of lease payments for each of the first seven years
   d. For operating leases, lease income relating to lease payments

SUGGESTED SOLUTIONS

1. Which of the following is a criterion that is used to determine whether a lessor's lease is a sales-type lease:
   a. Incorrect. Criterion 1 requires that there is a transfer (rather than not a transfer) of ownership at the end of the lease.
   b. Correct. Criterion 2 provides that the lease must grant the lessee an option to purchase the leased asset and the lessee is reasonably certain to exercise it.
   c. Incorrect. The lease term is 75% or more (not 80%) of the remaining economic life of the leased asset
   d. Incorrect. The present value of the lease payments and residual value must exceed 90% of the fair value of the leased asset, not 60% of the carrying amount.

2. Company X is a lessor and has classified a new lease as an operating lease. Which of the following is correct in terms of how X should account for the operating lease:
   a. Incorrect. If a lease is categorized as an operating lease from the lessor's perspective, no asset or liability is recorded on the transaction and the original asset is retained.
   b. Correct. A lessor's operating lease retains the leased asset on its balance sheet which is correct.
   c. Incorrect. Because no lease obligation is recorded, there is no interest income on the lease, making the answer incorrect.
   d. Incorrect. There is no lease asset recorded so that there is no amortization.

3. Company Z is a lessor with a sales-type lease. At the commencement date, it is not probable that Z will collect lease payments from the lessee. How should Z account for the lease going forward:
   a. Incorrect. Because the collection is not probable, ASU 2016-02 does not permit the receipts to be recorded as income, making the answer incorrect. Instead, they are gathered in a deposit account.
   b. Correct. The ASU requires that the lease payments received be recorded as a deposit liability until collectibility of the lease payments, plus any amount necessary to satisfy a residual value guarantee provided by the lessee, becomes probable.
   c. Incorrect. In a sales-type lease, rental income is not recorded. Further, because of the collectability issue, no income is recorded until collectability becomes probable.
   d. Incorrect. When collectability is a problem, ASU 2016-02 requires the payments received to be recorded in a deposit account and not credited against the net investment account, making the answer incorrect.

4. Which of the following is a disclosure required by a lessor under ASU 2016-02 requirements:
   a. Incorrect. The ASU requires a general, not detailed, description of the leases.
   b. Incorrect. The ASU requires that the disclosure be for a minimum first five years, and in total, and not ten years.
   c. Incorrect. The maturity analysis of lease payments is required for each of the first five years, not seven years.
   d. Correct. ASU 2016-02 requires that a lessor disclose, for its operating leases, lease income relating to lease payments.

VII. Transition and Effective Date Information

A. General- Existing Leases

A key element of ASU 2016-02 is that it does not grandfather existing leases. That means that on the effective date of the ASU, the following must be done:

1. Existing leases that do not qualify for the 12-month short-term lease election:

    a. Existing operating leases must be capitalized under the new ASU by bringing onto the balance sheet a right-of-use asset and lease obligation

    b. Existing capital lease assets and liabilities must be adjusted to conform with the calculated right-of-use assets and lease obligations

2. Any existing leases that qualify for the 12-month short-term election on the effective date would not be capitalized under the new lease standard.

3. Disclosures must be expanded to conform with the list of disclosures under ASU 2016-02.

B. Transition

The following represents the transition and effective date information related to ASU 2016-02, *Leases (ASC 842):*

1. Effective dates

a. A public business entity, a not-for-profit entity, and an employee benefit plan:

- Shall apply the amendments in ASU 2016-02 for financial statements issued for *fiscal years beginning after December 15, 2018*, and interim periods within those fiscal years. Earlier application is permitted.

b. All other entities (including non-public entities):

- Shall apply the amendments in ASU 2016-02 for financial statements issued for *fiscal years beginning after December 15, 2019*, and interim periods within fiscal years beginning after December 15, 2020. Earlier application is permitted.

c. In the financial statements in which an entity first applies the ASU 2016-02 amendments, the entity shall recognize and measure leases that exist *at the beginning of the earliest comparative period presented*.

d. An entity shall *adjust equity at the beginning of the earliest comparative period presented*, and the other comparative amounts disclosed for each prior period presented in the financial statements, as if the amendments in ASU 2016-02 had always been applied, subject to the requirements.

2. Practical expedients

a. An entity may elect the following *practical expedients*, which must be elected as a package and applied consistently by an entity to *all of its leases* (including those for which the entity is a lessee or a lessor), when applying the ASU 2016-02 to leases that commenced before the effective date:

1) Under the practical expedient, an entity is not required to reassess the following:

a) Whether any expired or existing contracts are or contain leases

b) Whether initial direct costs exist for any existing leases

c) The lease classification for any expired or existing leases

- All existing leases that were classified as operating leases under previous GAAP will automatically be classified as operating (Type B) leases, and

- All existing leases that were classified as capital leases under previous GAAP will automatically be classified as finance (Type A) leases.

b. An entity also may elect a practical expedient, which must be applied consistently by an entity to all of its leases (including those for which the entity is a lessee or a lessor) to use hindsight in determining the lease term when:

1) Considering lessee options to extend, terminate the lease, or purchase the underlying asset, and

2) Assessing impairment of the entity's right-of-use assets. This practical expedient may be elected separately or in conjunction with the practical expedients in (f).

VIII. Leases: Sale and Leaseback Transactions

If an entity (the transferor) transfers an asset to another entity (the transferee) and leases that asset back from the transferee, both the transferor and the transferee shall account for the transfer contract and the lease as follows:

1. Determining whether the transfer of the asset is a sale

a. An entity shall apply the requirements in ASC 606 on revenue from contracts with lessee (customer) when determining whether the transfer of an asset shall be accounted for as a sale of the asset including:

- The existence of a contract
- When an entity satisfies a performance obligation by transferring control of an asset.

Note: The existence of a leaseback (that is, a seller-lessee's right to use the underlying asset for a period of time) does not, in isolation, prevent the buyer lessor from obtaining control of the asset.

However, the buyer-lessor is not considered to have obtained control of the asset in accordance with the guidance on when an entity satisfies a performance obligation by transferring control of an asset in ASC 606 if the leaseback would be classified as a finance lease or a sales-type lease.

2. An option for the seller-lessee to repurchase the asset would preclude accounting for the transfer of the asset as a sale of the asset unless both of the following criteria are met:

   a. The exercise price of the option is the fair value of the asset at the time the option is exercised.

   b. There are alternative assets, substantially the same as the transferred asset, readily available in the marketplace.

3. Transfer of the asset is a sale

   a. If the transfer of the asset is a sale, both of the following apply:

      1) The seller-lessee shall:

         - Recognize the transaction price for the sale at the point in time the buyer-lessor obtains control of the asset based on guidance found in ASC 606

         - Derecognize the carrying amount of the underlying asset

         - Account for the lease in accordance with ASC Subtopic 842-20.

      2) The buyer-lessor shall account for the purchase in accordance with other GAAP and for the lease in accordance with ASC 842-30.

4. Transfer of the asset is not a sale

   a. If the transfer of the asset is not a sale, both of the following apply:

      - The seller-lessee shall not derecognize the transferred asset and shall account for any amounts received as a financial liability in accordance with other GAAP.

      - The buyer-lessor shall not recognize the transferred asset and shall account for the amounts paid as a receivable in accordance with other GAAP.

5. Initial measurement

   a. Transfer of the asset is a sale: An entity shall determine whether a sale and leaseback transaction is *at fair value* based on the difference between either of the following, whichever is more readily determinable:

      - The sale price of the asset and the fair value of the asset

      - The present value of the lease payments and the present value of market rental payments.

b. If the sale and leaseback transaction is not at fair value, the entity shall adjust the sale price of the asset on the same basis the entity used to determine that the transaction was not at fair value.

The entity shall account for *both of the following*:

- Any increase to the sale price of the asset as a prepayment of rent

- Any reduction of the sale price of the asset as additional financing provided by the buyer-lessor to the seller-lessee. The seller-lessee and the buyer-lessor shall account for the additional financing in accordance with other GAAP.

c. In determining whether the sale and leaseback transaction is at fair value, the entity should consider those variable payments it reasonably expects to be entitled to (or to make) based on all of the information (historical, current, and forecast) that is reasonably available to the entity.

- For a seller-lessee, this would include estimating any variable consideration to which it expects to be entitled.

- A sale and leaseback transaction is not off market solely because the sale price or the lease payments include a variable component.

d. If the transaction is a related party lease, ASU 2016-02 states that an entity shall not make certain adjustments required for sale-leaseback transactions but shall provide disclosures about related party lease transactions.

6. Transfer of the asset is not a sale

a. In a sale-leaseback transaction, the seller lessee shall adjust the interest rate on its financial liability as necessary to ensure that both of the following apply:

- Interest on the financial liability is not greater than the principal payments on the financial liability over the shorter of the lease term and the term of the financing. The term of the financing may be shorter than the lease term because the transfer of an asset that does not qualify as a sale initially may qualify as a sale at a point in time before the end of the lease term.

- The carrying amount of the asset does not exceed the carrying amount of the financial liability at the earlier of the end of the lease term or the date at which control of the asset will transfer to the buyer-lessor (for example, the date at which a repurchase option expires if that date is earlier than the end of the lease term).

7. Disclosure

a. If a seller-lessee enters into a sale and leaseback transaction, a seller-lessee shall disclose both of the following:

- The main terms and conditions of that transaction

- Any gains or losses arising from the transaction separately from gains or losses on disposal of other assets.

IX. Leases: Leveraged Lease Arrangements

1. ASU 2016-02 provides guidance on the accounting for leveraged leases, from the perspective of the lessor.

2. A leveraged lease is defined as follows:

   "From the perspective of a lessor, a lease that was classified as a leveraged lease in accordance with the leases guidance in effect before the effective date and for which the commencement date is before the effective date."

3. The author has not included that guidance in this course.

REVIEW QUESTIONS

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1. Company X is implementing ASU 2016-02 and elects the practical expedients. Which of the following is an element of the practical expedient:
   a. The expedient must be elected individually for each expedient element
   b. An entity is not required to reassess any expired contracts to determine if any contain leases
   c. An entity must reassess the lease classification of expired leases
   d. Any entity is required to reassess initial direct costs for any existing leases

2. Company Y sells a property and leases it back in a sales-leaseback transaction. The transaction of the asset is a sale. Which of the following is correct with respect to the transaction:
   a. The seller-lessee should not recognize the transaction price for the sale
   b. The seller should account for the lease in accordance with ASC 842, *Leases*
   c. The seller should continue to carry the underlying leased asset
   d. The buyer-lessor should not account for the lease under ASC 842, *Leases*

SUGGESTED SOLUTIONS

1. Company X is implementing ASU 2016-02 and elects the practical expedients. Which of the following is an element of the practical expedient:
   a. Incorrect. The practical expedient must be elected as a package, for all leases.
   b. Correct. One of the benefits of the practical expedient is that an entity is not required to perform any reassessment of expired or existing contracts to determine if any contain leases that may be subject to ASU 2016-02.
   c. Incorrect. The practical expedient does not require an entity to reassess the lease classification of expired leases, making the answer incorrect.
   d. Incorrect. The practical expedient allows an entity not to reassess initial direct costs for any existing leases.

2. Company Y sells a property and leases it back in a sales-leaseback transaction. The transaction of the asset is a sale. Which of the following is correct with respect to the transaction:
   a. Incorrect. If it is a sale, the seller-lessee should recognize the transaction price for the sale at the point in time at which the buyer-seller obtains control of the asset.
   b. Correct. Because it is a sales-leaseback, the seller should account for the lease in accordance with ASC 842, Leases, similar to any other lease.
   c. Incorrect. ASU 2016-02 requires that the seller derecognize (remove) the carrying amount of the underlying leased asset to reflect the original sale.
   d. Incorrect. Because it is an actual lease transaction, the buyer-lessor should account for the lease under ASC 842, *Leases*, similarly to other leases.

X. Impact of Changes to Lease Accounting

What might be the impact of changes to lease accounting?

The ASU 2016-02 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 existing operating leases to interest and amortization expense under ASU 2016-02.

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 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 is 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, five-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. 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 (true 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.

XI. Impact of Lease Changes on Nonpublic Entities

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.[9] 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?

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 leased asset and liability, and

[9] Equipment Leasing and Financing Association (ELFA) "Companies: New Lease Rule Means Labor Pains" (CFO. com).

- 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 leased 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.

XII. Other Considerations- Dealing with Financial Covenants

The lease standard is likely to 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:

Ratio	**Likely impact of ASU 2016-02's lease standard**
EBITDA: *[Earnings before interest, taxes, depreciation and amortization]*	Finance (Type A) leases: Favorable impact due to shift from rental expense to interest and amortization expense, both of which are added back in computing EBITDA. Operating (Type B) leases: May be favorable impact depending on whether "lease expense" is added back to compute EBITDA.
Interest coverage ratio: $\frac{\textit{Earnings before interest and taxes}}{\textit{Interest expense}}$	May be negatively impacted from lower ratio
Debt-equity ratio: $\frac{\textit{Total liabilities}}{\textit{Stockholders' equity}}$	Negative impact from higher ratio

There 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.

XIII. Avoiding the New Lease Standard

For many non-public entities, the new lease standard is a costly nuisance under which lease assets must be measured and recorded and offer no value to lenders. In fact, many lenders are just becoming familiar with the new standard given that there is a delayed effective date until calendar Year 2020 for nonpublic entities. Those lenders might be concerned that the additional lease debt could drive otherwise compliant borrowers into violations of loan covenants such as debt-equity ratios. To avoid the violations, the lenders might be required to offer carve-out exceptions under which lease debt will be excluded from the debt-equity ratio. That change could have regulatory challenges and come under the scrutiny of bank examiners.

What are the options non-public entities have available to them if they seek to avoid implementing the new standard?

The author offers a few suggestions:

Option 1: Convert leases to short-term leases with a lease term of 12 months or less.

Option 2: Use a special-purpose framework such as tax-basis of accounting which does not recognize ASU 2016-02 rules.

Option 3: Ensure that lease contract language does not qualify the contract as a lease.

Option 4: Insert a GAAP exception into the audit, review or compilation report

Option 5: Ignore complying with ASU 2016-02 due to immateriality of leases.

Option 6: Hope the PCC provides private company exception

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.

1. Per the author, which of the following is likely to be an effect of the new lease standard:
   a. The lessee's income statement will have lower total lease expense in the earlier years of new leases
   b. There will 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

2. One change that may occur because of the new lease standard being implemented is_____:
   a. Companies that typically purchase a single-tenant building may choose to lease instead of buy
   b. Tenants in multi-tenant buildings might sign longer-term leases
   c. Tenants in single-tenant buildings with long term leases may choose to buy
   d. There is likely to be no change

3. Which of the following is a possible result of the new lease standard on related-party leases:
   a. Most related-party leases will have to be recorded on balance sheets
   b. Most related parties do not have formal leases or leases 12 months or less
   c. Most related-party leases will create a consolidation under the VIE rules
   d. Most related-party leases have formal long-term leases and cannot be modified

SUGGESTED SOLUTIONS

1. Per the author, which of the following is likely to be an effect of the new lease standard:
   a. Incorrect. 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 be a positive (not negative) shift to cash from operations from cash from financing activities in the statement of cash flows.
   c. Incorrect. Total expense for GAAP may differ from total expense for income tax purposes resulting in deferred income taxes being recorded.
   d. **Correct. The lessee's EBITDA may increase as there is a shift from rent expense to interest and amortization expense. Interest and amortization are not deducted in arriving at EBITDA while rent expense under existing operating leases is deducted.**

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

3. Which of the following is a possible result of the new lease standard on related-party leases.
   a. Incorrect. Most related-party leases can be rewritten into short-term leases and avoid being recorded under the short-term lease exception
   b. Correct. Because most related parties do not have formal leases or leases 12 months or less they should qualify for the short-term lease exception.
   c. Incorrect. Although the VIE consolidation rules might apply to related-party leases, there are ways to avoid consolation including using the private company exception.
   d. Incorrect. Most related-party leases do not have formal long-term leases and can't be modified easily, making the answer incorrect.

CHAPTER 2:

Financial Instruments:
ASU 2016-01 and ASU 2016-13

ASU 2016-01
Financial Instruments – Overall (Subtopic 825-10)
Recognition and Measurement of Financial Assets and Financial Liabilities

ASU 2016-13
Financial Instruments – Credit Losses
(Topic 326)
Measurement of Credit Losses on Financial Instruments

Financial Instruments:
ASU 2016-01 and ASU 2016-13

Introduction

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

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

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

As stated in the survey:

1. "Fair value information is the only information relevant to financial decision making. …… Decisions about whether to purchase, sell or hold investments are based upon the fair values. Financial statements based on outdated historical costs are less useful for making such assessments."

2. Because current financial statements include a mixture of historical cost and fair value, investors who rely on fair values for decision making must expend considerable effort to restate cost to fair value.

3. Historic cost itself is in reality historic market value, the amount of a past transaction, and is never comparable on a firm-to-firm basis because the costs were incurred at different dates by different firms.

4. Investor conversion of historical cost components to fair value would be eliminated if GAAP recorded assets and liabilities at fair value at inception with a periodic revaluation to fair value.

5. FASB should make a move to fair value accounting a priority.

The fact is that the historical cost model is inconsistent with the way in which investors and other third parties measure an entity- by the change in entity value. Presently, GAAP uses a fair value model to record the initial measurement of assets and liabilities. Thereafter, many assets are recorded at historical cost, such as fixed assets, while others are recorded at fair value or a hybrid of cost and fair value.

Recent FASB action on financial instruments

Most recently, the FASB placed four financial instruments projects on its agenda, two of which have been issued as final statements and are the subject of this course as follows:

Recent Financial Instrument Projects	
ASU	**Date Issued or Status**
ASU 2016-01, *Financial Instruments-Overall*.	Issued in January 2016 Effective date: – Public companies: Calendar year 2018 – Nonpublic companies: Calendar year 2019
ASU 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*	Issued in June 2016 Effective date: – Public companies: Calendar year 2020 – Nonpublic companies: Calendar year 2021
Accounting for Financial Instruments: Hedge Accounting	Pending
Accounting for Financial Instruments: Interest Rate Risk Disclosures	Research project- pending

In this chapter, the author addresses two recently issued ASUs as follows:

- ASU 2016-01, *Financial Instruments- Overall*
- ASU 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*

As the reader can see from the previous chart, both ASUs have delayed effective dates. In fact, a nonpublic entity will not implement ASU 2016-13 related to credit losses until calendar year 2021.

Prior to the effective dates, one should expect further guidance on the two ASUs following the pattern of other significant FASB projects. For example, the FASB's revenue project resulted in the issuance of ASU 2014-09. *Revenues from Contracts with Customers.* Since that time, the FASB has issued at least five additional ASUs to clarify some of the ambiguous language found in the original ASU 2014-09. Readers should expect a similar action by the FASB with respect to ASU 2016-01 and 2016-13, both of which are significant enough and have a high level of complexity that they will require further guidance.

ASU 2016-01: Financial Instruments – Overall (Subtopic 825-10) Recognition and Measurement of Financial Assets and Financial Liabilities

Issued: January 2016

Effective date: ASU 2016-01 is effective as follows:

For public business entities: the amendments in the ASU are effective for fiscal years *beginning after December 15, 2017*, and interim periods within those annual periods.

All other entities, including nonpublic entities, not-for-profit entities and employee benefit plans on plan accounting: the amendments in the ASU are effective for fiscal years *beginning after December 15, 2018*, and interim periods within fiscal years beginning after December 15, 2017.

The ASU provides a limited option to apply the ASU changes early. Except for the limited early application guidance, early adoption is not permitted. The ASU is applied by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The amendments related to equity securities without readily determinable fair values (including disclosure requirements) should be applied prospectively to equity investments that exist as of the date of adoption of ASU 2016-01.

I. Objective

The primary objective of ASU 2016-01 is to enhance the reporting model for financial instruments to provide users of financial statements with more decision-useful information.

II. Background

In the mid-2000s, the FASB and IASB started a joint project to improve and obtain convergence of the accounting for financial instruments.

During the 2008 global economic crisis, the importance of the financial instruments project was highlighted with the need to improve the accounting models for financial instruments to reflect the complex economic environment. Consequently, the prime objective of the financial instruments project is to enhance the reporting model for financial instruments and to provide financial statement users with more useful information.

The ASU amendments address certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. It does not address credit losses which is addressed in ASU 2016-13: *Financial Instruments – Credit Losses (Topic 326) Measurement of Credit Losses on Financial Instruments.*

The amendments made by ASU 2016-01 affect all entities that hold financial assets or owe financial liabilities.

Prior to the effective date of ASU 2016-01, GAAP for investments and financial instruments has been found in several ASC topics as follows:

ASC 320, *Investments- Debt and Equity Securities*
ASC 323, *Equity Method and Joint Ventures*
ASC 325, *Investments- Other*
ASC 810, *Consolidations*

Overarching sections that affect the accounting for investments include:

ASC 820, *Fair Value Measurement, and*
ASC 825, *Financial Instruments*

With respect to the accounting for investments, prior to ASU 2016-01, GAAP has provided three tiers of ownership and different accounting rules related to each as follows:

Ownership level	**General accounting treatment**
1. Ownership of less than 20% of the voting shares	Investment recorded at cost or fair value depending on whether the investment has a *readily determinable fair value*
2. Ownership of 20-50% of the voting shares or when one entity has *significant influence* over another entity	Use the equity method
3. Ownership of more than 50% of the voting shares or having a controlling financial interest through other than ownership[10]	Consolidate the entities

[10] One example is the variable interest entity rules under which consolidation might occur when a primary beneficiary has a controlling financial interest in a variable interest entity (VIE).

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

GAAP for Investments- Prior to ASU 2016-01	
Ownership of voting stock	**Accounting Treatment**
TIER 1: Less than 20% Ownership	
a. Investment (debt or equity): Fair value is *not readily determinable* (e.g., most closely held stock)	ASC 325 - Investments recorded at amortized cost. A write down is made to lower of cost or fair value if a loss is other-than temporary
b. Investment (debt or equity securities): Fair value *is readily determinable* (e.g., debt or equities traded on an exchange). Investments placed into three categories:	ASC 320 (formerly FASB No. 115) - Securities are recorded at fair value or cost based on three investment categories: 1. *Held-to-maturity securities*- Recorded at amortized cost 2. *Trading securities*- Recorded at fair value- gain/loss presented on the income statement 3. *Available-for-sale securities*- Recorded at fair value- gain/loss presented in stockholders' equity, net of taxes (other comprehensive income)
TIER 2: Equity Method: 20-50% or Significant Influence	
a. Use the equity method	ASC 323 (formerly APB No. 18): Use the equity method
TIER 3: Consolidation or Combined Financial Statements	
a. Consolidation based on more than 50% ownership of voting stock	ASC 810- Consolidate in all cases
b. Exceptions where consolidation is based on other than ownership. [controlling financial interest]	**Four exceptions to the more than 50% consolidation rules- Consolidate even if more-than-50% ownership threshold is not met:** **1. Entities controlled by contract** **2. General partner that controls a limited partnership** **3. Miscellaneous transactions involving research and development arrangements and rabbi trusts** **4. Variable interest entities (VIEs)**
c. Combined financial statements	Option to combine financial statements of two or more entities when it is more meaningful to do so.

When there is ownership of *less than 20% of the outstanding voting shares*, existing GAAP has *two sets of rules* that apply depending on whether the investment (equity or debt) has a *readily determinable fair value.*

Investments that do not have a readily determinable fair value: If the investments do not have a readily determinable fair value (such closely held stock, convertible debt or redeemable preferred stock):

- The investments are *recorded at cost* in accordance with ASC 325, *Investments-Other*.
- Subsequently, the investments are adjusted to the lower of cost or market if there is a significant loss and that loss is *other-than-temporary*.

Investments in securities with readily determinable fair value: If the investments are securities with readily determinable fair value (e.g., traded on a public exchange), the rules of ASC 320, *Investments-Debt and Equity Securities* (formerly FASB No. 115) apply.

ASC 320 places investments in securities into *three categories* and has separate rules for each category. [11]

The **three (3) categories** are as follows:

1. Debt securities held to maturity- Debt securities that management plans to hold until maturity.
2. Trading securities- Both debt and equity securities that are bought and held for the purpose of selling them in the near term (generally within one year).
3. Available-for-sale securities- Both debt and equity securities that are not categorized as either held to maturity or trading securities, are automatically categorized as available-for-sale. In this category, management has essentially not decided what it plans to do with the securities.

At the time of purchase, a security is placed into one of the three categories based on management's positive intent and ability. Once a security is placed in a particular category, it generally can be changed only where there are significant unforeseeable circumstances.

Regardless of the category, if there is a decline in the fair value of individual investments below amortized cost that is *other-than-temporary*, the cost basis is written down to fair value with the recording of a realized loss. The written-down cost basis becomes the new basis going forward.

The following table summarizes the existing accounting treatment for investments that are not recorded at equity and not consolidated (e.g., generally less than 20% ownership in voting shares).

[11] For non-profit organizations, the accounting for securities is found in ASC 958, *Not-for-Profit Entities*, which requires that investments in securities be recorded at fair value with unrealized gains and losses presented in the statement of activity.

Existing GAAP Rules- Investments < 20% Pre-ASU 2016-01				
	Securities with Readily Determinable Fair Value **----------[3 CATEGORIES----------**			**Investments- not readily determinable fair value**
	Debt securities held to maturity	**Trading securities**	**Available-for- sale securities**	**Mostly closely held investments**
Type	Debt	Debt and equity	Debt and equity	Debt or equity
Intent	Hold to maturity	Sell in the near term[12]	Undecided	Not applicable
Record at	Cost	Fair value	Fair value	Cost
Unrealized gains or losses	Not applicable	Presented on income statement	Presented in stockholders' equity, net of tax (other comprehensive income)	Not applicable
Balance sheet	Based on maturity date	Current even if sale is expected beyond one year	Based on management's intent at year end	Current or non-current based on management's intent
Other-than-temporary losses	**Investment written down and realized loss recognized on income statement**			

Therefore, under existing GAAP, there is one set of rules for debt and equity securities (three categories) and other rules for investments for which fair value is not readily determinable, (recorded at cost), subject to an other-than-temporary impairment writedown.

Since 2005, the FASB and the IASB have had a long-term objective to improve and simplify the reporting for financial instruments.

In March 2006, both boards clarified their intentions to jointly improve and bring about convergence of financial reporting standards by issuing a *Memorandum of Understanding, A Roadmap for Convergence between IFRSs and U.S. GAAP—2006–2008.*

[12] Although the intent is to sell the securities in the near term (within one year), securities can qualify as trading even if the intent is to sell securities beyond one year.

In May 2010, the FASB issued its first exposure draft, *Accounting for Financial Instruments and Revisions to the Accounting for Derivatives and Hedging Activities—Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815).*

In February 2013, the FASB issued a revised exposure draft, *Financial Instruments— Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*.

In response to both exposure drafts, the FASB observed that most financial statement users agreed that fair value is a more relevant measure for financial instruments and, in particular for financial instruments that are part of a trading portfolio or that otherwise are held for sale.

Based on the revised 2013 exposure draft, the FASB chose to focus on the following key changes with respect to financial instruments, and ultimately culminated with the issuance of ASU 2016-01 in January 2016.

Equity securities:

a. Measure equity investments at fair value through net income, thereby eliminating the available-for-sale presentation of changes in the fair value of an equity investment in other comprehensive income.

b. Measure equity investments without readily determinable fair values by recognizing in net income any observable price changes, both upward and downward, in the period in which the change occurs, increasing the frequency of remeasurement of those investments to fair value.

c. Simplify the impairment method for equity investments without readily determinable fair values with a one-step approach that also provides for more timely recognition of any impairment.

d. Present in other comprehensive income, rather than in net income, changes in the fair value of a liability that are attributable to changes in instrument-specific credit risk for liabilities for which an entity elects the fair value option.

e. Require public business entities to report all fair value disclosures based on an exit price; eliminating the ability to use an entry price for certain fair value disclosures.

Debt securities:

a. Retain the existing three-category rules: held to maturity, trading and available for sale debt securities.

b. Makes limited expansion of disclosures for debt securities.

In issuing ASU 2016-01, the FASB also concluded that the following provisions reduce the cost and complexity in preparing information provided about an entity's exposure to financial instruments:

a. Exempt entities (other than public entities) from the requirement to disclose fair value information about financial instruments measured at cost.

b. Exempt public entities from disclosing methods and assumptions used to estimate the fair value of financial instruments that are measured at cost; however, a public entity is required to present either parenthetically on the face of the statement of financial position or in the notes to financial statements the fair value of those financial instruments.

c. Clarify that an entity should assess a valuation allowance on deferred tax assets related to debt securities that are classified as available-for-sale in combination with the entity's other deferred tax assets.

ASU 2016-01 changes the existing GAAP model for investments, by making two specific changes to the accounting for equity investments:

- Supersedes the existing requirement to classify equity securities with readily determinable fair values into different categories (that is, trading or available-for-sale).

- Requires equity securities (including other ownership interests, such as partnerships, unincorporated joint ventures, and limited liability companies) to be *measured at fair value* with changes in the fair value *recognized through net income*.

Specific changes made by ASU 2016-01 to the accounting for financial instruments, including investments follow:

a. ASU 2016-01 splits the accounting for investments between:

    - Debt securities, and
    - Equity securities.

b. ASU 2016-01 retains the three categories for debt securities:

    - Held for maturity
    - Trading
    - Available for sale

c. Requires 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*.

    - The *three-category rules for securities* have been eliminated for equity investments and now only apply to debt securities.

d. Moves the authority for equity investments without readily determinable fair values (such as closely held stock) from ASC 325 to new ASC 321,[13] and permits such investments to be measured one of two ways:

    - At fair value using the new ASC 321 rules for investments in equity securities, or

[13] ASC 325-20, *Investments- Other- Cost Method Investments* is superseded by ASU 2016-01.

- By electing an optional practical expedient (optional formula) as follows: Cost minus impairment, if any, plus or minus changes in observable prices in orderly transactions for the identical or a similar investment of the same issuer.

e. Simplifies 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 using a *one-step approach*.

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

g. Makes specific changes limited to public business entities:

- Eliminates 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.

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

h. Requires 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.

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

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

The scope of ASU 2016-01 does not apply to equity investments that are accounted for under the equity method of accounting, or, result in consolidation of an investee.

Changes relative to International Standards

ASU 2016-01 represents a joint FASB-IASB project to improve the accounting for financial instruments and to achieve convergence on a single recognition and measurement model. With that said, ASU 2016-01 makes only targeted improvements to GAAP and retains the current framework for accounting for financial instruments in GAAP.

This is contrasted to the IASB's more expansive changes reflected in their IFRS 9, *Financial Instruments*.

Although differences do exist between the guidance in GAAP and the guidance in IFRS related to the accounting for financial instruments, the amendments in ASU 2016-01 achieve convergence with IFRS in the following areas:

1. ASU 2016-01 requires an entity to present separately in other comprehensive income, the portion of the total change in the fair value of a liability that results from a change in the instrument-specific credit risk for financial liabilities that the entity has elected to measure at fair value in accordance with the fair value option.

2. ASU 2016-01 requires most equity investments to be measured at fair value, which is consistent with the guidance in IFRS 9.[14]

3. ASU 2016-01 clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities, which is the same as the direction in which the IASB is going in its proposed amendments to IAS 12, *Income Taxes*.

[14] There is a difference in that IFRS 9 allows an entity to make an irrevocable election at initial recognition to present subsequent changes in fair value in other comprehensive income for investments in equity instruments that otherwise are measured at fair value through the income statement.

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.

1. If one entity owns between 20-50% of the voting shares in (or has significant influence over) another entity that is publicly traded, what is the general accounting treatment for the investment:
   a. Consolidate the entities
   b. Investment should be recorded at cost
   c. Investment should be recorded at fair value
   d. Use the equity method

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

3. Under existing ASC 320 (formerly FASB No. 115), trading securities must be presented as:
   a. Current assets
   b. Long-term assets
   c. Either current or long-term depending on the company's intent
   d. Split between current and long-term

SUGGESTED SOLUTIONS

1. If one entity owns between 20-50% of the voting shares in (or has significant influence over) another entity that is publicly traded, what is the general accounting treatment for the investment:
   a. Incorrect. Consolidation occurs if there is more than 50% of the voting shares in another entity.
   b. Incorrect. The cost method applies if one entity owns less than 20% of the voting shares in another entity and the investment's fair value is not readily determinable (such as a closely held stock). In this example, the stock is publicly traded so that the fair value is readily determinable. Thus, cost treatment is not appropriate.
   c. Incorrect. The fair value method may be applied if one entity owns less than 20% of the voting shares in another entity and the investment's fair value is readily determinable. Fair value does not apply if the investment is recorded using the equity method or is consolidated.
   d. **Correct. If one entity owns between 20-50% of the voting shares or where one entity has significant influence over another, the accounting treatment for the investment generally is to use the equity method. Significant influence is assumed at between 20 percent to 50 percent ownership.**

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

3. Under existing ASC 320 (formerly FASB No. 115), trading securities must be presented as:
   a. **Correct. ASC 320 requires trading securities to be presented as current assets, by definition, unless there are extenuating circumstances.**
   b. Incorrect. Generally, trading securities should be presented as current rather than long-term per ASC 320.
   c. Incorrect. ASC 320 does not offer any flexibility for presentation of trading securities on the balance sheet as anything other than current. In comparison, ASC 320 does provide that securities available for sale (AFS) should be presented as current or long-term based on the company's intent at the end of the year.
   d. Incorrect. ASC 320 does not allow for the splitting of a trading security between current and long-term on the balance sheet.

III. Definitions

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.

The term equity security does not include any of the following:

a. Written equity options (because they represent obligations of the writer, not investments)

b. Cash-settled options on equity securities or options on equity-based indexes (because those instruments do not represent ownership interests in an entity)

c. 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.

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 public business entity:

a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).

b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.

c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of, or for purposes of issuing securities that are not subject to contractual restrictions on transfer.

d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.

e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including footnotes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to satisfy 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.

Security

A share, participation, or other interest in property or in an entity of the issuer or an obligation of the issuer that has all the following characteristics:

a. It is either represented by an instrument issued in bearer or registered form, or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer.
b. It is of a type commonly dealt on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment.
c. It either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.

IV. Rules – Debt Securities

1. Changes to GAAP Codification:

The GAAP Codification of Topics for investments is amended as follows:

Existing GAAP Codification	**New GAAP Codification after ASU 2016-01**
ASC 320, Investments—Debt and Equity Securities ASC 323, Investments—Equity Method and Joint Ventures ASC 325, Investments—Other	ASC 320, Investments—Debt Securities **ASC 321, Investments—Equity Securities** ASC 323, Investments—Equity Method and Joint Ventures ASC 325, Investments—Other

2. Debt Securities- ASC 320, As Amended:

The ASU amends ASC 320 to <u>*apply it solely to debt securities*</u> with guidance for equity securities moved to the new ASC 321.

a. Scope of new ASC 320

The guidance in amended ASC 320, *Investments—Debt Securities*, applies to all entities, including the following entities that are not deemed to belong to specialized industries:

- Cooperatives and mutual entities (such as credit unions and mutual insurance entities), and
- Trusts that do not report substantially all of their debt securities at fair value.

b. Types of debt instruments included within ASC 320

All of the following debt instruments are considered within the scope of ASC 320 if they meet the definition of a debt security:

1) Loans restructured as securities:

   For example, any loan that was restructured in a troubled debt restructuring involving a modification of terms would be subject to the provisions of ASC 320 if the debt instrument meets the definition of a security.

2) Beneficial interests in securitized financial assets that are in equity form but that meet the definition of a debt security.

   For example, some beneficial interests issued in the form of equity represent solely a right to receive a stream of future cash flows to be collected under preset terms and conditions (that is, a creditor relationship), while others, according to the terms of the special-purpose entity, must be redeemed by the issuing entity or must be redeemable at the option of the investor. Consequently, those beneficial interests would be within the scope of both this Topic and Subtopic 325-40 since they are required to be accounted for as debt securities.

3) Certificates of deposit (CDs) or guaranteed investment contracts:

   Note: Most CDs are not considered debt securities. However, ASC 320 provides that certain negotiable jumbo CDs and guaranteed investment contracts might meet the definition of security, which was modeled after the definition provided in the Uniform Commercial Code. Most CDs are not considered debt securities.

4) Redeemable convertible preferred stock:

   For example, convertible preferred stock that has mandatory redemption provisions or is redeemable at the option of the investor, is considered a debt security and ASC 320 would apply,

   Note: Even if a loan could readily be converted into a security, the loan is not a debt security until it has been securitized. An example of an unsecuritized loan is an unsecuritized mortgage loan. However, after mortgage loans are converted to mortgage-backed securities, they are subject to the guidance in this Topic.

c. ASC 320 exclusions

The guidance in amended ASC 320 *does not apply* to the following entities:

1) Entities in certain specialized industries whose specialized accounting practices include accounting for substantially all investments in debt securities at fair value, with changes in value recognized in earnings (income) or in the change in net assets.

   Examples of those entities include:

   a) Brokers and dealers in securities (ASC 940)

b) Defined benefit pension and other postretirement plans (ASC 960, 962, and 965)
c) Investment companies (ASC 946)

d. Classification of debt securities

ASU 2016-01 retains the three-category rules for debt securities even though these rules have been eliminated for equity securities.

ASU 2016-01 states that at acquisition, an entity shall classify *debt securities* into one of the following three categories:

1) Held-to-maturity debt securities: Investments in *debt securities* shall be classified as held-to maturity only if the reporting entity has the *positive intent and ability to hold* those securities to maturity.

2) Trading debt securities: If a (debt) security is acquired with the intent of selling it within hours or days, the security shall be classified as trading.

   Note: At acquisition, an entity is not precluded from classifying as trading a security it plans to hold for a longer period. Classification of a security as trading shall not be precluded simply because the entity does not intend to sell it in the near term.

3) Available-for-sale debt securities: Investments in *debt securities* not classified as trading debt securities or as held-to-maturity debt securities shall be classified as available-for-sale debt securities.

At acquisition, an investor shall document the classification of debt securities within one of the three categories noted above.

e. Subsequent measurement- debt securities

Investments in debt securities shall be measured subsequently as follows:

Trading (debt) securities: Investments in *debt securities* that are classified as trading:

- Shall be measured subsequently at fair value in the statement of financial position
- Unrealized holding gains and losses for trading securities shall be included in earnings

Available-for-sale (debt) securities: Investments in *debt securities* that are classified as available for sale:

- Shall be measured subsequently at *fair value* in the statement of financial position
- Unrealized holding gains and losses for available-for-sale securities shall be excluded from earnings and reported in other comprehensive income (net of taxes), and part of stockholders' equity.

Exception: All or a portion of the unrealized holding gain and loss of an available-for-sale security that is designated as being hedged in a fair value hedge shall be recognized in earnings during the period of the hedge, per ASC 815-25-35-1 through 35-4. *Derivatives and Hedging.*

Held-to-maturity (debt) securities: Investments in debt securities classified as held to maturity:

- Shall be measured subsequently at *amortized cost* in the statement of financial position.

EXAMPLE:

Facts:

XYZ Corporation is issuing a *full set of financial statements* for the year ended December 31, 20X1.

XYZ has an investment in a debt security that is classified as available for sale.

The following financial data applies to XYZ Corporation for the year ended December 31, 20X1.

Revenue	$1,000,000
Expenses	800,000
Income from operations	200,000
Income taxes	80,000
Net income	120,000
Retained earnings:	
Beginning of year	2,000,000
End of year	$2,120,000

Other comprehensive income items: (posted directly to stockholders' equity)	
Unrealized gains on **debt securities** available-for-sale	$50,000
Income taxes allocated	(20,000)
Net gain	$30,000
Foreign currency translation adjustments	$40,000
Income taxes allocated	(16,000)
Net amount	$24,000

Conclusion:

The unrealized gain on available-for-sale debt securities, and the foreign currency translation adjustments are presented in stockholders' equity as part of other comprehensive income, net of the tax effect.

Because XYZ Corporation is issuing a full set of financial statements, the company is required to present a display of comprehensive income in a financial statement format in either:

- A single continuous statement of income and comprehensive income (or called statement of comprehensive income), or
- Two separate, but consecutive statements: statement of income followed by a statement of comprehensive income.

In this example, XYZ chooses to present one continuous statement of income and comprehensive income.

Statement of income and comprehensive income

XYZ Corporation
Statement of Income and Comprehensive Income
For The Year Ended December 31, 20X1

Revenue	$1,000,000
Expenses	800,000
Income from operations	200,000
Income taxes	80,000
Net income	120,000
Other comprehensive income:[15]	
Unrealized gain on **debt securities** available for sale (net of tax of $20,000)	30,000
Foreign currency translation adjustments (net of tax of $16,000)	24,000
Total other comprehensive income	54,000
Comprehensive income	$174,000

[15] Alternatively, the tax effect of other comprehensive income could be presented as follows:

Unrealized gain- debt securities	$50,000
Foreign currency adjustments	40,000
Other comprehensive income, before taxes	90,000
Income tax expense allocated	(36,000)
Other comprehensive income	$54,000

Presentation of changes in components of accumulated other comprehensive income in the statement of stockholders' equity

Regardless of whether a single or two-statement format is used to present comprehensive income, ASC 220 requires an entity to present on the face of the financial statements or in the notes to financial statements, the changes in the accumulated balance for each component of accumulated other comprehensive income.

The changes may be shown either in the statement of stockholders' equity or in the notes to financial statements. Continuing with the previous example, the entity chooses to present a statement of stockholders' equity.

Present the changes in each component of accumulated other comprehensive income in the statement of stockholders' equity.

XYZ Corporation
Statement of Stockholders' Equity
For The Year Ended December 31, 20X1

			Accumulated Other Comprehensive Income		
	Total	Retained Earnings	Unrealized gains-**debt securities**	Foreign currency adjustment	Common Stock
Beginning balance	$2,525,000	$2,000,000	$10,000	$15,000	$500,000
Net income	120,000	120,000			
Unrealized gains on **debt securities** available for sale	**30,000**		**30,000**		
Foreign currency translation adjustments	24,000	0	0	24,000	0
Ending balance	$2,699,000	$2,120,000	$40,000	$39,000	$500,000

Note: The requirement is to present the changes in each component of accumulated other comprehensive income. The two changes in accumulated other comprehensive income (unrealized gains and foreign currency adjustments) are shown net of tax. However, there is no requirement to disclose the tax effect of these changes when presenting the changes in accumulated other comprehensive income. Notice also that there is no labeling required such as "other comprehensive income" or "comprehensive income."

Presentation of balance sheet- debt securities

Regardless of the format for presenting comprehensive income, ***accumulated other comprehensive income*** must be presented as a separate component on the balance sheet as follows:

XYZ Corporation
Balance Sheet
December 31, 20X1

Assets:	
Cash	$XX
Accounts receivable	XX
Debt Securities, available-for-sale	XX
Property and equipment, net	XX
Total assets	$XX
Liabilities:	
Accounts payable	$XX
Accrued expenses	XX
Deferred income taxes	XX
Total liabilities	XX
Stockholders' equity:	
Common stock	XX
Retained earnings	XX
Accumulated other comprehensive income	**79,000**[16]
Total stockholders' equity	XX
Total liabilities and stockholders' equity	$XX

Note: ASC 220, *Comprehensive Income*, requires that accumulated other comprehensive income be presented as a separate component in the equity section of the balance sheet. It does not require that the individual components be presented as long as they are presented elsewhere such as in the statement of stockholders' equity or in the notes to financial statements.

f. Reassessment of classification- debt securities

At each reporting date, the appropriateness of the classification of an entity's investments in debt securities shall be reassessed.

Example: If an entity no longer has the ability to hold debt securities to maturity, their continued classification as held-to-maturity would not be appropriate.

The transfer of a debt security between categories of investments shall be accounted for at fair value based on the following rules:

Accounting for transfers among categories- debt securities

[16] Unrealized gains on debt securities ($39,000) plus foreign exchange adjustments ($40,000) totals ($79,000).

Action	Accounting treatment
From trading category	No action The unrealized gain or loss at the date of transfer was already recognized in earnings.
To trading category	Portion of the unrealized gain or loss at the date of transfer that has not been previously recognized in earnings is recognized in earnings immediately.
Into the available-for-sale from the held to maturity category	The unrealized gain or loss at the date of transfer is reported in other comprehensive income.
Into the held-to-maturity from the available-for-sale category	The unrealized gain or loss shall continue to be reported as accumulated other comprehensive income (in stockholders' equity). That accumulated other comprehensive income is amortized over the remaining life of the security as an adjustment of the yield like the amortization of a premium or discount. The amortization is an adjustment of interest income.

g. Transfers between categories- debt securities

ASU 2016-01 retains the existing language found in ASC 320 with respect to transfers of debt securities between categories. That language states the following:

Transfers from the held-to-maturity category- debt security:

Transfers from the held-to-maturity should be rare except for transfers due to the changes in circumstances such as:

- Evidence of a significant deterioration in the issuer's creditworthiness (such as a downgrading of an issuer's published credit rating)

- A change in tax law that eliminates or reduces the tax-exempt status of interest on the debt maturity (but not a change in the marginal tax rates applicable to interest income)

- A major business combination or major disposition (such as a sale of a component of an entity) that necessitates the sale or transfer of held-to-maturity securities to maintain the entity's existing interest rate risk position or credit risk policy

- A change in statutory or regulatory requirements significantly modifying either what constitutes a permissible investment of the maximum level of investments in certain kinds of securities, thereby causing an entity to dispose of a held-to-maturity security

- A significant increase by the regulatory in the industry's capital requirements that causes the entity to downsize by selling held-to-maturity securities, or

- A significant increase in the risk weights of debt securities used for regulatory-risk-based capital purposes.

Note: Certain other events may cause the entity to sell or transfer a held-to-maturity security without tainting the held-to-maturity classification for the remainder debt securities. To avoid tainting the entity's intent to hold the remainder debt securities to maturity, the following *four conditions* must be met:

- The event is isolated
- The event is nonrecurring
- The event is unusual for the reporting entity, and
- The event could not have been reasonably anticipated.

Transfers to or from the trading category for debt securities should be rare, given the nature of the trading security.

Available-for-sale securities should not be automatically transferred into the trading category simply because the passage of time causes the maturity date to be within one year or because management intends to sell the security within one year.

h. Impairment of individual available-for-sale and held-to-maturity debt securities

ASC 320, as amended, provides guidance on impairment of individual available-for-sale and held-to-maturity *debt securities* and applies for investments in all of the following:

1. Debt securities that are within the scope of ASC 320[17]

2. Debt securities within the scope of ASC 958-320, *Not-for-Profit Entities*, and that are held by an entity that reports a performance indicator as defined in ASC 954-225-45-4 through 45-7, *Health Care Entities*.

Steps for identifying and accounting for impairment- debt security

ASU 2016-01 retains ASC 320's *two-step approach* for impairment of debt securities that are classified as either held-to-maturity or available-for-sale categories.

Step 1: Determine whether the debt security is impaired

[17] Exception: A bifurcated host instrument under ASC 815-15, *Derivatives and Hedging*, would be evaluated for other-than-temporary impairment in accordance with the guidance in Section 320-10-35 if the bifurcated host instrument meets the scope of this guidance.

1. Impairment shall be assessed at the individual security level of the debt security.

   - Individual security level means the level and method of aggregation used by the reporting entity to measure realized and unrealized gains and losses on its debt securities.

     (For example, debt securities of an issuer bearing the same Committee on Uniform Security Identification Procedures [CUSIP] number that were purchased in separate trade lots may be aggregated by a reporting entity on an average cost basis if that corresponds to the basis used to measure realized and unrealized gains and losses for the debt securities of the issuer.)

   - If the *fair value of the debt security is less than its cost*, proceed to *Step 2*.

Step 2: Evaluate whether the debt security has an other-than-temporary impairment

1. If the fair value of the debt investment is less than its amortized cost basis at the balance sheet date, the impairment is either *temporary* or *other than temporary*.

   a. If the impairment is *temporary*, no impairment loss is recorded.

   b. If the impairment loss is *other than temporary*, an impairment loss is recorded (see rules discussed below).

2. Factors to consider in determining if an impairment of a debt security is other than temporary:

   - If an entity intends to sell the debt security

   - Whether it is more likely than not that it will be required to sell the security before the recovery of its amortized cost basis due to contractual or regulatory obligations

   - Whether the entity expects to recover the entire amortized cost basis even if it does not intend to sell it

   - The collectability of the debt security, the remaining payment terms, prepayment speeds, financial condition of the issuer, expected defaults, and value of any underlying collateral.

3. If *other-than-temporary,* an impairment loss is recorded in earnings based on the following rules:

   a. If the entity *intends to sell the debt security* or it is more likely than not (more than 50% probability) it will be required to sell the debt security before recovery of the amortized cost less any current-period credit loss, an impairment loss is recognized in earnings as follows:

      Example: Company X has an impairment loss as the fair value of a debt security is less than the amortized cost basis. The entity intends to sell the debt security before recovery of the impairment loss. The debt security is categorized as held to maturity and is recorded at amortized cost, prior to the impairment loss writedown.

      Conclusion: The entity should record an impairment loss on the income statement computed as follows:

Amortized cost basis	$500,000
Fair value	300,000
Impairment loss (income statement)	$(200,000)

b. If the entity *does not intend to sell the debt security* or it is not more likely than not (more than 50% probability) it will be required to sell the debt security before recovery of the amortized cost less any current-period credit loss, an impairment loss is separated into two components:

1) The amount representing the credit loss[18]- recognized in earnings, and

2) The amount representing all other factors- recognized in other comprehensive income, net of taxes

Example:

Assume an entity has a debt security categorized as held to maturity and is recorded at amortized cost, prior to the impairment loss writedown.

Amortized cost basis	$500,000
Fair value	300,000
Impairment loss - total	$(200,000)

Entity does not intend to sell the debt security and it is not more likely than not it will be required to sell it before recovery of the $200,000 loss.

Conclusion:

The impairment loss is split into two amounts; the portion related to a credit loss, and the portion related to all other factors:

Amortized cost basis	$500,000
Present value of cash flows	350,000
Impairment loss – credit loss (income statement)	(150,000)
Balance of loss – other factors- other comprehensive income, net of taxes	(50,000
Impairment loss- total	$(200,000)

Note: If the investment is categorized as available for sale, any unrealized losses previously recorded as other comprehensive income should be reversed as part of the impairment loss entry.

Post-impairment- debt securities

1. After an impairment loss writedown of a debt security, the fair value becomes the new cost basis for the next period.

[18] Credit loss is computed as the difference between the present value of cash flows expected to be collected from the debt security less the amortized cost basis.

2. Subsequent recoveries in fair value should not restore losses on the income statement.

3. For debt securities held to maturity, any loss due to other factors recorded in other comprehensive income is amortized over the remaining life of the debt security with the offset being an increase in carrying value of the debt security until it is sold.

i. Balance sheet classification- debt securities

ASU 2016-01 retains existing guidance on the balance sheet classification of securities with a new focus only on debt securities in ASC 320.

Under the rule, an entity shall report its investments in available-for-sale debt securities and trading debt securities *separately* from similar assets that are subsequently measured using another measurement attribute on the face of the statement of financial position.

In doing so, an entity shall do *either* of the following:

- Present the aggregate of those *fair value and non-fair-value amounts* in the same line item and parenthetically disclose the amount of fair value included in the aggregate amount, or

- Present two separate line items to display the fair value and non-fair-value carrying amounts.

Note: Entities also shall refer to the guidance in ASC 825, *Financial Instruments*, on disaggregation of financial assets and financial liabilities by measurement category and form of financial asset (that is, securities or loans and receivables).

That guidance states:

> "An entity shall *separately present financial assets and financial liabilities by measurement category* and form of financial asset (such as securities or loans and receivables) in the statement of financial condition or the accompanying notes to the financial statements."

Current vs. long-term on the balance sheet- debt securities

ASU 2016-01 retains the existing rules for determining the classification of debt securities as current versus long-term on the balance sheet as follows:

a. An entity that presents a classified statement of financial position shall report individual held-to-maturity debt securities, individual available-for-sale debt securities, and individual trading debt securities as *either current or noncurrent*, based on the guidance of ASC 210-10-45, *Balance Sheet.*

   1) In general, that results in debt securities being presented as follows:

      - Held to maturity - current or long-term based on the maturity date

- Trading securities- current[19]
- Available for sale- typically current or long-term based on management's intent.[20]

j. Statement of cash flows presentation- debt securities

Trading -debt securities

Questions:

How should the unrealized gain or loss recorded on debt securities classified as trading be presented on the statement of cash flows?

How should the purchases and sales of debt securities classified as trading be presented on the statement of cash flows?

Response: The following rules apply:

a. The unrealized gain on ***trading securities*** should be presented on the income statement. The gain should be shown as an ***adjustment in the operating activities*** section of the statement of cash flows if the indirect method is used. If the direct method is used, the transaction is not presented in the statement.

b. Cash flows related to the purchase and sale of debt securities categorizes as trading are typically presented as inflows and outflows within the ***operating activities*** section.

   Note: ASC 230-10-45-19, *Statement of Cash Flows*, provides that cash receipts and payments resulting from the purchase and sales of securities classified as trading debt securities shall be classified on the statement of cash flows *"based on the nature and purpose for which the securities were acquired."* Because, in most cases, trading debt securities are purchased for the sole purpose of selling them within a short period of time, the cash flows related to those trading debt securities should be shown in the operating activities section.

[19] ASCC 320 indicates that with respect to trading securities, the entity's intent is to sell them in the near term (usually within one year of the balance sheet date) and will be held for only a short period of time. Therefore, if a security is acquired with the intent of selling it within hours or days, clearly the security must be classified as trading and presenting the security as a current asset. In fact, ASC 210-10-45-1(f), *Balance Sheet- Classification of Current Assets,* states that a current asset includes a debt securities that are classified as trading securities. Thus, the general rule is that debt securities classified as trading securities are presented as current on the balance sheet. However, a security may be classified as trading even if management intends to sell the security beyond one year. The FASB deliberately used the terms "generally" and "principally" in describing the trading category. Thus, there are instances, albeit rare, in which a trading security may be presented as a long-term asset due to the holder's intent to sell the security outside the current operating cycle (e.g., generally beyond one year from the balance sheet date).

[20] In general, debt securities classified as available-for-sale should be classified as current or long-term based on management's intent to use those funds within the current operating cycle even if it does not intend to sell the debt securities within that cycle. ASC 210-10-45-1(f*), Balance Sheet- Classification of Current Assets,* states that a current asset includes marketable securities "representing an investment of cash available for current operations."

Example:

Company X has the following information for the year ended December 31, 20X1 related to its trading debt securities:

Unrealized gain	$100,000
Purchases of trading debt securities	(2,000,000)
Proceeds from sales of trading debt securities	2,800,000

Conclusion:

The transactions are presented on the statement of cash flows as follows:

Cash flow from operating activities:	
Net income	$XX
Adjustments:	
Depreciation	XX
Deferred income taxes	(XX)
Unrealized gain on trading debt securities	**(100,000)**
	XX
Changes in:	
accounts receivable	(XX)
Inventory	XX
Accounts payable and accrued expenses	XX
Trading securities (1)	**800,000**[21]
Net cash from operating activities	XX
Cash flow from investing activities:	Not shown
Cash flow from financing activities:	Not shown
Increase (decrease) in cash and cash equivalents	XX
Cash and cash equivalents:	
Beginning of year	XX
End of year	$XX

Presented net as follows: Proceeds $2,800,000 – Purchases $(2,000,000) = $800,000

Available-for-sale -debt securities

Example 2: Same facts except the investment is classified as available-for-sale.

[21] ASC 230 permits certain cash flows to be presented net versus gross, if such items turnover quickly, are large and the maturities are short. In most instances, the cash flows related to trading debt securities qualify for net cash flow treatment.

Questions:

How should the unrealized gain or loss recorded on the debt securities classified as available-for-sale be presented on the statement of cash flows?
How should the purchases and sales of debt securities be presented on the statement of cash flows classified as available-for-sale?

Response: The following rules apply:

The unrealized gain on securities *available for sale* is presented as other comprehensive income in stockholders' equity, net of applicable federal and state income taxes. Consequently, there is no cash flow effect and no presentation of the unrealized gain on the statement of cash flows.

Any realized gains from the sales of available-for-sale debt securities are shown as adjustments to cash flow from operating activities.

Cash flows related to the purchase and sales of available-for-sale debt securities are presented as cash inflows and outflows in the investing activities section. In most cases, the purchases and sales are presented gross, not net.

Example:

Company X has debt securities classified as available for sale.

Assume that the tax rate is 40%, the net gain is as follows:

Unrealized gain- available for sale debt securities	$100,000
Tax effect: deferred income taxes	(40,000)
Net unrealized gain presented in stockholders' equity (other comprehensive income)	$60,000

Entry:	dr	cr
Allowance for appreciation	100,000	
Deferred income tax liability		40,000
Unrealized gain (stockholders' equity)		60,000

Assume further:

Realized gain on sale of available-for-sale debt securities	$200,000
Purchases of available-for-sale debt securities	(2,000,000)
Proceeds from sales of available-for sale debt securities	3,000,000

Conclusion:

- There is no presentation on the statement of cash flows of the net unrealized gain on the debt security classified as available for sale.

- Because the net unrealized gain of $60,000 does not affect cash or flow through the income statement, the transaction is not presented on the statement of cash flows. In analyzing the change in the investment account in the preparation of the statement of cash flows, the $100,000 change should be ignored along with the $40,000 change in deferred income taxes and the $60,000 unrealized gain in stockholders' equity.

- The realized gain on sale of $200,000 is an adjustment of cash from operating activities.

- The purchases of $2,000,000 and proceeds from sales ($3,000,000) are shown in the investing activities section.

Cash flow from operating activities:	
Net income	$XX
Adjustments:	
Depreciation	XX
Deferred income taxes	(XX)
Gain on sale of available-for-sale debt securities	**(200,000)**
	XX
Changes in:	
Accounts receivable	(XX)
Inventory	XX
Accounts payable and accrued expenses	XX
Net cash from operating activities	XX
Cash flow from investing activities:	
Purchase of available-for-sale debt securities	**(2,000,000)**
Proceeds from sales of available-for-sale debt securities	**3,000,000**
Net cash from investing activities	XX
Cash flow from financing activities:	Not shown
Increase (decrease) in cash and cash equivalents	XX
Cash and cash equivalents:	
Beginning of year	XX
End of year	$XX

k. Disclosures- debt securities

ASU 2016-01 *does not make any substantive changes to the existing disclosures required for debt securities in ASC 320*.

The exception is that it does modify the disclosure immediately below related to debt securities in an unrealized loss position for which *other-than-temporary impairments have not been recognized in earnings*.

Such a situation would occur respect to:

- Debt securities held to maturity, or
- Available-for-sale debt securities

Additional disclosure: Impairment of debt securities- ASU 2016-01

For debt securities in an unrealized loss position, for which any *other-than-temporary impairments have not been recognized* in earnings, an entity shall disclose all the following in its interim and annual financial statements:

a. As of each date for which a statement of financial position is presented, quantitative information, aggregated by category of investment-each major security type that the entity discloses in tabular form:

   - The aggregate related fair value of investments with unrealized losses
   - The aggregate amount of unrealized losses (that is, the amount by which amortized cost basis exceeds fair value).

There are other minor edits to the disclosure which are noted below.

Example Disclosure: Investments in an Unrealized Loss Position that Are Not Other-Than-Temporarily Impaired

The following is a sample disclosure extracted from ASC 320, as amended and as modified by the author.

The disclosure presents the table that includes the gross unrealized losses and fair value of Company A's investments with unrealized losses that are not deemed to be other-than-temporarily impaired (in millions), aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at December 31, 20X3.

It describes the investor's rationale for not recognizing all unrealized losses presented in the table as other-than-temporary impairments. The investor shall provide meaningful disclosure about individually significant unrealized losses.

To facilitate the narrative disclosures and for simplicity, this Example presents only the quantitative information as of the date of the latest statement of financial position. That information is required as of each date for which a statement of financial position is presented, except in the period of initial application of the other-than-temporary impairment guidance.

NOTE X:	**Less than 12 months**		**12 months or greater**		**Total**	
	Fair Value	**Unrealized losses**	**Fair value**	**Unrealized losses**	**Fair value**	**Unrealized losses**
U.S. Treasury obligations and direct obligations of U.S. government agencies	$172	$2	$58	$1	$230	$3
Federal agency mortgage-backed Securities	367	5	18	1	385	6
Corporate bonds	150	7	0	0	150	7
Total	$689	$14	$76	$2	$765	$16

U.S. Treasury obligations: The unrealized losses on Entity A's investments in U.S. Treasury obligations and direct obligations of U.S. government agencies were caused by interest rate increases. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost basis of the investments. Because Entity A does not intend to sell the investments and it is not more likely than not that Entity A will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, Entity A does not consider those investments to be other-than-temporarily impaired at December 31, 20X3.

Federal agency mortgage-backed securities: The unrealized losses on Entity A's investment in federal agency mortgage-backed securities were caused by interest rate increases. Entity A purchased those investments at a discount relative to their face amount, and the contractual cash flows of those investments are guaranteed by an agency of the U.S. government. Accordingly, it is expected that the

securities would not be settled at a price less than the amortized cost basis of Entity A's investments. Because the decline in fair value is attributable to changes in interest rates and not credit quality, and because Entity A does not intend to sell the investments and it is not more likely than not that Entity A will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, Entity A does not consider those investments to be other-than-temporarily impaired at December 31, 20X3.

Corporate bonds: Entity A's unrealized loss on investments in corporate bonds relates to a $150 investment in Entity B's Series C Debentures. Entity B is a manufacturer. The unrealized loss was primarily caused by a recent decrease in profitability and near-term profit forecasts by industry analysts resulting from intense competitive pricing pressure in the manufacturing industry and a recent sector downgrade by several industry analysts. The contractual terms of those investments do not permit Entity B to settle the security at a price less than the amortized cost basis of the investment. While Entity B's credit rating has decreased from A to BBB (Standard & Poor's), Entity A currently does not expect Entity B to settle the debentures at a price less than the amortized cost basis of the investment (that is, Entity A expects to recover the entire amortized cost basis of the security). Because Entity A does not intend to sell the investment and it is not more likely than not that Entity A will be required to sell the investment before recovery of its amortized cost basis, which may be maturity, it does not consider the investment in Entity B's debentures to be other-than-temporarily impaired at December 31, 20X3.

-end of disclosure-

l. Other issues- debt securities

Short Sales of Debt Securities

Sales of securities that the seller does not own at the time of sale, are obligations to deliver securities, and are not considered debt securities.

Scope Application: No Look-Through Permitted- Debt Securities

An entity should not look through the form of its investment to the nature of the securities held by an investee to determine whether the scope of revised ASC 320, *Investments—Debt Securities.*

Example: An entity invests in a limited partnership interest (or a venture capital entity) that meets the definition of an equity security. However, substantially all of the partnership's assets consist of investments in debt securities.

Conclusion: It is not appropriate to look through the form of an investment to determine whether it is a debt security.

In the specific example, the investment would be considered an equity security, and not a debt security. Therefore, ASC 320 would not apply to that type of investment.

Another example of an investment that is considered an equity security is an investment in a mutual fund that invests only in U.S. government debt 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.

1. Company X has an investment in the bonds issued by Company Y that are traded on a public exchange. X has not decided what it wants to do with the bonds as it has no plans to sell the bonds or hold them until they mature. How should X measure and record the bonds on its financial statements:
   a. At amortized cost
   b. At fair value with the unrealized gain or loss recorded on the income statement
   c. At fair value with the unrealized gain or loss recorded in stockholders' equity
   d. At market value

2. Company Z has an investment in a debt security that is categorized as held to maturity. Z wants to transfer the security from the held-to-maturity category to another category but understands that transfers should be rare. Which of the following would be an excellent excuse that Z could use to legitimately justify the transfer:
   a. Creditworthiness of the debt issuer has improved significantly
   b. A change in the tax law significantly improves the tax-exempt status of interest on the debt maturity
   c. The investment now qualifies as a permissible investment when it did not qualify, previously
   d. X has a major acquisition that requires X to transfer the security

3. Big Al is a CPA who is auditing Company B. Al is assessing whether a specific debt security impairment is other than temporary. Which of the following is a factor that Al should consider in determining whether the security impairment is other than temporary:
   a. If the entity plans to hold onto the investment for at least five years
   b. Whether it is probable that B will be required to sell the security
   c. Whether B expects to recover the fair value of the investment
   d. The extent to which the investment is collectible

4. Bruce Springsteen CPA is preparing financial statements for a client. The client has an investment in a debt security that the client purchased with the intent of selling it. At the end of the year, the fair value of the security has increased by $100,000. How should Bruce present the $100,000 increase on the entity's statement of cash flows:
   a. As financing activities
   b. As a decrease in investing activities
   c. As an adjustment in operating activities
   d. As a disclosure only

SUGGESTED SOLUTIONS

1. Company X has an investment in the bonds issued by Company Y that are traded on a public exchange. X has not decided what it wants to do with the bonds as it has no plans to sell the bonds or hold them until they mature. How should X measure and record the bonds on its financial statements:
   a. Incorrect. The investment would be recorded at amortized cost if it were categorized as held to maturity. Because X has not committed to holding the investment until maturity, categorizing the investment as held to maturity is not appropriate.
   b. Incorrect. Recording the investment at fair value with the unrealized gain or loss recorded on the income statement is the approach used for an investment in debt security categorized as a trading security. Because X did not purchase the investment with the intent to sell it, the investment should not be categorized as a trading security.
   c. Correct. The investment in the debt security is categorized as available for sale which measures the investment at fair value with the unrealized gain or loss recorded in stockholders' equity as part of other comprehensive income, net of the tax effect. The available-for-sale classification is appropriate when the investment does not qualify to be classified as either held to maturity or trading. Thus, the answer is correct.
   d. Incorrect. The term "market value" is not used to measure investments in debt securities and is not a term that is synonymous with fair value.

2. Company Z has an investment in a debt security that is categorized as held to maturity. Z wants to transfer the security from the held-to-maturity category to another category but understands that transfers should be rare. Which of the following would be an excellent excuse that Z could use to legitimately justify the transfer:
   a. Incorrect. A deterioration in the issuer's creditworthiness, not an improvement, would be an excellent reason for Z to reclassify the debt from held-to-maturity to another category. Obviously, if the quality of debt is deteriorating, Z would not want to hold it until maturity.
   b. Incorrect. A change in the tax law that negatively impacts (rather than improves) the tax-exempt status of interest on the debt maturity is a good reason because the tax benefit of holding the security until maturity would deteriorate.
   c. Incorrect. One reason for transferring from the held-to-maturity category is a situation in which there is a change in statutory or regulatory requirements so that the investment is not a permissible asset to hold. In such a situation, the entity would be justified in deciding to no longer classify the investment as held to maturity, as it is no longer likely it will hold it until maturity.
   d. Correct. One acceptable reason would be if X has a major acquisition that requires X to transfer the security for various reasons which might include the need to maintain the entity's current interest rate risk position or credit risk policy. Or, another reason is that the acquisition results in a violation of a loan covenant that can be remedied by reclassifying the debt security from the held-to-maturity category.

3. Big Al is a CPA who is auditing Company B. Al is assessing whether a specific debt security impairment is other than temporary. Which of the following is a factor that Al should consider in determining whether the security impairment is other than temporary:
   a. Incorrect. One factor to consider is if the entity plans to sell the security, not hold it for 5 years.
   b. Incorrect. One factor is whether it is more likely than not (rather than probable) that B will have to sell the security before B can recover the cost based on contractual or regulatory obligations. Thus, the probable threshold is not used in ASU 2016-01, and is not correct.

c. Incorrect. One factor is whether B expects to recover the amortized cost, not the fair value of the investment, making the answer incorrect.

d. Correct. One factor that B should consider is the collectability of the debt security, and other factors that might include the remaining payment terms, prepayment speeds, financial condition of the issuer, expected defaults, and value of any underlying collateral.

4. Bruce Springsteen CPA is preparing financial statements for a client. The client has an investment in a debt security that the client purchased with the intent of selling it. At the end of the year, the fair value of the security has increased by $100,000. How should Bruce present the $100,000 increase on the entity's statement of cash flows:

a. Incorrect. First of all, financing activities relate to financing transactions and have nothing to do with investments. Thus, the answer is incorrect.

b. Incorrect. Under GAAP, none of the activity related to trading securities is presented in investing activities, making the answer incorrect.

c. Correct. GAAP provides that activity related to debt securities classified as trading, is presented in the operating activities section of the statement of cash flows. The unrealized gain or loss is presented as an adjustment in the operating activities section.

d. Incorrect. GAAP does not provide for disclosing the transaction only.

V. Rules – Equity Securities

ASU 2016-01 introduces new ASC 321, *Investments—Equity Securities*.

Previously, the accounting for investments in equity securities was found in ASC 320, which included the accounting for both investments in debt and equity securities. With ASU 2016-01, the rules have been split so that now, ASC 320 provides guidance on debt securities, while new ASC 321 provides the rules for equity securities.

a. Scope of ASC 321

The guidance in the *Investments—Equity Securities* ASC 321 applies to all entities, including the following entities that are not deemed to be specialized industries for purposes of ASC 321:

- Cooperatives and mutual entities (such as credit unions and mutual insurance entities)
- Trusts that do not report substantially all of their securities at fair value

The guidance in ASC 321 *does not apply* to the following:

1) Entities in certain specialized industries whose specialized accounting practices include accounting for substantially all investments at fair value, with changes in value recognized in earnings (income) or in the change in net assets.

   Examples of those excluded entities are:

   - Brokers and dealers in securities (ASC 940)
   - Defined benefit pension and other postretirement plans (ASC 960, 962, and 965),
   - Investment companies (ASC 946).

2) Derivative instruments that are subject to the requirements of ASC 815, *Derivatives and Hedging*, including those that have been separated from a host contract as required by ASC 815-15-25.

3) Investments accounted for under the equity method (per ASC 323).

4) Investments in consolidated subsidiaries.

5) An exchange membership that has the characteristics specified in ASC 940-340-25-1(b), *Financial Services- Brokers and Dealers*, for an ownership interest in the exchange.

6) Federal Home Loan Bank and Federal Reserve Bank Stock.

b. Instruments

ASC 321, *Investments—Equity Securities* establishes standards of financial accounting and reporting for:

1) Investments in equity securities, and

b) Other ownership interests in an entity.

It includes:

- Investments in partnerships
- Unincorporated joint ventures
- Limited liability companies as if those other ownership interests are equity securities, and
- Investments in closely held stock

ASC 321 does not apply to equity securities of an entity if those investments are:

- Accounted for using the equity method, or
- Consolidated.

Thus, in general, such equity securities consist of investments of less than 20% of the voting shares, in most cases.

What is the definition of an equity security?

In general, the term "security" is defined as *any form of ownership* and extends beyond an instrument that is traded on a public exchange.

However, as used in ASC 321, an "equity security" is defined as:

> "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."

The definition, as used in ASC 321, includes *all equity investments* including:

- Equities publicly traded on an exchange, and
- Closely held equity investments (such as closely held stock and LLC interests).

ASC 321 provides that certain instruments are not considered equity securities such as:

a. Written equity options (because they represent obligations of the writer)

b. Cash-settled options on equity securities or options on equity-based indexes (because those instruments do not represent ownership interests in an entity)

c. 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.

Observation: It is common to consider a "security" to be an investment that is publicly traded. Yet, the definition of an equity security found in ASC 321 expands well beyond publicly traded instruments and includes most ownership interests including those closely held. Thus, in applying ASC 321, a company should consider all of its investments in equities including both publicly traded investments

and investments in closely held stock or other equity interests, such as those in LLCs, trusts, and partnerships.

Note further that an equity security excludes investments that are measured using the equity method (generally 20-50% ownership) or consolidated (generally more than 50% ownership).

c. Definitions- ASC 321

ASC 321 provides certain definitions which are summarized in the following chart.

Definitions- ASC 321

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. The term equity security *does not* include any of the following:

a. Written equity options (because they represent obligations of the writer, not investments)
b. Cash-settled options on equity securities or options on equity-based indexes (because those instruments do not represent ownership interests in an entity)
c. 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.

Holding Gain or Loss: The net change in fair value of a security. The holding gain or loss does not include dividend or interest income recognized but not yet received or write-downs for impairment.

Market Participants: Buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics:

a. They are independent of each other, that is, they are not related parties, although the price in a related-party transaction may be used as an input to a fair value measurement if the reporting entity has evidence that the transaction was entered into at market terms.
b. They are knowledgeable, having a reasonable understanding about the asset or liability and the transaction using all available information, including information that might be obtained through due diligence efforts that are usual and customary.
c. They are able to enter into a transaction for the asset or liability.
d. They are willing to enter into a transaction for the asset or liability, that is, they are motivated but not forced or otherwise compelled to do so.

Orderly Transaction: A transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale)

Readily Determinable Fair Value: An equity security has a readily determinable fair value if it meets any of the following conditions:

a. The fair value of an equity security is readily determinable if sales prices or bid-and-asked quotations are currently available on a securities exchange registered with the U.S. Securities and Exchange Commission (SEC) or in the over-the-counter market, provided that those prices or quotations for the over-the-counter market are publicly reported by the National Association of Securities Dealers Automated Quotations (NASDAQ) systems or by OTC Markets Group Inc. Restricted stock meets that definition if the restriction terminates within one year.
b. The fair value of an equity security traded only in a foreign market is readily determinable if that foreign market is of a breadth and scope comparable to one of the U.S. markets referred to above.
c. The fair value of an equity security that is an investment in a mutual fund or in a structure similar to a mutual fund (that is, a limited partnership or a venture capital entity) is readily determinable if the fair value per share (unit) is determined and published and is the basis for current transactions.

Related Parties: Related parties include:

a. Affiliates of the entity
b. Entities for which investments in their equity securities would be required, absent the election of the fair value option under the Fair Value Option Subsection of Section 825-10-15, to be accounted for by the equity method by the investing entity
c. Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management
d. Principal owners of the entity and members of their immediate families
e. Management of the entity and members of their immediate families
f. Other parties with which the entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests
g. Other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

Security: A share, participation, or other interest in property or in an entity of the issuer or an obligation of the issuer that has all of the following characteristics:

a. It is either represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer.
b. It is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment.
c. It either is one of a class, or series or by its terms, is divisible into a class or series of shares, participations, interests, or obligations.

d. Measurement- equity securities

Investments in *equity securities* shall be measured subsequently as follows:

- At fair value in the statement of financial position, and
- Unrealized holding gains and losses for equity securities shall be included in *earnings*.

The three categories previously used to categorize investments in securities (held to maturity, trading, and available for sale) no longer apply to equity securities.

Example: Company X has a 15 percent investment in Company Y, a publicly traded entity with a readily determinable fair value. At December 31, 2019, the investment in Y is carried on X's balance sheet at fair value of $1,700,000 in accordance with ASU 2016-01.

The general ledger carries the $1,700,000 as follows:

Investment cost	$1,200,000
Allowance for unrealized gain at December 31, 2019	500,000
Investment- fair value- December 31, 2019	$1,700,000

At December 31, 2020, the fair value of X's investment in Y's stock has increased to $2,000,000.

Conclusion: In accordance with ASU 2016-01, an equity investment is recorded at fair value with the change in the unrealized gain or loss recorded on the income statement.

At December 31, 2020, the fair value has increased from $1,700,000 to $2,000,000 as follows:

	Dec 31, 2019	Dec 31, 2020	Entry Dec 31, 2020
Investment cost	$1,200,000	$1,200,000	
Allowance- unrealized gain	500,000	800,000	$300,000
Investment- fair value	$1,700,000	$2,000,000	$300,000

X makes the following entry at December 31, 2020:

Entry at December 31, 2020:	dr	cr
Allowance for unrealized gain	300,000	
Unrealized gain on equity securities		**300,000

** Presented on the 2020 income statement

The investment is presented on the December 31, 2020 balance sheet at fair value of $2,000,000 as follows:

Company X
Balance Sheet
December 31, 2020

Investments:	
Investment in Y common stock, at fair value	***$2,000,000***

Company X
Statement of Income
For the Year ended December 31, 2020

Net Sales	$XX
Cost of goods sold	XX
Gross profit	XX
Operating expenses	XX
Income from operations	XX
Other income:	
Unrealized gain on equity securities	***300,000***
Net income before income taxes	XX
Income taxes	XX
Net income	$XX

e. Exception: Equity securities without readily determinable fair values

An entity has *two choices* in measuring the equity security *without a readily determinable fair value*:

- Record the investment at fair value, or
- Elect to use an (optional practical expedient) *Optional Formula*[22] as noted below.

[22] The optional formula is available only if the entity does not qualify for the practical expedient to estimate fair value in accordance with ASC 820-10-35-59, *Fair Value Measurement*). ASC 820-10-35-59, *Fair Value Measurement,* offers a practical expedient to estimate fair value for a reporting entity that meets two criteria. a) The investment does not have a readily determinable fair value, and b) The investment is in an investment company or is an investment in a real estate fund for which it is industry practice to measure investment assets at fair value on a recurring basis and to issue financial statements using the measurement principles of ASC 946, *Financial Services- Investment Companies.* Few entities qualify for this practical expedient.

OPTIONAL FORMULA

Equity security without a readily determinable fair value:

	Cost	$X
-	Minus: Impairment loss	(X)
+/ -	Plus or minus: Changes resulting from ***observable price changes*** in orderly transactions for the ***identical or a similar investment of the same issuer.***	X
	Value of equity security- without a readily determinable fair value	$X

1) An election to measure an equity security using this *Optional Formula* shall be made for each investment separately.

2) Once an entity elects to measure an equity security using the *Optional Formula* above, the entity shall continue to apply the measurement until the investment does not qualify to be measured using the Optional Formula.

   Examples of situations in which the investment *no longer qualifies* to be measured using the Option Formula follow:

   - The investment fair value becomes readily determinable, or

   - The investment becomes eligible for the practical expedient to estimate fair value in accordance with paragraph 820-10-35-59, *Fair Value Measurements*.[23]

3) At each reporting period, the entity shall reassess whether the equity security without a readily determinable fair value qualifies to be measured using the Optional Formula.

Note: Under GAAP in effect prior to ASU 2016-01, an investment in equity securities that did not have a readily determinable fair value and that was not accounted for by the equity method or consolidated, was measured at cost, less any impairment that was determined to be other than temporary.

In ASU 2016-01, the FASB sought to provide an improvement to use of the cost method by requiring those investments to be measured using the Optional Formula. Most respondents told the FASB favored use of the Optional Formula because it reduces the complexity, increases operability, and is an improvement over the cost method.

How does one identify observable price changes to adjust an equity security without a readily determinable fair value?

[23] ASC 820-10-35-59, *Fair Value Measurement*, offers a practical expedient to estimate fair value for a reporting entity that meets two criteria. a) The investment does not have a readily determinable fair value, and b) The investment is in an investment company or is an investment in a real estate fund for which it is industry practice to measure investment assets at fair value on a recurring basis and to issue financial statements using the measurement principles of ASC 946, *Financial Services- Investment Companies.* Few entities qualify for this practical expedient.

ASC 321-10-55-8 provides little guidance:

> *"To identify observable price changes, an entity should consider relevant transactions that occurred on or before the balance sheet date that are known or can reasonably be known. To identify price changes that can reasonably be known, the entity should make a reasonable effort (that is without expending undue cost and effort) to identify any observable transactions that it may not be readily aware of. The entity need not conduct an exhaustive search for all observable price changes."*

How does one identify an identical or similar investment of the same issuer to adjust an equity security without a readily determinable fair value?

ASC 321-10-55-9 states the following:

> *"To identify whether a security issued by the same issuer is similar to the equity security held by the entity, the entity should consider the different rights and obligations of the securities.*
>
> *Differences in rights and obligations could include characteristics such as voting rights, distributions rights and preferences, and conversion features. The entity should adjust the observable price of a similar security for the different rights and obligations to determine the amount that should be recorded as an upward or downward adjustment in the carrying value of the security….. to reflect the current fair value of the security."*

What happens if there are no observable price changes of identical or similar investments?

Then, there would be no adjustments. Instead, one would measure the value of the investment at cost minus any impairment losses recorded.

Example:

Company X has an investment in 10% of the closely held stock of Company Y. The cost of the investment is $100,000. For the year ended December 31, 2019, there is no evidence of impairment in the investment in Y. Further, there are no purchases or sales of the investment in Y and no purchases or sales of investments in identical or similar investments in Y. X elects the Optional Formula to value its investment in Y in 2019.

Conclusion:

For 2019, X should value the investment using the Optional Formula. That means, on January 1, 2019, X uses the $100,000 beginning cost, and adjusts it for an impairment loss in 2019, and any changes in observable price changes from identical or similar transactions in Y. For 2019, the facts in the example state that there are no purchases or sales of Y's stock to X or to other investors.

For year ending December 31, 2019, X values the investment in X as follows;

	Cost	$100,000
-	Minus: Impairment loss	(0)
+/-	Plus or minus: Changes resulting from ***observable price changes*** in orderly transactions for the ***identical or a similar investment of the same issuer.***	(0)
	Value of equity security- without a readily determinable fair value	$100,000

Because there are no changes due to impairment losses or purchases and sales of identical or similar investments in Y, there are no adjustments to the $100,000 cost. Thus, on December 31, 2019, the Company presents the investment on the balance sheet at $100,000, computed by the Optional Formula.

Change the facts:

In 2019, X learns that another investor in Y sold his 15% ownership in Y's voting shares for $240,000. The shares sold have no different rights than the 10% shares owned by X.

Conclusion:

Using the Optional Formula, X should adjust the carrying amount of its investment in Y as follows:

	Cost	$100,000
-	Minus: Impairment loss	(0)
+	Plus change resulting from an observable price change from sale of Y stock to other party	60,000
	Value of equity security- without a readily determinable fair value	$160,000

Calculation: $240,000 x 10%/15% = $160,000.
$160,000 less $100,000 = $60,000 adjustment.

Entry: December 31, 2019:	dr	cr
Allowance for unrealized gain**	60,000	
Unrealized gain on equity securities		60,000

** Added to $100,000 investment carrying amount on the balance sheet, to present the investment at $160,000 at December 31, 2019. Alternatively, the $60,000 adjustment can be recorded directly to the investment cost.

Observation: Under the new ASC 321 rules, all equity investments (with few exceptions) must be measured and recorded at fair value with the unrealized gain or loss recorded on the income statement. However, if a particular equity investment's fair value is not readily determinable, that entity would have a problem determining fair value. Thus, ASC 321 provides an optional formula to use. Under this formula, an entity uses its cost as a base, then builds on that cost by reducing it for any impairment losses recognized. Then, it increases or decreases that base amount for any changes that can be determined in the observable price changes of similar or identical investments of the same issuer.

The problem is that in many instances, it may be impossible to determine the observable price change as there may not be an open market.

ASC 321-10-55-8 is quite clear that in determining observable price changes for an equity investment without a readily determinable fair value, two rules apply:

- The effort should be done "*without expending undue cost and effort*," and
- The entity "*need not conduct an exhaustive search*" for all observable price changes.

The reality is that unless there is an actual sale of a portion of the investment to a third party, there will be no observable price changes to the investment. Thus, absent a purchase or sale transaction and assuming there is no evidence of an impairment, the investment will remain at the original cost on the balance sheet.

What about the previous rules for investments in closely held stock found in ASC 325?

Prior to the application of ASU 2016-01, investments in closely held stock have been recorded and measured at cost with writedowns for any other-than-temporary impairment losses. Those rules have been found in ASC 325, *Investments- Other*. ASU 2016-01 amends most of ASC 325 to eliminate the cost rule for investments in closely held stock. Now, all investments in equity securities (including closely held stock) must be measured at fair value under ASC 321 unless the equity method or consolidation applies.

However, if the fair value is *not readily determinable* (which is the case for most investments in closely held stock or other equity), an entity has the option to measure the equity security using the optional practical expedient (Optional Formula) (cost minus impairment losses plus or minus the change in the observable value of identical or similar investments by the same issuer). If an entity does not elect the Optional Formula, it must default to valuing the investment at fair value. ASU 2016-01 does not offer a third alternative.

f. Impairment of equity securities without readily determinable fair values

Equity investments recorded at fair value have no impairment loss because the investment is already recorded at fair value at any financial statement date.

With respect to investments in equity securities *without a readily determinable fair value*, the situation is different if an entity uses the Optional Formula. In such an instance, the investment may be recorded at fair value so that an impairment loss would impact the carrying amount of the investment.

New one-step impairment model

ASC 321 provides a *new one-step impairment test* for investments in equity securities without a readily determinable fair value.
In accordance with the impairment rules, an equity security *without a readily determinable fair value* shall be tested for impairment using a *qualitative assessment*.

An equity security without a readily determinable fair value shall be written down to its fair value if a *qualitative assessment* indicates that:

- The investment is impaired, and
- The fair value of the investment is less than its carrying value (as measured using the optional formula.

Qualitative assessment

At each reporting period, an entity that holds an equity security without a readily determinable fair value, shall make a qualitative assessment considering impairment indicators to evaluate whether the investment is impaired. Impairment indicators that an entity considers include, but are not limited to, the following:

a. A significant deterioration in the earnings performance, credit rating, asset quality, or business prospects of the investee

b. A significant adverse change in the regulatory, economic, or technological environment of the investee

c. A significant adverse change in the general market condition of either the geographical area or the industry in which the investee operates

d. A bona fide offer to purchase, an offer by the investee to sell, or a completed auction process for the same or similar investment for an amount less than the carrying amount of that investment, and

e. Factors that raise significant concerns about the investee's ability to continue as a going concern, such as negative cash flows from operations, working capital deficiencies, or noncompliance with statutory capital requirements or debt covenants.

If an equity security without a readily determinable fair value *is impaired* based on a qualitative assessment, an entity shall include an impairment loss in net income based on the following formula:

Fair value	$XX
Carrying amount (1)	XX
Unrealized loss (income statement)	$(XX)

(1) Carrying amount is measured using the optional formula: Cost – impairment losses recorded previously +/- the increase or decrease in the value of identical or similar investments in the same entity.

That is, if the investment is deemed to be impaired after conducting the qualitative assessment , the entity shall estimate the fair value of the investment to determine the amount of the impairment loss.

Is an entity permitted to reverse an impairment writedown in a subsequent period?

There is nothing in ASC 321 that specifically addresses recovery of writedowns. However, other guidance found in ASC 320 (debt securities) suggests the following rules apply:

a. Once an equity security without a readily determinable fair value is written down for an impairment loss, the writedown amount becomes the new carrying amount.

b. In subsequent periods, the new carrying amount is used to compare with the value determined using the Optional Formula to record an unrealized gain or loss recorded on the income statement.

Observation: The flaw in the above impairment model for an equity security without a readily determinable value is that the model requires use of fair value to measure that impairment loss. The rule is circular in that by definition, the entity cannot determine the fair value of the security. Yet, fair value must be obtained to measure the impairment loss.

Note: Existing GAAP prior to ASU 2016-01 requires cost method investments to be assessed for impairment based on whether the carrying amount is higher than the fair value of the investment. However, those rules state that impairment is not recognized unless it is determined to be *other than temporary* even if the carrying amount is higher.

In ASU 2016-01, the FASB decided to use a one-step test for recognizing impairment of equity securities without readily determinable fair values. According to the FASB, the one-step method is simpler and likely to result in more decision-useful information for users of financial statements than the current two-step method. The FASB also notes that the one-step method permits subsequent reversals of impairment losses in certain situations. The method of determining the carrying amount of an investment in equity securities without readily determinable fair values includes observable price increases. Thus, if the price of an equity security without a readily determinable fair value (or a similar security of the same issuer) increases, the entity in effect would "reverse" the previously recognized impairment to the extent of the subsequent observable price increase.

g. Equity securities previously accounted for under the equity method- equity method is no longer appropriate

The general rule is that an investment is recorded using the equity method if the investor has significant influence over the investee. Significant influence is assumed if there is ownership of 20- 50% of the voting shares.

ASU 2016-01 states:

> "If an equity security *no longer qualifies* to be accounted for under the equity method, the security's initial basis shall be the previous carrying amount of the investment when it was recorded using the equity method."

Example: An entity's level of ownership decreases below 20% and it no longer qualifies for use of the equity method due to:

- A sale of a portion of an investment by the investor
- Sale of additional stock by an investee
- Other transactions where the investor loses significant influence over the investee

In this instance, the following rules apply:

- An investor shall discontinue recording its share of investee earnings or losses of the investee for an investment that no longer qualifies for the equity method.

- The earnings or losses that relate to the stock retained by the investor and that were previously accrued shall remain as a part of the carrying amount of the investment.

- The investment account shall not be adjusted retroactively.

- The adjusted basis resulting from previous use of the equity method becomes the equity security's basis from which subsequent changes in fair value are measured.

- Subsequently, the equity security shall be accounted for at fair value using the ASC 321 rules noted below.

Example: Company X has a 20 percent investment in Company Y and has significant influence in Y. Thus, X uses the equity method to account for its investment in Y through December 31, 2015. In doing so, X records its share of Y's income through the investment account through December 31, 2015, resulting in an investment carrying amount of $2,000.000.

On January 1, 2016, X sells 10 percent of its investment in Y and no longer has significant influence.

At December 31, 2016, the fair value of X's investment in Y's stock is $2,200,000.

Conclusion: Because X no longer has significant influence, effective January 1, 2016, it no longer qualifies to use the equity method to account for its investment in Y. That means that X should account for its investment at fair value and measure the investment at fair value at December 31, 2016.

In doing so, at December 31, 2016, the carrying amount (adjusted basis) of the investment while it was measured using the equity method ($2,000,000) is compared with the fair value of $2,200,000, with the resulting unrealized gain of $200,000 recorded in X's 2016 income statement as follows:

At December 31, 2016:	
Fair value	$2,200,000
Carrying amount	2,000,000
Unrealized gain (income statement)	$ 200,000

Entry:	dr	cr
Allowance for unrealized gain**	200,000	
Unrealized gain on equity securities		200,000

** Added to $2,000,000 investment carrying amount on the balance sheet, to present the investment at $2,200,000 at December 31, 2016.

h. Accounting for the sale of equity securities

If an entity is recording its equity securities at fair value under ASU 2016-01 and subsequently sells the security, the following rules should be applied:

1) The carrying amount is adjusted to the fair value as of the sale date.

2) No realized gain or loss is recorded.

3) Any deferred income taxes are reversed to reflect the removal of the temporary difference.

Example:

Company X holds an investment in Company Y as follows on December 31, 20X7:

Fair value recorded on the balance sheet	$3,000,000
Original cost (tax basis)	2,000,000
Unrealized gain (allowance on balance sheet)	$1,000,000

X has a deferred tax liability in the amount of $400,000 as follows:

Temporary difference: $1,000,000 x 40% = $400,000

On March 31, 20X8, X sells the investment for $3,500,000, representing the fair value on that date.

Conclusion:

X should make the following entries on March 31, 20X8:

Entry:	dr	cr
Allowance for unrealized gain	500,000	
Unrealized gain on equity securities		500,000
Income tax expense- deferred	200,000	
Deferred income tax liability		200,000
To adjust the investment to fair value at the sale date ($3,500,000 - $3,000,000) and record a deferred tax liability for the $500,000 x 40% = $200,000		

	DIT liability	**Investment in Y (cost)**	**Allowance**
Balances- 12-31-X7	$(400,000	$2,000,000	$1,000,000
Entry- adjust to 3-31-X8	(200,000)	0	500,000
Balances at 3-31-X8 prior to sale	(600,000)	2,000,000	1,500,000
Entry to record sale	600,000	(2,000,000)	(1,500,000)
Balances after sale 3-31-X8	$ 0	$ 0	$ 0

Entry March 31, 20X8 to record the sale:	dr	cr
Cash	3,500,000	

Allowance for unrealized gain		1,500,000
Investment in Y		2,000,000
Deferred income tax liability	600,000	
Income tax expense- deferred		600,000**

To adjust the investment to fair value at the sale date ($3,500,000 - $3,000,000) and record a deferred tax liability for the $500,000 x 40% = $200,000

** The income tax expense- deferred will be offset with a current income tax expense due to a realized gain of $1,500,000 being recorded as an M-1 on the tax return.

i. No look-through permitted rule- equity securities

An entity should not look through the form of its investment to the nature of the securities held by an investee to determine whether the investment is an equity or debt security.

Example 1: An entity invests in a limited partnership interest (or a venture capital entity) that meets the definition of an equity security.

However, substantially all of the partnership's assets consist of investments in debt securities or equity securities.

Conclusion: It is not appropriate to look through the form of an investment to determine whether the investment is a debt or equity security.

In the specific example, the investment would be considered an equity security so that it would be measured and recorded at fair value with the unrealized gain or loss recorded on the income statement.

Example 2: An entity holds an investment in a mutual fund that invests only in U.S. government debt securities.

Conclusion: That investment would be considered an equity security even though all of the underlying investments consist of debt securities.

j. Disclosures – equity securities

ASU 2016-01 adds in ASC 321 additional disclosures that must be made with respect to investments in equity securities.

The following disclosures are required for all interim and annual periods.

Investments in equity securities:

For each period for which the results of operations are presented, an entity shall disclose the portion of unrealized gains and losses for the period that relates to equity securities still held at the reporting date. The portion of unrealized gains and losses for the period related to equity securities still held at the reporting date is calculated as follows:

Net gains and losses recognized during the period on equity securities	$105
Less: Net gains and losses recognized during the period on equity securities sold during the period	(80)
Unrealized gains and losses recognized during the reporting period on equity securities still held at the reporting date	$25

Investments in equity securities without readily determinable fair values:

An entity that applies the *Optional Formula* for equity securities without readily determinable fair values shall disclose all of the following:

- The carrying amount of investments without readily determinable fair values
- The amount of impairments and downward adjustments, if any, both annual and cumulative
- The amount of upward adjustments, if any, both annual and cumulative
- As of the date of the most recent statement of financial position, additional information (in narrative form) that is sufficient to permit financial statement users to understand the quantitative disclosures and the *information that the entity considered* in reaching the carrying amounts and upward or downward adjustments resulting from observable price changes.

Note: In ASU 2016-01, the FASB noted that with respect to equity securities for which fair values are not readily determinable, it decided to measure such investments at fair value only upon an observable price change. The FASB decided that users need information about that measurement and the inputs to it to understand the carrying amount and how it differs from both fair value and amortized cost. Thus, ASU 2016-01 adds a required disclosure of the carrying amount of those investments in equity securities, as well as the adjustments made to the carrying amount because of observable price changes and impairment charges during the reporting period. An entity also would have to disclose the information it considered in developing the carrying amount and upward or downward adjustments resulting from observable price changes.

Are other disclosures required?

Yes. ASU 2016-01 adds the above-noted disclosures to other disclosures already required by other ASC sections. Thus, an entity is still required to include other disclosures such as fair value disclosures required by ASC 820, *Fair Value Measurement*, and ASC 825, *Financial Instruments*, including information above the fair value by level 1, 2 and 3 inputs, among others.

k. Other presentation matters- equity securities

Statement of financial position

An entity also shall refer to guidance in ASC 825-10-45-1A, *Financial Instruments*, on disaggregation of financial assets and financial liabilities *by measurement category* and form of financial asset (that is, securities or loans and receivables).

ASC 825-10-45-1A states:

> "An entity shall separately present financial assets and financial liabilities by *measurement category* and *form of financial asset* (such as securities or loans and receivables) in the statement of financial condition or the accompanying notes to the financial statements."

What this means is that equity securities should be classified on the balance sheet by measurement category separated into two line items on the balance sheet:

- Equity securities (measured at fair value per ASC 321), and
- Equity securities without readily determinable fair values (measured using the Optional Formula)[24]

Current vs. long-term on the balance sheet- equity securities

ASU 2016-01 does not provide any specific guidance as to how to categorize equity securities on the balance sheet. Previously, ASC 320 offered guidance on categorization when the equity securities were subject to being classified as trading or available for sale. Now, those categories no longer exist for equity securities.

Consequently, an entity should follow the general GAAP rules for classifying assets into current and non-current (long-term) found in ASC 210, *Balance Sheet*.

ASC 210-10-45-1(f), *Balance Sheet- Classification of Current Assets* provides overall guidance as to whether an asset is current or noncurrent (long-term), based on *management's intent:*

[24] Optional method: Cost minus impairment losses previously taken, plus or minus the changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer.

Balance Sheet Classification of Equity Securities	
Intent of management	**Balance Sheet Classification**
Management's intent is to: • Sell the equity securities in the near term (within one year of the balance sheet date, or • Use the equity securities in its operations within the current operating cycle even if it does not intend to sell the equity securities within the cycle.	Current
Management's intent is: • Not to sell the equity securities within the current operating cycle, or • *Not to use the funds* in its operations within the current operating cycle	Long-term

Note: In general, equity securities should be classified as current or long-term based on management's intent to use those funds within the current operating cycle even if it does not intend to sell the equity securities within that cycle. ASC 210-10-45-1(f), *Balance Sheet- Classification of Current Assets*, states that a current asset includes marketable securities "representing an investment of cash available for current operations."

Should equity securities be presented on the balance sheet separately from debt securities?

Yes.

ASC 825-10-45-1A, *Financial Instruments*, states:

> "An entity shall separately present financial assets and financial liabilities by *measurement category* and form of financial asset (such as securities or loans and receivables) in the statement of financial condition or the accompanying notes to the financial statements."

That means that securities should be presented on the balance sheet separately for each measurement category and form of financial asset. If an entity has both debt and equity securities, in most cases they should be separated on the balance sheet (or in the related notes) as follows:

Equity securities:
- Measured at fair value, and
- Measured using the optional formula (without readily determinable fair value)

Debt securities:
- Held to maturity
- Trading
- Available for sale

Observation: For ease of presentation, a cleaner option is to combine the investments on the balance sheet and, in the notes to financial statements, separate the investments by equity and debt securities, and further subsets within those categories.

Groupings on the balance sheet of financial instruments

Existing GAAP provides guidance on presenting financial assets and financial liabilities on the face of the balance sheet.

Example: Loans or trade receivables may be presented as aggregate amounts on the statement of financial position, but receivables held for sale must be presented separately.

a. GAAP requires that disaggregated information about major categories of loans or trade receivables must be provided either on the face of the statement of financial position or in the notes to financial statements.

b. ASU 2016-01 does not make any changes to GAAP's requirements for presenting information about financial assets and financial liabilities on the face of the statement of financial position or in the notes.

c. The ASU does conclude that providing information about financial assets and financial liabilities grouped by *measurement category* in the notes would provide users with the information they need.

Note: According to the FASB, a reporting entity may provide disaggregated information about financial assets and financial liabilities by measurement category *in the notes* to the statement of financial position rather than on the face of that statement. In addition, the FASB concluded that because the amendments in the ASU retain current accounting based on the form of financial assets (that is, loans and receivables versus securities), a reporting entity should further disaggregate the information about the financial assets by class of the asset either in the balance sheet or in the notes to financial statements.

Cash Flow Presentation

ASU 2016-01 states that an entity shall classify cash flows from purchases and sales of equity securities on the *basis of the nature and purpose for which it acquired the securities*.

Here are the unofficial rules:

Purpose of acquiring the Equity Securities	Presentation in Statement of Cash Flows
Purchased with the intent of selling the equity securities	Unrealized gain or loss presented as an adjustment in ***operating activities*** Purchases and sales of equity securities shown in ***operating activities***
Purchased without the intent to sell the equity securities	Unrealized gain or loss presented as an adjustment in ***operating activities*** Purchases and sales of equity securities shown in ***investing activities***

Example:

Company X has transactions in equity securities. The securities were purchased to invest excess cash in the business. X did not purchase the securities with the intent to sell them on a short-term basis. From time to time, X does sell individual securities if the market for that security has peaked.

Assume the following:

Unrealized gains on equity securities (income statement)	$500,000
Purchases of equity securities	(2,500,000)
Proceeds from sales of equity securities	200,000

Conclusion:

a. The unrealized gain is shown as an adjustment to net income in the operating activities section of the statement of cash flows.

b. The purchases and sales of equity securities are classified on the *basis of the nature and purpose for which it acquired the securities*. Because the securities were purchased with the intent to hold them (and not sell or trade them), the cash flows related to the purchases and sales should be shown in the investing activities section in the statement of cash flows.

Following is an example of a cash flow statement presentation:

Cash flow from operating activities:	
Net income	$XX
Adjustments:	
Depreciation	XX
Deferred income taxes	(XX)
Unrealized gain on equity securities	**(500,000)**
	XX
Changes in:	
accounts receivable	(XX)
Inventory	XX
Accounts payable and accrued expenses	XX
Net cash from operating activities	XX
Cash flow from investing activities:	
Purchase of equity securities	**(2,500,000)**
Proceeds from sales of equity securities	**200,000**
Net cash from investing activities	XX
Cash flow from financing activities:	Not shown
Increase (decrease) in cash and cash equivalents	XX
Cash and cash equivalents:	
Beginning of year	XX
End of year	$XX

Note: If the securities had been purchased with the intent to trade or sell them on a short-term basis, the purchases and sales would have been presented in the operating activities section on a net basis of $(2,300,000) based on $2,500,000 minus $200,000.

l. Application of ASC 321 to certain instruments and transactions

ASC 321 provides some guidance as to the scope of certain transactions and whether they are considered equity securities, subject to the amendments made by ASU 2016-01.

1) Convertible preferred stock

   If convertible preferred stock is not redeemable, it is considered an equity security and, therefore, the rules found in ASC 321 would apply.

2) Call options and forward contracts on equity securities

   An option to buy an equity security that does not meet the definition of a derivative instrument is considered an equity security. An investment in an option on securities should be accounted for under

the requirements of ASC 815-10, *Derivatives and Hedging*, if the option meets the definition of a derivative instrument, including the criteria for net settlement found in ASC 815- 10-15-83(c).

The equity security rules found in ASC 321 apply to those forward contracts and options that are not derivative instruments subject to ASC 815-10, but that involve the acquisition of securities that will be accounted for under ASC 321.

3) Short sales of equity securities

Sales of securities that the seller does not own at the time of sale are obligations to deliver securities, not investments. Thus, they are not considered equity securities. Short sale obligations are addressed in the guidance for certain industries. For example:

- ASC 940-320-35-1 with respect to broker-dealers, and
- ASC 942-405-25-1 with respect to depository institutions

m. Scope- application by noncontrolling shareholders

ASC 970-323-25-10, *Real Estate- General*, explains that an investment in a corporate subsidiary that is a real estate venture shall be accounted for by the investor-parent using the principles applicable to investments in subsidiaries rather than those applicable to investments in corporate joint ventures. That is, that paragraph requires that noncontrolling shareholders in such a real estate venture should account for as an equity security.

n. Investments- equity method and joint ventures, - partnerships, joint ventures and limited liability entities

Accounting for investments in limited liability companies

ASC 323-30-35-3 states:

> "An investment in a limited liability company that maintains a specific ownership account for each investor- similar to a partnership capital account structure, shall be viewed as similar to an investment in a limited partnership for purposes of determining whether a noncontrolling investment in the LLC is accounted for as an equity security (per ASC 321) or the equity method per ASC 323."

Question: Should an LLC be accounted for similar to a corporation or partnership in determining whether the equity method should be used?

Response: ASC 323, *Investments- Equity Method and Joint Ventures*, prescribes the accounting for investments in the common stock of corporations that are not consolidated. ASC 323 specifies that investments that allow the investor to exercise significant influence over the operating and financial policies of an investee should be accounted for using the equity method. ASC 323 also establishes a presumption of significant influence for investments of between 20 to 50 percent of the investee's outstanding voting stock.

ASC 323 indicates that *"many of the provisions of the equity method would be appropriate for partnerships and joint ventures"* even though ASC 323 only applies to investments in common stock of corporations.

ASC 323 further states that investors in unincorporated entities such as partnerships and unincorporated joint ventures generally shall account for their investments using the equity method if the investor has the ability to exercise significant influence over the investee.

What this means is this:

1. If an entity has an investment in an LLC in which the entity can exert significant influence (assumed between 20-50% ownership), the equity method should be used.

2. If the ownership is less than 20% or the entity lacks significant influence, the investment should be treated as an equity security per ASC 321, and measured at fair value with the unrealized gain or loss recorded in earnings.

o. Deferred tax assets

ASU 2016-01 amends ASC 740, *Income Taxes* as follows:

1) An entity shall evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale debt securities in combination with the entity's other deferred tax assets.

   - That deferred tax asset is created on the temporary difference due to the change in fair value (unrealized losses) of debt securities recognized in other comprehensive income.

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.

1. Which of the following is a type of investment to which the new ASC 321 equity security rules *do not apply:*
   a. Investments in equity securities, and
   b. Investments in partnerships
   c. Investments in closely held stock
   d. Investments in consolidated subsidiaries

2. In accordance with ASC 321, which of the following is considered an equity security:
   a. A publicly traded investment in common stock
   b. Written equity option
   c. Convertible debt
   d. Preferred stock

3. Company M has an investment in 10 percent of the outstanding shares of Company NP, a nonpublic entity. The investment in NP *does not* have a readily determinable fair value. Which of the following is correct:
   a. M must measure the investment in NP at fair value
   b. M may elect to use an Optional Formula to measure the investment
   c. M must measure the investment using a combination of fair value and the Optional Formula
   d. M must measure the investment at cost and is not permitted to use any other method.

4. Which of the following is an adjustment an entity makes in applying the Optional Formula for equity securities without a readily determinable fair value:
   a. Replacement cost
   b. Selling costs
   c. Impairment loss
   d. Fair value

5. An entity has an equity security without a readily determinable fair value. The entity records a writedown for an impairment loss of $100,000. In the next year, which of the following is correct:
   a. The loss can be recovered up to $100,000 of the previously recorded loss
   b. Once written down, the written down amount becomes the new carrying amount
   c. The written-down amount must be recorded using an allowance account
   d. There is no impairment loss permitted for equity securities without a readily determinable fair value

6. An entity has investments in both equity and debt securities. How should the investments be presented on the balance sheet:
   a. All investments should be combined into one total amount on the balance sheet
   b. Investments shall be separately presented by measurement category and form of financial asset
   c. Investments should be netted against any corresponding liabilities and presented as one net amount on the balance sheet
   d. Investments should be combined into two categories; one for investments with unrealized gains, and a second category for investments with unrealized losses

SUGGESTED SOLUTIONS

1. Which of the following is a type of investment to which the new ASC 321 equity security rules *do not apply:*
   a. Incorrect. Investments in equity securities are covered within the scope of ASC 321 which consists of instruments of ownership
   b. Incorrect. Investments in partnerships represent an investment in equity covered by ASC 321. An investment in a partnership interest represents ownership.
   c. Incorrect. Investments in closely held stock are included in the scope of ASC 321 because closely held stock consists of an equity ownership interest.
   d. Correct. ASC 321 specifically excludes investments in consolidated subsidiaries and investments that are recorded using the equity method. Thus, the answer is correct.

2. In accordance with ASC 321, which of the following is considered an equity security:
   a. Correct. An equity security is defined as any security representing an ownership interest in an entity. A publicly traded investment in common stock is included in that definition.
   b. Incorrect. ASC 321 specifically excludes from the definition of an equity security, a written equity option because it represents an obligation of the writer, not an investment.
   c. Incorrect. ASC 321 states that convertible debt that by its terms must be redeemed by the issuer or redeemed at the option of the investor.
   d. Incorrect. One exclusion from the definition of an equity security is redeemable preferred stock.

3. Company M has an investment in 10 percent of the outstanding shares of Company NP, a nonpublic entity. The investment in NP *does not* have a readily determinable fair value. Which of the following is correct:
   a. Incorrect. By definition, because the investment in NP does not have a readily determinable fair value, the investment in NP cannot be measured at fair value. Making the answer incorrect.
   b. Correct. In situations in which an investment does not have a readily determinable fair value, ASU 2016-01 offers an election to use an Optional Formula to measure the investment.
   c. Incorrect. ASU 2016-01 does not provide for measuring the investment using a combination of fair value and the Optional Formula. ASU 2016-01 allows for either using the Optional Formula or fair value, but not a combination of the two.
   d. Incorrect. The ASU offers use of the Optional Formula and does not require that the investment be measured at cost only, making the answer incorrect.

4. Which of the following is an adjustment an entity makes in applying the Optional Formula for equity securities without a readily determinable fair value:
   a. Incorrect. Cost, but not replacement cost, is used in the formula as cost is the starting point to which adjustments are made.
   b. Incorrect. Selling costs are not used in the formula making the answer incorrect.
   c. Correct. Using the Optional Formula, the cost is reduced by any impairment loss incurred.
   d. Incorrect. Fair value is not used. The reason for using the Optional Formula in the first place is because fair value is not determinable.

5. An entity has an equity security without a readily determinable fair value. The entity records a writedown for an impairment loss of $100,000. In the next year, which of the following is correct:

a. Incorrect. There is nothing in ASC 321 that provides for a recovery up to $100,000 of the previously recorded loss although such a provision would be logical.
b. Correct. The ASU provides that once written down, the written-down amount becomes the new carrying amount going forward.
c. Incorrect. The ASU does not require use of an allowance account to record an impairment loss. Instead, the writedown can be applied directly to the cost.
d. Incorrect. Because an equity securities without a readily determinable fair value is likely to use the Option Method, the security may not be recorded at fair value. Thus, an impairment assessment is appropriate.

6. An entity has investments in both equity and debt securities. How should the investments be presented on the balance sheet:
   a. Incorrect. GAAP does not provide for combining all investments into one total amount on the balance sheet. Instead, they should be classified by measurement category.
   b. Correct. ASC 825 requires that financial assets and liabilities be separately presented by measurement category and form of financial asset. Such presentation should be presented either on the balance sheet or in the notes.
   c. Incorrect. ASC 825 does not allow for netting of assets and liabilities making the answer incorrect.
   d. Incorrect. Investments are presented based on measurement category and form of asset, not based on unrealized gains and losses, making the answer incorrect.

VI. Changes in Disclosures

Changes to Fair Value Disclosures Made by ASU 2016-01:

ASU 2016-01 amends ASC 825, *Financial Instruments*, and ASC 820, *Fair Value Measurement*, to changes some of the fair value disclosures required under existing GAAP. Although there are numerous insignificant disclosure edits, following are the key changes to fair value disclosures made by ASU 2016-01:

CHANGE 1: Fair Value Disclosure Exemption- Trade Receivables and Trade Payables

Previous GAAP in ASC 825-10-50-14 has exempted from fair value disclosures trade receivables and trade payables, *if the carrying amount approximates fair value*.

ASU 2016-01 amends ASC 310, *Receivables-Overall*, to change the exemption as follows:

a. For trade receivables and payables, no fair value disclosure is required under ASC 825 if *the trade receivable or payable is due in one year or less*.

Assuming trade receivables and payables are due in one year or less, disclosure of fair value of trade receivables and payables is typically not required.

Must the company disclose the fact that the fair value disclosure is not required for trade receivables or payables?

No. There is no requirement that an entity disclose that the fair value disclosure is not required for trade receivables and payables.

What about trade receivables and payables that are due later than one year?

If trade receivables and payables are due beyond to one year, the disclosure exemption no longer applies. Therefore, an entity is required to disclose fair value as follows:

Example: Company X has trade receivables that are due 18 months from the sale date. The trade receivables are recorded at net realizable value of $2,000,000. X has not imputed interest as the interest component is not material.

Conclusion: Because the due date exceeds one year, the fair value disclosure exemption is not available. Therefore, X must disclose the fair value of the trade receivables, which should approximate the carrying value.

Sample disclosure:

NOTE X: Fair Value of Financial Instruments

At December 31, 20X1, the Company had trade receivables in the amount of $2,000,000with a due date of June 30, 20X3. The trade receivables are recorded at net realizable value which approximates fair value.

CHANGE 2: Eliminate the requirement to disclose the fair value of financial instruments measured at amortized cost for entities that are non-public entities

Existing GAAP exempts *certain non-public entities* from the requirement to disclose fair value of financial instruments if those instruments are measured at amortized costs.

One example is if an entity has debt securities held to maturity which are recorded at cost.

Under existing GAAP, a non-public company that meets all of the following conditions is not required to include fair value disclosures for financial instruments that are not recorded at fair value at the balance sheet date:

- The entity is a non-public entity,
- The entity's total assets are less than $100 million at the balance sheet date, and
- The entity has no derivative instruments other than commitments related to the origination of mortgage loans to be held for sale during the reporting period.

Thus, under existing GAAP, smaller non-public entities are not required to include fair value disclosures for financial instruments unless those instruments are recorded on the balance sheet at fair value.

Conversely, public entities are required to disclose fair value information about all financial instruments regardless of whether they are recorded on the balance sheet at fair value.

ASU 2016-01 amends ASC 825-10-50-2A and 3 as follows:

a. The requirement to disclose fair value for financial instruments recorded at cost only applies to public companies, and *does not apply to nonpublic entities regardless of size*.

   Thus, the requirement that a non-public entity must have total assets less than $100 million and no derivative instruments is eliminated. Now all nonpublic entities are exempt from fair value disclosures for financial instruments recorded at cost.

b. The ASU retains the requirement that all entities, including nonpublic entities, must disclosure information about concentrations of credit risk of all financial instruments for annual periods, and may do so optionally for interim periods.

CHANGE 3: Eliminate the requirement for public 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

ASU 2016-01 amends ASC 825-10-50-10 as follows for public entities:

a. With respect to financial instruments recorded at cost, a public entity is no longer required to disclose the methods and significant assumptions used to estimate the fair value.

b. The public entity is required to continue to disclose either in the body of the financial statements or in the notes:

- The fair value of the financial instruments, and
- The level of the fair value hierarchy within which the fair value measurements are categorized in their entirety (such as Level 1, 2 and 3).

CHANGE 4: New requirement that a public entity must use the exit price notion when measuring the fair value of financial instruments for disclosure purposes

Existing GAAP permits a public entity to use *entry prices* to measure the fair value of certain assets, such as loans, that do not have market prices. Those entities rely on ASC 825-10, *Financial Instruments*, which permits use of an entry price to measure the fair value disclosure.

ASU 2016-01 makes the following change:

a. It requires public business entities that are required to disclose fair value of financial instruments measured at amortized cost on the balance sheet, to measure that fair value using the *exit price* notion consistent with ASC 820, *Fair Value Measurement*.

Note: This change to GAAP eliminates the entry price method previously used by some entities for disclosure purposes for some financial assets. Previously, GAAP permitted entities an option to measure fair value in two different ways. This change results in increased comparability between fair values of financial instruments held by different entities and provides users with more comparable information as compared with current practice.

Observation: The FASB noted that the decision usefulness of the fair values presently disclosed is impaired by the different methods of determining the fair values of loans. Some are based on entry prices while others are based on exit prices. The FASB decided that the potential increase in the costs to some entities of developing estimates of the fair values of financial assets for which observable market prices are not available is justified by the resulting increase in the decision usefulness of the fair value information provided.

In making its decision to require disclosures to be measure fair value using the exit (rather than entry) price, the FASB observed that the change will now permit users of financial statements of public entities to review all entities' fair value disclosures, relying on the fact that the fair values are measured on a consistent basis.

CHANGE 5: Elimination of the Overriding Practicality Exception to Measure Fair Value

Existing GAAP provides a series of exceptions under which an entity can avoid fair value measurements.

One of them found in ASC 820 is that an entity is not required to measure fair value if it is *not practicable to do so*. One example of lack of practicability is where the entity will incur *excessive costs to develop* fair value information.

ASU 2016-01 *eliminates the exception for practicability*, altogether.

Fair Value Measurements Disclosure-ASC 820

ASC 820-10-50, *Fair Value Measurements*, requires an entity to include fair value disclosures. Because debt and equity securities are now separated into ASC 320 and ASC 321, respectively, the breakout of the components of the fair value disclosure has changed. Following is a sample disclosure that reflects the breakout of debt and equity securities.

NOTE X: FAIR VALUE MEASUREMENTS
A summary of assets and liabilities measured at fair value at December 31, 20X1 follows:

	Fair Value Measurements By Level of Input				
Description (in millions)	Year Ended 12-31-X1	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)	Total gains (losses)
Recurring fair value measurements:					
Equity securities:					
Equity securities- real estate industry	$115	$95	$20		
Equity securities- oil and gas industry	90	50	40		
	$205	$145	$60		
Available-for-sale **debt** securities:					
Residential mortgage-backed securities	$100	$0	$70	$30	
Commercial mortgage-backed securities	90	0	0	90	
Corporate bonds	85	85	0	0	
	$275	$85	$70	$120	
Other equity securities:					
Private equity investments	$80	$0	$0	$80	
Venture capital equity investments	20	0	0	20	
	$100	0	0	$100	
Total recurring fair value measurements	$580	$230	$130	$220	
Non-recurring fair value measurements:					
Long-lived assets held and used	$100	$0	$100	$ 0	$(25)
Goodwill	30	0	0	30	(35)
Total non-recurring fair value measurements	$130	$0	$100	$30	$(60)

Must the fair value disclosures include equity securities without readily determinable fair values?

No. ASU 2016-01 amends ASC 825-10-50-8, *Financial Instruments*, to expand the list of financial instruments for which fair value disclosures are not required.

That list of exempt financial instruments now includes:

- ***Investments in equity securities without readily determinable fair values***
- Trade receivables and payables due in one year or less, and
- Deposit liabilities with no defined or contractual maturities.

Thus, if an entity has an investment in equity securities without readily determinable fair values, those securities are not included in the fair value disclosure (by level 1, 2 and 3 inputs).

Financial Liabilities for Which Fair Value Option Is Elected

If an entity has designated a financial liability under the fair value option in accordance with ASC 825, *Financial Instruments*, the entity shall measure the financial liability at fair value with qualifying changes in fair value recognized in net income.

a. The entity shall present separately in other comprehensive income the portion of the total change in the fair value of the liability that results from a change in the instrument-specific credit risk.

b. The entity may consider the portion of the total change in fair value that excludes the amount resulting from a change in a base market risk, such as a risk-free rate or a benchmark interest rate, to be the result of a change in instrument-specific credit risk.

   Note: Alternatively, an entity may use another method that it considers to faithfully represent the portion of the total change in fair value resulting from a change in instrument-specific credit risk.

c. The entity shall apply the method consistently to each financial liability from period to period.

d. Upon derecognition of a financial liability designated under the fair value option in accordance with this Subtopic, an entity shall include in net income the cumulative amount of the gain or loss on the financial liability that resulted from changes in instrument-specific credit risk.

e. The guidance in ASC 825-10-45-5, *Financial Instruments*, does not apply to financial liabilities of a consolidated collateralized financing entity measured using the measurement alternative in ASC 810-10-30-10 through 30-15 and 810-10- 35-6 through 35-8, *Consolidation*.

VII. Effective Date and Transition- ASU 2016-01

The following represents the transition and effective date information related to ASC No. 2016-01:

a. A public business entity shall apply the ASU for fiscal years (and interim periods within those fiscal years), *beginning after December 15, 2017*.

   Except as indicated in (c), early application by a public business entity is *not permitted*.

b. All other entities (including nonpublic entities, non-profits and employee benefit plans) shall apply the ASU for fiscal years *beginning after December 15, 2018*, and interim periods within fiscal years beginning after December 15, 2019. Early application is permitted for all other entities as of the fiscal years beginning after December 15, 2017, including interim periods within those fiscal years.

   Except as indicated in (b) through (d), earlier application by all other entities is not permitted.

c. *Adoption of financial liability guidance under the fair value option*: All entities may adopt the financial liability presentation guidance for financial statements of fiscal years or interim periods that have not yet been issued or that have not yet been made available for issuance.

d. Entities that are not public business entities may elect not to disclose the information about fair value of financial instruments required by ASC 825-10-50, *Financial Instruments*, in financial statements of fiscal years or interim periods that have not yet been made available for issuance.

   That information includes an exemption for all nonpublic entities to include disclosures about fair value for financial instruments that are recorded at cost.

   Note: The FASB notes that it decided to permit entities that are not public business entities to adopt the amendments that exempt them from the disclosure requirements on fair value of financial instruments recorded at cost found in ASC 825-10-50. The FASB concluded that because these disclosure requirements are no longer required upon the effective date of ASU 2016-01, there is no need for entities to present those disclosures in the financial statements of reporting periods that have not yet been made available for issuance.

e. An entity shall apply changes made by ASU 2016-01 as follows:

   1) Equity securities: Record a *cumulative-effect adjustment to the statement of financial position* as of the beginning of the fiscal year in which the ASU is applied.

      - The offset is recorded as an adjustment to beginning retained earnings.

   2) Equity securities without readily determinable fair values: The changes related to equity securities without readily determinable fair values (including disclosure requirements) shall be applied *prospectively* to all equity investments that exist as of the date of adoption of ASU 2016-01.

   3) Restatement of the prior years' financial statements is not required.

f. An entity shall apply prospectively the changes made by ASU 2016-01 that requires public entities to use the exit price notion in ASC 820 on fair value measurement to be used to measure fair value of financial instruments for disclosure purposes.

   1) If because of measuring fair value of financial instruments in accordance with guidance in ASC 820, *Fair Value Measurements*, the prior-year figures shown for comparative purposes will no longer be comparable, an entity shall make a disclosure to explain that fact.

2) That disclosure is in conformity with the guidance in ASC 205-10 on presentation of financial statements that requires that any change in the manner of or basis for presenting corresponding items for two or more periods that affects comparability of financial statements shall be disclosed.

g. An entity shall disclose the following, consistent with ASC 250-10, *Accounting Changes and Error Corrections*, in the period that the entity adopts the pending content that links to this paragraph:

1) The nature of and reason for the change in accounting principle, including an explanation of the newly adopted accounting principle.

2) The method of applying the change.

3) The effect of the adoption on any line item in the statement of financial position, if material, as of the beginning of the fiscal year for which the pending content that links to this paragraph is applied. Presentation of the effect on financial statement subtotals is not required.

4) The cumulative effect of the change on retained earnings or other components of equity in the statement of financial position as of the beginning of the fiscal year for which the pending content that links to this paragraph is applied.

5) An entity that issues interim financial statements shall provide the disclosures in (1) through (4) in each interim financial statement of the fiscal year of change and the annual financial statement of the period of the change.

Note: The FASB notes that the amendments in ASU 2016-01 require that transition to the amendments be effected by a cumulative-effect adjustment to the statement of financial position as of the beginning of the fiscal year in which the guidance is adopted, (that is, a modified-retrospective approach). Using this approach, the amounts reported in accumulated other comprehensive income for equity securities that exist as of the date of adoption previously classified as available-for-sale are to be reclassified to retained earnings. Further, amounts attributable to changes in instrument-specific credit risk for financial liabilities measured under the fair value option that exist as of the date of adoption should be reclassified from retained earnings to accumulated other comprehensive income.

The amendments related to equity securities without readily determinable fair values (including related disclosure requirements) will be applied prospectively to all equity investments that exist as of the date of adoption of the ASU.

Example- Adoption of ASU 2016-01:

Company X, a nonpublic entity, adopts ASU 2016-01 effective for year ended December 31, 2019.

X has equity securities on its December 31, 2018 balance sheet that were classified as available- for-sale as follows:

At December 31, 2018:

Fair value available-for-sale equity securities	$3,000,000

Original cost (tax basis)	2,000,000
Unrealized gain	1,000,000
Deferred income taxes	(400,000)
Accumulated other comprehensive income- (stockholder's equity)	$600,000

Company X
Balance Sheet
December 31, 2018

Assets:	
Cash	$XX
Accounts receivable	XX
Equity securities, available-for-sale	**3,000,000**
Property and equipment, net	XX
Total assets	$XX
Liabilities:	
Accounts payable	$XX
Accrued expenses	XX
Deferred income taxes	**400,000**
Total liabilities	XX
Stockholders' equity:	
Common stock	XX
Retained earnings	XX
Accumulated other comprehensive income	**600,000**
Total stockholders' equity	XX
Total liabilities and stockholders' equity	$XX

Conclusion: In adopting ASU 2016-01, X adjusts the beginning balance sheet on January 1, 2019 with a cumulative-effect adjustment, to remove accumulated other comprehensive income with a corresponding adjustment to retained earnings.

Entry January 1, 2019 to record adoption of ASU 2016-01:	dr	cr
Accumulated other comprehensive income	600,000	
Retained earnings		600,000

Assume further that on December 31, 2019, information on the equity securities follows:

Fair value- equity securities	$3,600,000
Original cost (tax basis)	2,000,000
Unrealized gain 12-31-19	1,600,000

Unrealized gain 12-31-18	1,000,000
Adjustment- 12-31-19	$600,000

The company makes the following entry to reflect the unrealized gain under the amendments made by ASU 2016-01:

Entry December 31, 2019 to record unrealized gain:

Allowance for unrealized gain- equity securities	600,000	
Unrealized gain (income statement)		600,000
Income tax expense- deferred (40%)	240,000	
Deferred income tax liability		240,000

Company X
Balance Sheet
December 31, 2019

Assets:	
Cash	$XX
Accounts receivable	XX
Investment- equity securities, at fair value	**3,600,000**
Property and equipment, net	XX
Total assets	$XX
Liabilities:	
Accounts payable	$XX
Accrued expenses	XX
Deferred income taxes	**640,000**
Total liabilities	XX
Stockholders' equity:	
Common stock	XX
Retained earnings	XX
Accumulated other comprehensive income	**0**
Total stockholders' equity	XX
Total liabilities and stockholders' equity	$XX

Company X
Statement of Income
For the Year Ended December 31, 2019

Revenue	$XX
Expenses	XX
Income from operations	XX
Other income:	
Unrealized gain on equity securities	**600,000**
Net income before income taxes	XX
Income taxes (includes $240,000 of deferred income taxes)	XX
Net income	$XX

XYZ Corporation
Statement of Stockholders' Equity
For The Year Ended December 31, 2019

			Accumulated Other Comprehensive Income	
	Total	Retained Earnings	**Unrealized gains-equity securities**	Common Stock
Beginning balance	$XX	$XX	**$600,000**	$XX
Net income	XX	XX		
Adjustment to adopt ASU 2016-01	**0**	**600,000**	**(600,000)**	
Ending balance	$XX	$XX	$ 0	$XX

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.

1. In order for a company to avoid having to disclose the fair value of financial instruments measured at amortized cost, which of the following attributes must the company have:
   a. It must be a nonpublic entity
   b. It must have total assets of less than $100 million
   c. It must have derivatives
   d. It must have at least one instrument recorded at fair value

2. Company X is implementing ASU 2016-01 for its equity securities. Which of the following is the appropriate way in which X should implement the ASU:
   a. The ASU should be implemented prospectively going forward
   b. The ASU should be implemented through a cumulative effect adjustment with the offset posted to the income statement
   c. The ASU should be implemented by recording a cumulative effect adjustment with the offset recorded as an adjustment to beginning retained earnings
   d. Retrospectively by restating all previous years presented comparatively

SUGGESTED SOLUTIONS

1. In order for a company to avoid having to disclose the fair value of financial instruments measured at amortized cost, which of the following attributes must the company have:
   a. **Correct. One requirement is that the company must be a nonpublic entity. The exception does not apply to public entities.**
   b. Incorrect. ASU 2016-01 eliminates the previous requirement that an entity must have total assets of less than $100 million. Now, there is no size threshold under which an entity's assets must be under.
   c. Incorrect. The requirement is that it cannot have derivatives.
   d. Incorrect. There is no requirement that the entity must have at least one instrument recorded at fair value, making the answer incorrect.

2. Company X is implementing ASU 2016-01 for its equity securities. Which of the following is the appropriate way in which X should implement the ASU:
   a. Incorrect. ASU 2016-01 does not permit prospective application for equity securities.
   b. Incorrect. Although the ASU does provide for implemented through a cumulative effect adjustment, the offset is not to the income statement. Rarely, does GAAP permit any implementation adjustment to impact the income statement.
   c. **Correct. The ASU requires implementation by recording a cumulative effect adjustment with the offset recorded as an adjustment to beginning retained earnings.**
   d. Incorrect. The ASU does not require any restatement of previous years making the answer incorrect.

ASU 2016-13: Financial Instruments – Credit Losses (Topic 326) Measurement of Credit Losses on Financial Instruments

Issued: June 2016

Effective date: ASU 2016-13 is effective as follows:

For public business entities that are SEC filers: the amendments in the ASU are effective for fiscal years beginning after December 15, 2019, including interim periods within those annual periods. For all other public business entities, the amendments are effective for fiscal years beginning after December 15, 2020, including interim periods within those fiscal years.

All other entities, including nonpublic entities, not-for-profit entities and employee benefit plans on plan accounting: the amendments in the ASU are effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021.

All entities may adopt the amendments in this Update earlier as of the fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

I. Objective

The primary objective of the ASU is to provide financial statement users with more decision-useful information about the expected credit losses on financial instruments and other commitments to extend credit held by a reporting entity at each reporting date.

II. Background

Existing GAAP uses various credit impairment models with respect to financial instruments. The existing objective of such models has been to delay recognition of credit losses until the loss was probable of incurring (the "incurred loss" approach).

Under the "incurred loss" approach, recognition is delayed until it is probable a loss has been incurred. That is, it must be probable that the loss is incurred and the amount must be estimable.

1. ASC 310-10, *Receivables*, uses the contingency rules to determine when an allowance for doubtful accounts on receivables is required.

2. ASC 450-20, *Contingencies- Loss Contingencies*, requires recognition of an allowance for credit losses on receivables when both of the following conditions are met under the incurred loss model:

    a. Information available before the financial statements are issued or are available to be issued indicates that it is probable that an asset has been impaired at the date of the financial statements.

    b. The amount of the loss can be reasonably estimated.

3. The two conditions above may be considered in relation to individual receivables or in relation to groups of similar types of receivables.

4. If the conditions are met, accrual shall be made even though the particular receivables that are uncollectible may not be identifiable.

5. The two conditions (probable and reasonably estimated) may be considered in relation to individual receivables or in relation to groups of similar types of receivables.

6. If the two conditions are met, accrual shall be made even though the particular receivables that are uncollectible may not be identifiable.

   Typically calculated:
   - % sales
   - % AR
   - %s applied to aging based on historical experience

7. It is <u>inappropriate to consider possible or expected future trends</u> that may lead to additional losses.

According to the FASB:

a. Financial institutions and other financial statement users have stated concerns that the existing "<u>probable threshold</u>" GAAP approach limits an entity's ability to record credit losses that the entity expects to occur, but have not yet met the "probable" threshold.

b. Entities seek to replace the "probable" approach with one that assesses an entity's allowance for credit losses (e.g., allowance for bad debts):

   - Using forward-looking information
   - Based on the entity's own internal expectations

During the global financial crisis there was an inconsistency as to the timing of estimating credit losses versus recording those losses:

1. For management purposes, financial statement users were estimating expected credit losses and devaluing investments based on forward-looking information.

2. For GAAP, entities were recording losses using the incurred loss model based on a probable threshold.

3. Because of the lag in recording losses using the existing GAAP "probable" threshold model, GAAP assets have been overstated as they do not reflect the true net collectible amount.

FASB-IASB 2008 project commences

In 2008, the FASB and the International Accounting Standards Board (IASB) established a Financial Crisis Advisory Group (FCAG) to advise both boards on improvements to financial reporting in response to the earlier financial crisis.

The FCAG did the following:

1. It identified as a weakness in current GAAP the delayed recognition of credit losses that the probable model creates that results in the potential overstatements of assets.

2. The FCAG recommended exploring more forward-looking alternatives to the incurred loss methodology.

The project resulted in the June 2016 issuance of ASU 2016-13, *Financial Instruments– Credit Losses (Topic 326) Measurement of Credit Losses on Financial Instruments.*

ASU 2016-13:

- Eliminates major portions of existing ASC 310, *Receivables*
- Creates new ASC 326, *Financial Instruments- Credit Losses*
- Moves large portions of ASC 310 into new ASC 326, *Financial Instruments- Credit Losses*
- Amends ASC 320 with respect to impairment of available-for-sale debt securities.
- Amends various other ASC sections

New ASC 326, Financial Instruments- Credit Losses

a. ASU 2016-13 adds new ASC 326 to provide guidance on how an entity should measure credit losses on financial instruments using the new <u>expected credit loss model</u> that applies to:

   - ASC 326-10- provides general guidance on the new expected credit loss model

   - ASC 326-20- provides specific guidance on financial instruments <u>measured at amortized cost</u> and certain other financial instruments.

   - ASC 326-30- provides guidance <u>on modifications to the impairment model for available-for-sale debt securities</u>.

b. The new ASC 326 applies to all entities.

III. Scope of ASC 326

1. The amendments affect entities holding financial assets and net investment in leases that are <u>not accounted for at fair value through net income</u>.

2. The amendments affect certain financial assets recorded at amortized cost (ASC 326-20):

   - Loans
   - Debt securities categorized as either held to maturity
   - Trade receivables
   - Net investments in leases
   - Off-balance-sheet credit exposures
   - Reinsurance receivables, and

- Any other financial assets not excluded from the scope that have the contractual right to receive cash.

3. ASC 326-20 applies to all entities that have any of the following items:

   a. Financial assets measured at amortized cost basis, including the following:

      - Financing receivables
      - Held-to-maturity debt securities (which are recorded at cost)
      - Trade receivables that result from revenue transactions with customers and other income
      - Reinsurance receivables that result from insurance transactions within the scope of ASC 944 on insurance
      - Receivables that relate to repurchase agreements and securities lending agreements within the scope of ASC 860

   b. Net investments in leases recognized by a lessor in accordance with ASC 842 on leases

   c. Off-balance-sheet credit exposures not accounted for as insurance

4. ASC 326-20 guidance does not apply to the following items:

   a. Financial assets measured at fair value through net income (such as equity securities)
   b. Available-for-sale debt securities (covered in ASC 326-30)
   c. Loans made to participants by defined contribution employee benefit plans
   d. Policy loan receivables of an insurance entity
   e. Promises to give (pledges receivable) of a not-for-profit entity, and
   f. Loans and receivables between entities under common control.

IV. ASU 2016-13 amendments

General amendments

ASU 2016-13 amendments do the following:

1. Eliminate the current GAAP "incurred loss" model for measuring credit losses, which measures credit losses based on achieving a "probable" threshold and by considering only past events and conditions.

2. Introduce a new "expected credit loss" model under which, in measuring a credit loss, an entity must broaden the information used to develop an expected credit loss estimate that reflects the amount the entity expects to collect.

   a. The expected credit loss model uses the following to determine collectability of financial instruments:

- Past information **(EXISTING GAAP)**
- Current information **(NEW)**, and
- Future information **(NEW).**

b. Under the expected credit loss model, an entity records the full amount of expected credit losses (as opposed to maintaining a probable threshold that must be met before all expected credit losses are recognized)

Existing GAAP: Only some of the expected credit losses are recognized in the allowance account before the probable threshold is met.

New GAAP: The full amount of expected credit losses is recognized in the allowance account well before any probable threshold would have been met.

FORMULA FOR ALLOWANCE FOR CREDIT LOSSES:
Expected credit loss model:

Balance of the financial assets (e.g., AR)
LESS: Amount expected to be collected over the remaining contractual life
= ALLOWANCE BALANCE

3. Modifies the impairment model for available-for-sale (AFS) debt securities (ASC 326-30), and

4. Provides a simpler model for dealing with purchased financial assets that have credit deterioration (ASC 326-20).

Financial statement presentation of allowance balance and activity

1. The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial asset(s) to present the net carrying value at the amount expected to be collected on the financial asset.

2. The income statement shall reflect any adjusts to measure credit losses for newly recognized financial assets, as well as the expected increases or decreases of expected credit losses that have taken place during the period.

New expected credit loss model

1. The ASU amendments provide that the measurement of expected credit losses should be based on broader relevant information using:

- Past events, including historical experience,
- Current conditions, and
- Reasonable and supportable forecasts that affect the collectibility of the reported amount

Information to Use in Measurement of Credit Losses New ASU 2016-13	
Category of Information	**Type of Information Obtained**
Historical loss information	Historical credit loss experience of financial assets with similar risk characteristics. Historical loss information can be internal or external historical loss information.
+ Current Conditions adjustments	Adjustments to reflect changes in historical information to current conditions, such as changes in unemployment rates, property values, commodity values, delinquency, or other factors that are associated with credit losses on the financial asset or in the group of financial assets).
+ Reasonable and supportable forecasts	Adjustments to historical information reflective of an entity's forecast of the economic condition of the financial asset in the future.
= EXPECTED CREDIT LOSS	

2. An entity shall not rely solely on past events to estimate expected credit losses.

   a. When an entity uses historical loss information, it shall consider the need to adjust historical information to reflect the extent to which management expects current conditions and reasonable and supportable forecasts to differ from the conditions that existed for the period over which historical information was evaluated.

   b. An entity <u>shall not adjust historical loss information</u> for existing economic conditions or expectations of future economic conditions for periods that are <u>beyond the reasonable and supportable period</u>.

3. An entity shall measure expected credit losses of financial assets on a collective (pool) basis when <u>similar risk characteristic(s) exist.</u>

4. At inception, an entity is required to estimate credit losses expected over the life of the financial asset's exposure.

5. When developing an estimate of expected credit losses on financial asset(s), an entity shall consider available information relevant to assessing the collectibility of cash flows that may include:

   - Internal information

- External information, or
- A combination of both internal and external information relating to past events, current conditions, and reasonable and supportable forecasts.

6. The allowance for credit losses may be determined using various methods.

   Examples include:

   - Discounted cash flow methods
   - Loss rate methods
   - Roll-rate methods
   - Probability-of-default methods, or
   - Methods that utilize an aging schedule (most likely for trade receivables).

7. If an entity estimates expected credit losses using methods that project future principal and interest cash flows (that is, a discounted cash flow method), the entity shall discount expected cash flows at the financial asset's effective interest rate.

Subsequent measurement -reporting changes in expected credit losses

1. At each reporting date, an entity shall record an allowance for credit losses on financial assets (including purchased financial assets with credit deterioration).

   a. An entity shall compare its current estimate of expected credit losses with the estimate of expected credit losses previously recorded.

   b. An entity shall report in net income (as a credit loss expense or a reversal of credit loss expense) the amount necessary to adjust the allowance for credit losses for management's current estimate of expected credit losses on financial asset(s).

   c. The method applied to initially measure expected credit losses for the assets generally would be applied consistently over time and shall faithfully estimate expected credit losses for financial asset(s).

Writeoffs and recoveries of financial assets

1. Rules are carried over from existing GAAP to the new GAAP:

   a. Writeoffs of financial assets, which may be full or partial writeoffs, shall be deducted from the allowance.

   b. The writeoffs shall be recorded in the period in which the financial asset(s) are deemed uncollectible.

   c. Recoveries of financial assets and trade receivables previously written off shall be recorded when received.

Financial assets secured by collateral

The ASU carries over existing rules found in ASC 310-10 with respect to loans secured by collateral:

1. A creditor shall measure impairment based on the fair value of the collateral when the creditor determines that foreclosure is probable.

2. When a creditor determines that foreclosure is probable, a creditor shall remeasure the loan at the fair value of the collateral.

3. If a creditor uses the fair value of the collateral to measure impairment of a collateral-dependent loan and repayment or satisfaction of a loan is dependent on the sale of the collateral, the fair value of the collateral shall be adjusted to consider estimated costs to sell.

4. A creditor may use a practical expedient and measure impairment based on a loan's observable market price, or the fair value of the collateral if the loan is a collateral-dependent loan.

   a. Collateral-Dependent Loan is defined as a loan for which the repayment is expected to be provided solely by the underlying collateral.

5. Regardless of the initial measurement method, an entity shall measure expected credit losses based on the fair value of the collateral when the entity determines that foreclosure is probable.

   FORMULA:

   Fair value of collateral
   LESS: Amortized cost of the financial asset
   = ALLOWANCE BALANCE

6. Practical expedient option:

   a. An entity may elect to use, as a practical expedient, the fair value of the collateral at the reporting date to record the allowance for credit losses if the asset is a *collateral dependent financial asset*.

   b. Definition of a collateral dependent financial asset:

      Is a financial asset for which:

      1) The repayment is expected to be provided substantially through the operation or sale of the collateral, and

      2) The borrower is experiencing financial difficulty based on the entity's assessment as of the reporting date

   c. If an entity uses the practical expedient on a collateral-dependent financial asset and repayment or satisfaction of the asset depends on the sale of the collateral, the fair value of the collateral shall be adjusted for estimated costs to sell (on a discounted basis).

      FORMULA:

Fair value of collateral – costs to sell
LESS: Amortized cost of the financial asset
= ALLOWANCE BALANCE

Available-for-sale debt securities:

ASU 2016-13 amends the accounting for the impairment of available-for-sale debt securities.

Existing GAAP- ASC 320-10: Investments—Debt Securities—Overall

1. For individual debt securities classified as, an entity applies a two-step approach to determine an impairment:

   Step 1: Determine if the individual security is impaired (fair value is less than amortized cost).
   Step 2: If the impairment is other-than-temporary, a direct write down is recorded.

2. The other-than-temporary writedown is recorded either:

   - In earnings, or
   - Split between earnings and other comprehensive income depending on whether the asset must be sold before its value will recover.

3. Writedowns are recorded directly against the asset and not by use of an allowance account.

4. Once written down, the security may not be written back up (no restoration of a writedown).

NEW ASC 326-30- Available-for-sale debt securities:

1. The ASU introduces a new ASC 326-30: *Financial Instruments—Credit Losses—Overall* which amends existing ASC 320-10, *Investments- Debt Securities*, with respect to impairments of available-for-sale debt securities.

2. The other-than-temporary threshold for recording losses is eliminated so that there is no longer a threshold that must be met to record credit losses on available-for-sale debt securities.

3. Credit losses relating to available-for-sale debt securities should be recorded through an allowance for credit losses, and not through a direct writedown of the asset.

   a. The ASU amendments limit the amount of the allowance for credit losses to the amount by which fair value is below amortized cost.

   b. Any credit losses on available-for-sale debt securities should be measured using an allowance account rather than a direct write down of the asset.

   c. Thus, an entity will be able to record reversals of credit losses. Current GAAP prohibits the recording of reversals once the debt security is written down.

Related-party loans

Do the new rules apply to loans and receivables between entities under common control?

No. ASC 326 specifically excludes loans and receivables between entities under common control from its scope. Therefore, an entity should evaluate any impairment on a related-party loan receivable using the contingency rules found in ASC 450. That is, a loss is recorded if a loss is probable and the amount can be reasonably estimated.

Disclosures

1. The ASU amendments retain most of the disclosures found in ASU 2010-20, *Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, with the following exceptions:

    a. The ASU updates the disclosures to reflect the change from the incurred loss to the new expected credit loss methodology.

    b. The ASU expands the current disclosures of credit quality indicators in relation to the amortized cost of financial receivables as follows:

        - Those disclosures are further disaggregated by year of origination (or vintage, although this expanded disclosure is optional for non-public business entities.

2. For instruments within the scope of the ASU, the following disclosures on credit risk and the measurement of expected credit losses:

    - Credit quality information
    - **Allowance for credit losses EXPANDED**
    - Past-due status
    - Nonaccrual status
    - Purchased financial assets with credit deterioration
    - Collateral-dependent financial assets
    - Off-balance-sheet credit exposures

Disclosures- Allowance for Credit Losses-EXPANDED

1. The ASU expands the disclosures requires of the allowance for credit losses.

2. An entity shall disclose all the following information related to the allowance for credit losses, by portfolio segment and major security type:

    a. A description of how expected loss estimates are developed **NEW**

    b. A description of the entity's accounting policies and methodology to estimate the allowance for credit losses, as well as a discussion of the factors that influenced management's current estimate of expected credit losses, including: **NEW**

1) Past events
2) Current conditions
3) Reasonable and supportable forecasts about the future

.

c. A discussion of risk characteristics relevant to each portfolio segment **NEW**

d. A discussion of the changes in the factors that influenced management's current estimate of expected credit losses and the reasons for those changes (for example, changes in portfolio composition, underwriting practices, and significant events or conditions that affect the current estimate but were not contemplated or relevant during a previous period) **NEW**

3. An entity shall disclose all the following information related to the allowance for credit losses, by portfolio segment and major security type: ***(all new disclosures)***

i.

a. Identification of changes to the entity's accounting policies, changes to the methodology from the prior period, its rationale for those changes, and the quantitative effect of those changes **NEW**

b. Reasons for significant changes in the amount of writeoffs, if applicable **NEW**

c. A discussion of the reversion method applied for periods beyond the reasonable and supportable forecast period **NEW**

d. The amount of any significant purchases of financial assets during each reporting period **NEW**

e. The amount of any significant sales of financial assets or reclassifications of loans held for sale during each reporting period **NEW**

4. Disclosure of roll forward of the allowance for credit losses **NEW**

a. An entity shall separately provide by portfolio segment and major security type the quantitative disclosures of the <u>activity in the allowance for credit losses</u> for financial assets, including all of the following:

The beginning balance in the allowance for credit losses
+ Current-period provision for expected credit losses
+ The initial allowance for credit losses recognized on financial assets accounted for as purchased financial assets with credit deterioration
- Writeoffs charged against the allowance
+ Recoveries of amounts previously written off, if applicable
= The ending balance in the allowance for credit losses.

Note: The ASU <u>*does not change*</u> the requirement that an entity must <u>*disclose the balance in the allowance for credit losses*</u> at the balance sheet date. That disclosure can be made either in the notes or presented as a separate amount directly on the balance.

Purchased financial assets with credit deterioration NEW Part of ASC 326-10

1. An entity shall record the allowance for credit losses for purchased financial assets with credit deterioration based on the rules found in ASC 326-10.

2. An entity shall add the allowance for credit losses at the date of acquisition to the purchase price to determine the initial amortized cost basis for purchased financial assets with credit deterioration.

3. Definition of purchased financial assets with credit deterioration:

   ASC 326-10 defines purchased financial assets with credit determination as:

   > *"Acquired individual financial assets (or acquired groups of financial assets with similar risk characteristics) that, as of the date of acquisition, have experienced a more-than-insignificant deterioration in credit quality since origination, as determined by an acquirer's assessment."*

Implementation

1. ASU 2016-13 amendments apply to the following effective dates:

   a. For public business entities that meet the definition of a Securities and Exchange Commission (SEC) filer, for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years

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

   c. For all other entities, including non-public entities, not-for-profit entities and employee benefit plans within the scope of ASC 960 through 965 on plan accounting, for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021.

   Early application is permitted for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

2. An entity shall implement the new rules for financial assets recorded at amortized cost by means of a cumulative-effect adjustment to the opening retained earnings as of the beginning of the first reporting period in which the new rules is effective.

3. An entity shall apply prospectively the changes made to purchased financial assets with credit deterioration, other-than-temporary available for sale debt securities,

4. An entity shall disclose the following in the period that the entity adopts the ASU:

   a. The nature of the change in accounting principle, including an explanation of the newly adopted accounting principle.

   b. The method of applying the change.

c. The effect of the adoption on any line item in the statement of financial position, if material, as of the beginning of the first period for which the ASU is effective.

d. Presentation of the effect on financial statement subtotals is not required.

e. The cumulative effect of the change on retained earnings or other components of equity in the statement of financial position as of the beginning of the first period for which the ASU is effective.

Example 1: Estimating Expected Credit Losses for Trade Receivables Using an Aging Schedule

Source: ASU 2016-13, as modified by the author.

Facts:

1. Entity E manufactures and sells products to a broad range of customers, primarily retail stores.

2. Customers typically are provided with payment terms of 90 days with a 2 percent discount if payments are received within 60 days.

3. Entity E has tracked historical loss information for its trade receivables and compiled the following historical credit loss percentages:

   0.3 percent for receivables that are current old
   8 percent for receivables that are 1–30 days old
   26 percent for receivables that are 31–60 days old
   58 percent for receivables that are 61–90 days old
   82 percent for receivables that are more than 90 days old

4. Entity E believes that this historical loss information is a reasonable basis on which to determine expected credit losses for trade receivables held at the reporting date because:

   a. The current receivables have similar risk characteristics to those used to develop the historical loss information:

      - The composition of the trade receivables at the reporting date is consistent with that used in developing the historical credit-loss percentages

      - Its lending practices have not changed significantly over time.

5. Entity E has determined that the current and reasonable and supportable forecasted economic conditions have improved as compared with the economic conditions included in the historical information.

   a. Entity E has observed that <u>unemployment has decreased as of the current reporting date</u>, and Entity E expects there will be an additional decrease in unemployment over the next year.

Conclusion:

1. E computes the expected credit loss and allowance using a method based on the aging of receivables.

2. E determines the expected credit loss by taking into account:

   - Past events, including historical experience,
   - Current conditions, and
   - Reasonable and supportable forecasts that affect the collectibility of the reported amount.

3. E is not permitted to rely solely on past events to estimate expected credit losses.

4. E decides to adjust the historical loss rates to reflect the effects of those differences in current conditions and forecasted changes due to improvement in employment. In doing so, Entity E estimates the loss rate to decrease by approximately 10 percent in each age bucket. Entity E developed this estimate based on its knowledge of past experience for which there were similar improvements in the economy.

At the reporting date, Entity E develops the following aging schedule to estimate expected credit losses.

Aging	Amortized Cost Basis	Credit Loss Rate	Expected Credit Loss Estimate
Current	$5,984,698	.27%	$16,159
1-30 days	8,272	7.2%	598
31-60 days	2,882	23.4%	674
61-90 days	842	52.2%	440
More than 90 days PAST DUE	1,100	73.8%	812
	$5,997,794		$18,681

E should make an entry to ensure that the allowance for credit losses has a year-end balance of $18,681.

Observation: By recording an allowance for credit losses of $18,681 under the new expected credit loss model, Entity E is likely recording a higher allowance than under the existing "probable" incurred loss model. The allowance includes an amount related to receivable balances that are not past due.

Aging	Amortized Cost Basis	Credit Loss Rate	Expected Credit Loss Estimate	PAST DUE?	PROBABLE LOSS?
Current	$5,984,698	.27%	$16,159	**NO**	**NO**
1-30 days	8,272	7.2%	598	**NO**	**NO**
31-60 days	2,882	23.4%	674	**NO**	**NO**
61-90 days	842	52.2%	440	**NO**	**NO**
More than 90 days **PAST DUE**	1,100	73.8%	812	**YES**	**YES**
	$5,997,794		$18,681		

Example 2: Estimating Expected Credit Losses—Practical Expedient for Collateral-Dependent Financial Assets (from ASU 2016-13)

Source: ASU 2016-13, as modified by the author.

Facts:

1. Bank F provides commercial real estate loans to developers of luxury apartment buildings. Each loan is secured by a respective luxury apartment building.

2. Over the past two years, comparable standalone luxury housing prices have dropped significantly, while luxury apartment communities have experienced an increase in vacancy rates.

3. At the end of 20X7, Bank F reviews its commercial real estate loan to Developer G and observes that Developer G is experiencing financial difficulty as a result of, among other things, decreasing rental rates and increasing vacancy rates in its apartment building.

4. After analyzing Developer G's financial condition and the operating statements for the apartment building, Bank F believes that it is unlikely Developer G will be able to repay the loan at maturity in 20X9.

5. Bank F believes that repayment of the loan is expected to be substantially through the foreclosure and sale (rather than the operation) of the collateral.

6. At December 31, 2017:

   - The amortized cost of the loan is $2,600,000.
   - Fair value of the apartment building is $2,000,000.
   - Estimated costs to sell the building are 5 percent.
   - There is no allowance for credit losses from the previous period.

Conclusion:

1. Bank F considers the asset (apartment building) to be a collateral dependent financial asset as follows:

   a. The repayment is expected to be provided substantially through the operation or sale of the collateral, and

   b. The borrower (Developer G) is experiencing financial difficulty based on Bank F's assessment as of the reporting date

2. Because Bank F considers the asset to be a collateral dependent financial asset, Bank F chooses to use the practical expedient for a collateral dependent financial asset under which:

   - The allowance for credit losses at 12-31-17 is computed using the fair value of the underlying collateral (apartment building fair value), less estimated costs to sell.

   - Estimated costs to sell are deducted from the fair value because repayment or satisfaction of the asset depends on the sale of the collateral.

The allowance for credit losses is computed at 12-31-17 as the difference between the amount F expects to collect on the loan (fair value less costs to sell) and carrying amount of the loan as follows:

Fair value	$2,000,000
Estimated costs to sell (5%)	(100,000)
Net	$1,900,000
Amortized cost	(2,600,000)
Allowance for credit losses- balance 12-31-17	$700,000

Entry: 12-31-17:	dr	cr
Credit losses (income statement)	700,000	
Allowance for credit losses		700,000

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect. To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow.

1. Big J's Credit Service is implementing the changes made by ASU 2016-13 to its financial asset portfolios. In estimating credit losses under the new rules, which of the following information should Big J use:
   a. Past events only
   b. Current events only
   c. Forecasted information only
   d. Past events, current events and forecast information

2. Breaken Legs Financial is a lender of hard money. It has one loan which is past due and it looks like foreclosure is probable. How should the company measure the loan under the new ASU 2016-13 rules:
   a. At carrying amount
   b. At fair value of the collateral
   c. At discounted cash flow
   d. At replacement cost

3. Alicia Jones CPA is implementing ASU 2016-13 for her client's portfolio. Alicia is making an entry to adjust the allowance for credit losses to the calculated amount under the new standards. What is the offsetting account for the entry:
   a. An other income or loss account which is below the line and outside income from continuing operations
   b. An other income or loss account within income from continuing operations
   c. Cost of goods sold
   d. Credit loss expense

4. Which of the following elements are part of the definition of a collateral dependent financial asset:
   a. Is a financial asset
   b. Repayment is not expected of any part of the loan
   c. Borrower is solvent even though the collateral might be weak
   d. Underlying debt has an above market interest rate to mitigate the damage from any collateral deficiency

5. ASU 2016-13 expands the disclosures required for credit losses. Which of the following is *not* a new disclosure required by ASU 2016-13:
   a. A description of how expected loss estimates are developed
   b. A description of accounting policies and methodology to estimate the allowance account
   c. The balance in the allowance for credit losses
   d. A discussion of the changes in the factors that influenced management's current estimate of losses

SUGGESTED SOLUTIONS

1. Big J's Credit Service is implementing the changes made by ASU 2016-13 to its financial asset portfolios. In estimating credit losses under the new rules, which of the following information should Big J use:
   a. Incorrect. The existing incurred losses model uses only past events while the new model expenses that category of information to be used to estimate credit losses.
   b. Incorrect. The new expected credit losses model adds current events to the information to be used but it is not limited to current events, making the answer incorrect.
   c. Incorrect. The new model adds forecasted information where it is reasonable and supportable and if it affects the collectability of the asset. However, ASU 2016-13 does not limit the information to forecasted information, making the answer incorrect.
   d. Correct. ASU 2016-13 expands the information used from the existing past events, to an information based on past and current events and forecast information that is reasonable and supportable. Thus, the answer is correct.

2. Breaken Legs Financial is a lender of hard money. It has one particular loan which is past due and it looks like foreclosure is probable. How should the company measure the loan under the new ASU 2016-13 rules:
   a. Incorrect. ASU 2016-13 does not provide for a loan secured by collateral to be measured at carrying amount. To do so, would not reflect the loss, if any, from any deficiency in collateral.
   b. Correct. ASU 2016-13 requires that the loan be measured at the fair value of the collateral when foreclosure of the collateral is probable.
   c. Incorrect. Although use of a discounted cash flow model is appropriate for most financial assets subject to the ASU 2016-13 rules, when there is collateral and foreclosure of the collateral is probable, fair value is the method required.
   d. Incorrect. Replacement cost is not used to measure the loan and has nothing to do with the amount collectible under the loan.

3. Alicia Jones CPA is implementing ASU 2016-13 for her client's portfolio. Alicia is making an entry to adjust the allowance for credit losses to the calculated amount under the new standards. What is the offsetting account for the entry:
   a. Incorrect. There is no account below the line outside of income from continuing operations making the answer incorrect.
   b. Incorrect. ASU 2016-13 does not provide for recording the adjustment in an other income or loss account within income from continuing operations. Thus, the answer is incorrect.
   c. Incorrect. ASU 2016-13 does not provide for presenting the adjustment in cost of goods sold. In fact, the credit adjustment has nothing to do with cost of goods sold.
   d. Correct. ASU 2016-13 states that an entity shall report in net income as a credit loss expense or a reversal of credit loss expense the amount needed to adjust the allowance for credit losses.

4. Which of the following elements are part of the definition of a collateral dependent financial asset:
   a. Correct. One element is that the asset must be a financial asset in order to qualify as a collateral dependent financial asset.
   b. Incorrect. The rule is that repayment is expected to be provided substantially through the operation or sale of the collateral, making the answer incorrect.

c. Incorrect. One element is that the borrower is experiencing financial difficulty based on the entity's assessment as of the reporting date.
d. Incorrect. ASU 2016-13 does not provide an element that addresses whether the underlying debt has an above market interest rate to mitigate the damage from any collateral deficiency.

5. ASU 2016-13 expands the disclosures required for credit losses: Which of the following is *not* a new disclosure required by ASU 2016-13:
   a. Incorrect. A description of how expected loss estimates are developed is a new disclosure required by ASU 2016-13, making the answer incorrect.
   b. Incorrect. A description of accounting policies and methodology to estimate the allowance account is a new disclosure required by ASU 2016-13.
   c. Correct. Disclosure of the balance in the allowance for credit losses is not a new disclosure and has been required for GAAP previously.
   d. Incorrect. A discussion of the changes in the factors that influenced management's current estimate of losses is a new disclosure. In making this disclosure, ASU 2016-13 requires that the reasons for the changes also be disclosed.

CHAPTER 3:

New Developments in Revenue Recognition

New Developments in Revenue Recognition

Update on Revenue Recognition

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers (Topic 606).*

The ASU makes sweeping changes to the entire revenue recognition model, which are long overdue. The final ASU consists of more than 700 pages encompassing three volumes.

Delay in the effective date of ASU 2014-09:

In August 2015, the FASB issued ASU 2015-14, *Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date,* to extend ASU 2014-09's effective dates by one year.

The revised effective dates are as follows:

- Public entities apply the new standards to annual reporting periods *beginning after December 15, 2017* (calendar year 2018).

- Nonpublic entities apply the new standard to annual reporting periods *beginning after December 15, 2018* (calendar year 2019).

Both public and nonpublic entities are permitted to adopt the new standard early, but not before the original public entity effective date of annual periods beginning after December 15, 2016.

Why the delay?

Per the FASB and financial press, companies surveyed believe they need more time to implement the standard for several reasons:

- There is a lack of resolution on a handful of accounting issues that the FASB is considering amending.

- There is a lack of IT solutions for the new standard as IT vendors wait for the FASB to clarify certain areas before the vendors update the software.

- There are logistical issues caused by the requirement to review existing customer contracts that could go back a decade or more.

- The FASB issued the standard nine months later than expected giving companies less time to implement the standard.

In fact, a PWC-FERF (Financial Executives Research Foundation) survey, entitled, *2014 Revenue Recognition Survey*, was published in November 2014. The survey of 174 respondents noted the following results:

1. Most (54%) respondents were familiar with the standard.

2. Areas of highest impact of time and effect related to the revenue standard include:

    - Disclosures
    - Separating performance obligations
    - Variable consideration
    - Collectibility issues
    - Contract modifications

3. A significant level of effort is being required in reviewing existing contracts.

4. There will be significant system changes required to implement the standard.

5. Changes to internal controls are expected to comply with the new standard.

FASB-IASB Joint Transition Resource Group (TRG) For Revenue Recognition

In June 2014, the FASB and IASB announced the formation of a *Joint Transition Resource Group for Revenue Recognition (TRG).*

The purpose of the TRG is to inform the FASB and IASB of potential revenue standard implementation issues that could arise as companies implement ASU 2014-09.

The TRG is comprised of financial statement preparers, auditors and users from various industries and geographic locations, along with those from both public and private companies. All TRG meetings are co-chaired by the Vice Chairmen of the FASB and IASB.

Changes since the issuance of ASU 2014-09

Since ASU 2014-09 was issued, there have been numerous practice issues that have come forth as companies start to review the implementation and logistical issues surrounding the standard.

These concerns have resulted in the FASB considering several changes and clarifications to the standard, as well as a further delay in the effective date of implementation.

In this section, the author addresses some of the changes that the TRG has focused on along with the FASB and IASB.

The FASB has identified several areas in which it plans to issue amendments and clarifications of ASU 2014-09:

- Licenses of intellectual property

- Identifying performance obligations

- Dealing with contract modifications and completed contracts

- Presenting sales tax gross versus net

- Gross vs. net revenue presentation
- Shipping and handling and whether it is a separate performance obligation
- Capitalization and Amortization of Incremental Costs of Obtaining a Contract
- Sales-Based or Usage-Based Royalty with Minimum Guarantee
- Payments to Customers
- Over Time Revenue Recognition
- Customer Options for Additional Goods and Services
- Evaluating How Control Transfers over Time
- Credit Cards
- Warranties
- Collectibility issues
- Variable Consideration
- Noncash consideration in revenue recognition
- Costs to Obtain a Contract
- Contract Modifications
- Performance Obligations

Changes made to date to ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)* follow:

Changes Made to ASU 2014-09 (ASC 606) Since Issuance		
ASU Issued	**Date Issued**	**What it does**
ASU 2015-14: Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date	August 2015	Defers to effective date of ASU 2014-09 by one year.
ASU 2016-04: Liabilities-Extinguishments of Liabilities (Subtopic 405-20): Recognition of Breakage for Certain Prepaid Stored-Value Products **	March 2016	Addresses derecognition (remove) of a prepaid stored-value product liability and Recognition of breakage revenue.
ASU 2016-08: Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net	March 2016	Addresses criteria used to determine whether an entity is a principal or agent in a specific performance obligation, in recording revenue gross versus net.
ASU 2016-10: Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing	April 2016	Provides further guidance in identifying performance obligations and licensing.
ASU 2016-12: Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients	May 2016	Provides further guidance to ASC 606 dealing with four areas including: 1) collectability, 2) presentation of sales and other taxes, 3) noncash consideration, and 4) contract modifications, completed contracts and technical corrections at transition.
ASU 2016-20: Technical Corrections and Improvements to Topic 606: Revenue from Contracts with Customers	December 2016	Makes numerous miscellaneous technical corrections and modifications to the originally issued ASU 2014-09.
** Not part of the revenue project, but has a direct impact on revenue in ASC 606.		

Some, but not all, of the above changes are discussed in this chapter.

ASU 2016-08: Revenue from Contracts with Customers- Topic 606- Principal versus Agent Considerations (Reporting Revenue Gross versus Net)

Issued: March 2016

Effective date: ASU 2016-08 is effective as follows:

The amendments in ASU 2016-08 affect the guidance in ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*, which is not yet effective.

The effective date and transition requirements for the amendments in this ASU are the same as the effective date and transition requirements of ASU 2014-09. ASC 2015-14, *Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date*, defers the effective date of ASC 2014-09 by one year.

ASU 2014-09 has been deferred by one year and is now effective as follows:

> *For public entities:* Effective for annual reporting periods *beginning after December 15, 2017*, including interim periods within that reporting period. Early application is not permitted.
>
> *All other entities*: (nonpublic entities): Effective for annual reporting periods *beginning after December 15, 2018*, and interim periods within annual periods beginning after December 15, 2018.

A nonpublic entity may elect to apply this guidance earlier, subject to certain restrictions.

I. Objective

The objective of ASU 2016-08 is to clarify when an entity is considered a principal or agent in satisfying a performance obligation. If considered a principal, gross revenue presentation is warranted while an agent is required to present revenue on a net basis.

II. Background

The issue as to whether an entity should record revenue on a gross or net basis has been around for several decades and came to prominence on or around year 2000 during the advent of the Internet boon.

Historically, Internet-based startups have created value driven by revenue growth regardless of profitability. In their infancy, companies such as Amazon, raised significant capital simply by demonstrating their ability to drive revenue even though these companies operated for years without generating a profit. Even Enron took advantage of the gross revenue situation when it grossed up some of its energy contracts on natural gas. Most recently, Snapchat has made an initial public offering despite having no profitability.

This revenue-driven model was highlighted during the period 1998 to 2002 as numerous startup companies occupied the Internet market and competed for startup capital prior to going public.

The goal for a typical Internet startup company has been to:

Step 1: Raise start-up capital,
Step 2: Drive revenue (not profits) to justify value, and
Step 3: Cash out with an Internet IPO.

Revenue growth, not profitability, has been the driver that has attracted investors to Internet-based companies with a captured market share. Again, Amazon is the perfect example of a company that drove revenue, captured market share, and ignored profitability. Facebook also attracted investors to its IPO due to the fact that it had more than 500 million of customers regardless of its profitability.

Presenting revenue gross when it should be net, is nothing more than another form of window dressing in which a company presents itself as a larger scale entity than reality dictates.

Consider the following example:

Assume Company X receives a 15% commission on $10 million of sales. Scenarios A and B illustrate two ways to present revenue:

	Company A Gross	Company B Net
Revenue	$10,000,000	$1,500,000
Cost of goods sold	8,500,000	0
Gross profit on sales	$1,500,000	$1,500,000

In looking at the two presentations in the previous table, which Company is larger, A or B?

Clearly Company A, with its $10 million of revenue, appears to be a larger business as compared with Company B with only $1,500,000 of sales. Which company would you invest in? The reality is that both companies are the same company with the only difference being a gross versus net revenue presentation.

FASB and SEC step in with guidance

To address the gross versus net issue in an ever-growing Internet startup environment, the FASB and SEC provided some guidance.

1. In 1999, the SEC issued SEC Staff Accounting Bulletin (SAB) 101, Revenue Recognition in Financial Statements. In its Question 10 in SAB 101, the SEC addressed the gross versus net presentation for an Internet company.

2. In 2000, the FASB issued EITF 99-19, Reporting Revenue Gross as a Principal versus Net as an Agent. The EITF offered an eight-point test to determine whether an entity was a principal (gross revenue treatment) or an agent (net revenue treatment).

Although there was overlap between the SEC and FASB guidance, there still was confusion as to when, precisely, an entity should follow gross versus net presentation.

From 2000 until 2014, no further substantive guidance was issued by any authoritative body until the FASB addressed the overall revenue model in 2014.

In 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers* (Topic 606) which represented a complete overhaul of the revenue model that had spanned across more than 200 separate pronouncements gathered over decades. ASU 2014-09 introduces a new ASC 606 to encompass most revenue-related GAAP issues going forward. Previous ASC 605 is superseded by ASC 606, once it becomes effective.

Within ASU 2014-09 is guidance on evaluating the principal versus agent (gross versus net) revenue presentation. ASU 20 2016-08 amends that guidance.

For a quick review, the core principle found in ASC 606's revenue model is that:

> *"An entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services."*

To achieve that core principle, ASC 606 offers five steps:

Step 1: Identify the contract(s) with a customer
Step 2: Identify the separate performance obligations in the contract
Step 3: Determine the transaction price
Step 4: Allocate the transaction price to the performance obligations in the Contract, and
Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation.

ASU 2014-09 addresses other revenue-related issues including:

- Costs associated with revenue recognition
- Revenue – returns and allowances
- Gross vs. net presentation
- Long-term contracts
- Disclosures

ASU 2014-09 provides some general rules to follow in determining whether an entity is a principal (gross treatment) or an agent (net treatment).

Paragraph 606-10-55-37 states:

> *"An entity is a <u>principal</u> if the entity <u>controls a promised good or service before the entity transfers</u> the good or service to a customer."*

ASU 2014-09, as originally issued, offers *five indicators* to assist an entity in determining whether the entity controls a specified good or service before it is transferred to a customer. If it controls the good or service, the entity is a principal and the revenue is recorded gross.

The five indicators found in ASU 2014-09 are:

1. Whether the entity is primarily responsible for fulfilling the contract
2. Whether the entity has inventory risk
3. Whether the entity has discretion in establishing prices
4. Whether the entity's consideration is in the form of a commission
5. Whether the entity is exposed to credit (collection) risk

After the issuance of ASU 2014-09, there was a considerable gap in time prior to the implementation date which is currently calendar 2018 for public companies and calendar 2019 for nonpublic entities.

Due to the vast changes that ASU 2014-09 makes to the revenue model, there have been numerous interpretative and implementation issues which still needed to be addressed.

In response, in June 2014, the FASB and the IASB announced the formation of the FASB-IASB Joint Transition Resource Group for Revenue Recognition (TRG) which is currently active.

One of the key objectives of the TRG is to inform the FASB and IASB about potential implementation issues that could arise when organizations implement the new revenue standard.

At the front of issues that required further guidance was the principal versus agent (gross versus net) guidance.

Discussions at TRG meetings informed the FASB about implementation issues related to the guidance on principal versus agent considerations, including:

- Identifying the unit of account at which an entity should assess whether it is a principal or an agent

- Identifying the nature of the good or the service provided to the customer (for example, whether it is a good, a service, or a right to a good or service)

- Applying the control principle to certain types of transactions, such as service arrangements

- Interaction of the control principle with the indicators provided to assist in the principal versus agent evaluation.

To address these issues, the FASB added a project on *principal versus agent* to its technical agenda to improve ASC 606 which resulted in the issuance of ASU 2016-08 in 2016.

ASU 2016-08 clarifies the following:

1. An entity must determine whether it is a principal or an agent for each specified good or service promised to the customer.

2. An entity must determine the nature of each specified good or service (for example, whether it is a good, a service, or a right to a good or service).

3. When another party is involved in providing goods or services to a customer, an entity that is a principal must consider when it obtains control of a good or another asset from the other party, right to a service that will be performed by another party, or a good or service from the other party that it combines with other goods or services.

4. Indicators to consider in determining whether an entity is a principal or agent with respect to a specified good or service have been scaled down from five to three as noted in the following table:

Indicators- Principal versus Agent (Gross versus Net)	
ASU 2014-09 Indicators **[5 TOTAL]**	**Revised Indicators- ASU 2016-08** **[REVISED 3 TOTAL]**
1. Whether the entity is primarily responsible for fulfilling the contract	1. Whether the entity is primarily responsible for fulfilling the contract
2. Whether the entity has inventory risk	2. Whether the entity has inventory risk
3. Whether the entity has discretion in establishing prices	3. Whether the entity has discretion in establishing prices
4. Whether the entity's consideration is in the form of a commission	**Removed**
5. Whether the entity is exposed to credit (collection) risk	**Removed**

Note: ASU 2016-08 is clear to state that the indicators are provided to assist an entity in determining whether it *controls a specified good or service before it is transferred to a customer*. One or more indicators may be more persuasive in the assessment that others. Moreover, the indicators should not be treated as a checklist of criteria to be met in all scenarios.

III. General Rules- Principal versus Agent Considerations- as Amended by ASU 2016-08

ASU 2016-08 specifically addresses the issues of principal versus agency relationships.

1. Principal or agent:

Principal: When an entity that is a principal satisfies a performance obligation, the entity recognizes revenue in the *gross amount of consideration* to which it expects to be entitled in exchange for the specified good or service transferred to the customer.

Agent: When an entity that is an agent satisfies a performance obligation, the entity recognizes revenue in the amount of *any fee or commission* (net) to which it expects to be entitled in exchange for arranging for the specified good or service to be provided by the other party.

2. When another party is involved in providing goods or services to a customer, the entity should determine whether the nature of its promise is a performance obligation:

   - To provide the specified goods or services itself (that is, the entity is a principal), or
   - To arrange for those goods or services to be provided by the other party (that is, the entity is an agent).

   a. An entity is required to determine whether it is a principal or an agent for each specified good or service promised to the customer.

   b. A specified good or service is considered a distinct good or service (or a distinct bundle of goods or services) to be provided to the customer.

   c. If a contract with a customer includes more than one specified good or service, an entity could be a principal for some specified goods or services, and an agent for others.

3. To determine the nature of its promise, the entity should:

   a. Identify the specified goods or services to be provided to the customer (which, for example, could be a right to a good or service to be provided by another party), and

   b. Assess whether it controls each specified good or service before that good or service is transferred to the customer.

Principal:

1. An entity is a principal if it *controls the specified good or service before* that good or service is transferred to a customer.

   a. An entity does not necessarily control a specified good if the entity obtains legal title to that good only momentarily before legal title is transferred to a customer.

   b. An entity that is a principal may satisfy its performance obligation to provide the specified good or service itself or it may engage another party (for example, a subcontractor) to satisfy some or all of the performance obligation on its behalf.

2. When another party is involved in providing goods or services to a customer, an entity that is a principal obtains control of any one of the following:

a. A good or another asset from the other party that it then transfers to the customer.

b. A right to a service to be performed by the other party, which gives the entity the ability to direct that party to provide the service to the customer on the entity's behalf.

c. A good or service from the other party that it then combines with other goods or services in providing the specified good or service to the customer.

Example: If an entity provides a significant service of integrating goods or services provided by another party into the specified good or service for which the customer has contracted, the entity controls the specified good or service before that good or service is transferred to the customer. This is because the entity first obtains control of the inputs to the specified good or service (which include goods or services from other parties) and directs their use to create the combined output that is the specified good or service.

3. When (or as) an entity that is a principal satisfies a performance obligation, the entity recognizes revenue in the gross amount of consideration to which it expects to be entitled in exchange for the specified good or service transferred.

4. Indicators of control- principal

a. ASU 2016-08 offers *three indicators* that supports that an *entity controls the specified good or service before* it is transferred to the customer (and is therefore a principal) include, but are not limited to, the following:[25]

1) The entity is *primarily responsible for fulfilling the contract promise to provide the specified good or service.*

- This indicator typically includes responsibility for the acceptability of the specified good or service (for example, primary responsibility for the good or service meeting customer specifications).

- If the entity is primarily responsible for fulfilling the promise to provide the specified good or service, this may indicate that the other party involved in providing the specified good or service is acting on the entity's behalf.

2) The entity has *inventory risk* before the specified good or service has been transferred to a customer, or after transfer of control to the customer (for example, if the customer has a right of return).

- If the entity obtains, or commits to obtain, the specified good or service before obtaining a contract with a customer, that may indicate that the entity has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the good or service before it is transferred to the customer.

3) The entity has *discretion in establishing the price* for the specified good or service.

[25] ASU 2016-08 reduces the number of indicates from five found in ASU 2014-09 to three in ASU 2016-08.

- Establishing the price that the customer pays for the specified good or service may indicate that the entity has the ability to direct the use of that good or service and obtain substantially all of the remaining benefits.

  Note: The ASU states that in some cases, an agent can have discretion in establishing prices. For example, an agent may have some flexibility in setting prices to generate additional revenue from its service of arranging for goods or services to be provided by other parties to customers.

Note: The indicators in 4(a), (b), and (c) above may be more or less relevant to the assessment of control depending on the nature of the specified good or service and the terms and conditions of the contract. In addition, different indicators may provide more persuasive evidence in different contracts.

If another entity (such as a subcontractor) assumes the entity's performance obligations and contractual rights in the contract so that the entity is no longer obliged to satisfy the performance obligation to transfer the promised good or service to the customer (that is, the entity is no longer acting as the principal), the entity should not recognize revenue for that performance obligation. Instead, the entity should evaluate whether to recognize revenue for satisfying a performance obligation to obtain a contract for the other party (that is, whether the entity is acting as an agent).

5. Indicators removed by ASU 2016-08:

   a. ASU 2016-08 removes two of the five indicators found in ASU 2014-09 as follows:

      - The entity's consideration is not in the form of a commission, and

      - The entity is exposed to credit risk for the amount receivable from the customer

Agent

1. If an entity is not a principal, it is an agent.

2. If an entity is an agent, revenue is recorded net.

3. An entity is an agent if the entity's performance obligation is to arrange for the provision of specified good or service by another party.

   a. An entity that is an agent does not control the specified good or service provided by another party before that good or service is transferred to the customer.

      Thus, an agent generally fails some or all three indicators of control found in ASU 2016-08:

   b. An agent:

      1) *Is not* the entity primarily responsible for fulfilling the contract promise to provide the specified good or service.

2) *Does not* have inventory risk.

3) *Does not* have discretion in establishing the price of the good or service.

c. When (or as) an entity that is an agent satisfies a performance obligation, the entity recognizes revenue in the amount of any fee or commission (net) to which it expects to be entitled in exchange for arranging for it's the specified goods or services to be provided by the other party.

Note: An entity's fee or commission might be the net amount of consideration that the entity retains after paying the other party the consideration received in exchange for the goods or services to be provided by that party.

Must an entity have title to a product to be considered a principal and qualify for gross revenue treatment?

No. ASU 2016-08 does not require that an entity have title to a product for it to be a principal.

The ASU does state that an entity does not necessarily control a specified good if it obtains legal title only *momentarily* before legal title is transferred to a customer. That is, an entity cannot rely on the fact that for a split second it had title, to justify principal (gross) treatment.

ASU 2016-08's model relies on the concept of "control" not "title" to determine whether an entity is a principal.

Ask one question:

> *Does the entity control the specified good or service before that good or service is transferred to a customer?*

If the entity has control before the good or service is transferred to a customer, it is considered a principal and records revenue from the specified good or service gross.

Ownership and title has nothing to do with control. For example, in many instances, an entity might be a distributor (middleman) in a drop-ship arrangement under which the goods are shipped directly from the manufacturer to the customer with no legal title transferred to the middleman/distributor.

Yet, the distributor still might have control before the goods are transfers to the customer based on satisfying some or all of the indicators to support principal treatment, such as:

a. The entity is primarily responsible for fulfilling the contract promise to provide the specified good to the customer even though it does not have title to the good.

b. The entity has inventory risk before the specified good is transferred to the customer, or after transfer of control to the customer (for example, if the customer has a right of return).

c. The entity has discretion in establishing the price that the customer pays for the specified good.

All of these indicators can be satisfied without the entity (distributor) taking any title to the property.

Following is a chart that compares the indicators for principal treatment under ASU 2016-08 versus those found in the 2014-09 revenue model.

Determining if An Entity is a Principal (Revenue Recorded Gross)	
Original ASU 2014-09	**Revised ASU 2016-08**
An entity is a principal if the entity *controls a promised good or service* before the entity transfers the that good or service to a customer.	An entity is a principal if it *controls the specified good or service* before that good or service is transferred to a customer.
Is silent as to the unit of measure used to determine control of a good or service.	Requires that an entity determine whether it is a principal or an agent for *each specified good or service promised* to the customer. A specified good or service is a *distinct good or service* (or a distinct bundle of goods or services) to be provided to the customer. An entity could be an agent for one specified good or service and be a principal for another specified good or service.
Factors indicating an entity controls a good or service: a. The entity is primarily responsible for fulfilling the contract. b. The entity has inventory risk before or after the goods have been ordered by a customer, during shipping, or on return. c. The entity has discretion in establishing prices for the other party's goods or services and, therefore, the benefit that the entity can receive from those goods or services is limited. d. The entity's consideration is not in the form of a commission e. The entity is exposed to credit risk for the amount receivable from the customer	Factors indicating an entity controls a specified good or service: a. The entity is primarily responsible for fulfilling the promise to provide the specified good or service. b. The entity has inventory risk before the specified good or service has been transferred to a customer, or after transfer of control to the customer (such as if the customer has a right of return). c. The entity has discretion in establishing the price for the specified good or service. **Removed** **Removed**

Observation: In its amendments made in ASU 2016-08, the FASB removed two indicators of a principal relationship from the list previously supplied in ASU 2014-09. Those are: 1) the entities consideration in the form of a commission or not a commission, and 2) whether the entity is exposed to credit risk for the amount receivable from the customer.

In its Basis for Conclusions section of ASU 2016-08, the FASB provided some insight as to why it removed two indicators from the list previously supplied in ASU 2014-09.

The FASB noted that although the compensation (commission) indicator might sometimes be helpful in assessing whether an entity is an agent, the FASB concluded that it would not be helpful in assessing whether an entity is a principal. Thus, it was removed.

Additionally, the FASB addressed it decision to remove credit risk from the list of indicators. Per the FASB, the feedback it received was that exposure to credit risk is generally not a helpful indicator when assessing whether an entity controls the specified good or service before being transferred to the customer. According to the FASB, Stakeholders observed that the credit risk indicator in the previous ASU 2014-09 guidance has been problematic from the perspective of entities trying to use exposure to credit risk to override stronger evidence of agency. The FASB concluded that removing the credit risk indicator should reduce some of the complexity in the principal versus agent evaluation because the credit risk indicator typically is less relevant to the evaluation for contracts with customers.

IV. Examples- Application of ASU 2016-08

Following are examples from ASU 2016-08, as modified by the Author.

Example 1: Arranging for the Provision of Goods or Services (Entity Is an Agent)

[From Examples of ASU 2016-08, as modified by the Author]

- An entity, Webco, operates a website that enables customers to purchase goods from a range of suppliers who deliver the goods directly to the customers.
- Under the terms of Webco's contracts with suppliers, when a good is purchased via the website, Webco is entitled to a <u>commission that is equal to 10 percent</u> of the sales price.
- Webco's website facilitates payment between the supplier and the customer at <u>prices that are set by the supplier.</u>
- Webco requires payment from customers before orders are processed, and all orders are nonrefundable.
- Webco has no further obligations to the customer after arranging for the products to be provided to the customer. Webco is not responsible for products being returned which is the responsibility of the various suppliers.

Conclusion:

Webco is an agent and revenue should be recorded net.

To determine whether Webco's performance obligation is to provide the specified goods itself (that is, Webco is a principal) or to arrange for those goods to be provided by the supplier (that is, Webco is an agent), Webco identifies the specified good or service to be provided to the customer and assesses whether it controls that good or service before the good or service is transferred to the customer.

a. The website operated by Webco is a marketplace in which suppliers offer their goods and customers purchase the goods that are offered by the suppliers.

b. Webco observes that the specified goods to be provided to customers that use the website are the goods provided by the suppliers, and no other goods or services are promised to customers by Webco.

c. Webco concludes that it does not control the specified goods before they are transferred to customers that order goods using the website.

d. Webco does not at any time have the ability to direct the use of the goods transferred to customers. For example, it cannot direct the goods to parties other than the customer or prevent the supplier from transferring those goods to the customer. Webco does not control the suppliers' inventory of goods used to fulfill the orders placed by customers using the website.

As part of reaching the conclusion that it is an agent, Webco considers the following *three indicators*.

Webco concludes that these indicators provide further evidence that it does not control the specified goods before they are transferred to the customers.

a. The supplier is primarily responsible for fulfilling the promise to provide the goods to the customer. Webco is neither obliged to provide the goods if the supplier fails to transfer the goods to the customer nor responsible for the acceptability of the goods.

b. Webco does not take inventory risk at any time before or after the goods are transferred to the customer. Webco does not commit to obtain the goods from the supplier before the goods are purchased by the customer and does not accept responsibility for any damaged or returned goods. Webco also has no responsibility for returned goods.

c. Webco does not have discretion in establishing prices for the supplier's goods. The sales price is set by the supplier.

Consequently, Webco concludes that:

- It is an agent and its performance obligation is to arrange for the provision of goods by the supplier.

- When Webco satisfies its promise to arrange for the goods to be provided by the supplier to the customer (which, in this example, is when goods are purchased by the customer), Webco recognizes revenue in the amount of the 10 percent commission to which it is entitled.

Example 2: Promise to Provide Goods or Services (Entity Is a Principal)

- Cleanpro enters into a contract with a customer to provide office maintenance services.
- Cleanpro and the customer define and agree on the scope of the services and negotiate the price.
- Cleanpro is responsible for ensuring that the services are performed in accordance with the terms and conditions in the contract.
- Cleanpro invoices the customer for the agreed-upon price monthly with 10-day payment terms.
- Cleanpro regularly engages third-party service providers to provide office maintenance services to its customers. When Cleanpro obtains a contract from a customer, Cleanpro enters into a contract with one of those service providers, directing the service provider to perform office maintenance services for the customer.
- The payment terms in the contracts with the service providers generally are aligned with the payment terms in Cleanpro 'scontracts with customers. However, Cleanpro is obliged to pay the service provider even if the customer fails to pay.

Conclusion:

Cleanpro is a principal and should record revenue it receives from its customers at the gross amount.

To determine whether Cleanpro is a principal or an agent, Cleanpro identifies the specified good or service to be provided to the customer and *assesses whether it controls that good or service before the good or service is transferred to the customer*.

Cleanpro observes that the specified services to be provided to the customer are the office maintenance services for which the customer contracted and that no other goods or services are promised to the customer.

While Cleanpro obtains a right to office maintenance services from the service provider after entering into the contract with the customer, that right is not transferred to the customer. That is, Cleanpro retains the ability to direct the use of, and obtain substantially all the remaining benefits from, that right. For example, Cleanpro can decide whether to direct the service provider to provide the office maintenance services for that customer, or for another customer, or at its own facilities. The customer does not have a right to direct the service provider to perform services that Cleanpro has not agreed to provide. Therefore, the right to office maintenance services obtained by Cleanpro from the service provider is not the specified good or service in its contract with the customer.

Cleanpro concludes that it controls the specified services before they are provided to the customer. Cleanpro obtains control of a right to office maintenance services after entering into the contract with the customer but before those services are provided to the customer.

The terms of Cleanpro's contract with the service provider give Cleanpro the ability to direct the service provider to provide the specified services on Cleanpro's behalf.

In addition, Cleanpro concludes that the following *three indicators* provide further evidence that the Cleanpro controls the office maintenance services before they are provided to the customer:

a. Cleanpro *is primarily responsible for fulfilling the promise to provide office maintenance services*. Although Cleanpro has hired a service provider to perform the services promised to the customer, it is Cleanpro itself that is responsible for ensuring that the services are performed and are acceptable to the customer (that is, Cleanpro is responsible for fulfilment of the promise in the contract, regardless of whether Cleanpro performs the services itself or engages a third-party service provider to perform the services).

b. *Inventory risk:* Although Cleanpro has the inventory risk, Cleanpro has mitigated its inventory risk with respect to the office maintenance services

- Cleanpro observes that it does not commit itself to obtain the services from the service provider before obtaining the contract with the customer. Nonetheless, Cleanpro concludes that it controls the office maintenance services before they are provided to the customer based on the evidence.

c. Cleanpro *has discretion in setting the price* for the services to the customer.

Thus, Cleanpro is a principal in the transaction and recognizes revenue in the gross amount of consideration to which it is entitled from the customer in exchange for the office maintenance services.

Example 3: Promise to Provide Goods or Services (Entity Is a Principal)

Travelpro negotiates with major airlines to purchase tickets at reduced rates compared with the price of tickets sold directly by the airlines to the public.

Travelpro agrees to buy a specific number of tickets and must pay for those tickets regardless of whether it is able to resell them. The reduced rate paid by Travelpro for each ticket purchased is negotiated and agreed in advance.

Travelpro determines the prices at which the airline tickets will be sold to its customers. Travelpro sells the tickets and collects the consideration from customers when the tickets are purchased.

Travelpro also assists the customers in resolving complaints with the service provided by the airlines. However, each airline is responsible for fulfilling obligations associated with the ticket, including remedies to a customer for dissatisfaction with the service.

Conclusion:

Travelpro is a principal and should record revenue gross.

To determine whether Travelpro's performance obligation is to provide the specified goods or services itself (that is, Travelpro is a principal) or to arrange for those goods or services to be provided by another party (that is, the entity is an agent), Travelpro identifies the specified good or service to be

provided to the customer and assesses *whether it controls that good or service before the good or service is transferred to the customer*.

Travelpro concludes that with each ticket that it commits itself to purchase from the airline, it obtains control of a right to fly on a specified flight (in the form of a ticket) that Travelpro then transfers to one of its customers.

Consequently, Travelpro determines that the specified good or service to be provided to its customer is that right (to a seat on a specific flight) that Travelpro controls. The entity observes that no other goods or services are promised to the customer.

Travelpro controls the right to each flight before it transfers that specified right to one of its customers because the entity has the ability to direct the use of that right by deciding whether to use the ticket to fulfill a contract with a customer and, if so, which contract it will fulfill.

Travelpro also has the ability to obtain the remaining benefits from that right by either reselling the ticket and obtaining all of the proceeds from the sale or, alternatively, using the ticket itself.

The indicators also provide relevant evidence that Travelpro controls each specified right (ticket) before it is transferred to the customer.

a. Travelpro is *primarily responsible for fulfilling the promise* to provide the airline tickets to customers who purchase them.

b. Travelpro has *inventory risk* with respect to the ticket because the entity committed itself to obtain the ticket from the airline before obtaining a contract with a customer to purchase the ticket.

    - Travelpro is obliged to pay the airline for that right regardless of whether it is able to obtain a customer to resell the ticket to or whether it can obtain a favorable price for the ticket.

c. Travelpro *establishes the price* that the customer will pay for the specified ticket.

Thus, Travelpro concludes that it is a principal in the transaction transactions with customers. Travelpro recognizes revenue in the gross amount of consideration to which it is entitled in exchange for the tickets transferred to the customers.

Example 4: Arranging for the Provision of Goods or Services (Entity Is an Agent)

- An entity sells vouchers that entitle customers to future meals at specified restaurants, and the sales price of the voucher provides the customer with a significant discount when compared with the normal selling prices of the meals (for example, a customer pays $100 for a voucher that entitles the customer to a meal at a restaurant that would otherwise cost $200).

- The entity does not purchase or commit itself to purchase vouchers in advance of the sale of a voucher to a customer; instead, it purchases vouchers only as they are requested by the customers. The entity sells the vouchers through its website, and the vouchers are nonrefundable.

- The entity and the restaurants jointly determine the prices at which the vouchers will be sold to customers.

- Under the terms of its contracts with the restaurants, the entity is entitled to 30 percent of the voucher price when it sells the voucher.

- The entity also assists the customers in resolving complaints about the meals and has a buyer satisfaction program. However, the restaurant is responsible for fulfilling obligations associated with the voucher, including remedies to a customer for dissatisfaction with the service.

Conclusion:

Entity is an agent and revenue should be recorded net at 30% of the voucher price.

To determine whether the entity is a principal or an agent, the entity identifies the specified good or service to be provided to the customer and *assesses whether it controls the specified good or service before that good or service is transferred to the customer*.

A customer obtains a voucher for the restaurant that it selects. The entity does not engage the restaurants to provide meals to customers on the entity's behalf. Thus, the entity is not responsible for fulfilling the goods and services. Therefore, the entity observes that the specified good or service to be provided to the customer is the right to a meal (in the form of a voucher) at a specified restaurant or restaurants, which the customer purchases and then can use itself or transfer to another person.

The entity also observes that no other goods or services (other than the vouchers) are promised to the customers.

The entity concludes that it does not control the voucher (right to a meal) at any time. In reaching this conclusion, the entity principally considers the following:

- The vouchers are created only at the time that they are transferred to the customers and, thus, do not exist before that transfer. Therefore, the entity does not at any time have the ability to direct the use of the vouchers or obtain substantially all of the remaining benefits from the vouchers before they are transferred to customers.

In addition:

a. The entity is *not responsible for fulfilling the promise* for the goods and services as that responsibility rests with the individual restaurants.

b. The entity *does not have inventory risk* with respect to the vouchers.

    - The entity neither purchases nor commits itself to purchase vouchers before they are sold to customers. The entity also has no responsibility to accept any returned vouchers.

c. The entity *does not determine the prices* at which the vouchers will be sold to customers. That action is done jointly with the restaurants.

Thus, the entity concludes that it is an agent in the arrangement with respect to the vouchers.

The entity recognizes revenue in the net amount of consideration to which the entity will be entitled in exchange for arranging for the restaurants to provide vouchers to customers for the restaurants' meals, which is the 30 percent commission it is entitled to upon the sale of each voucher.

Example 5: Entity Is a Principal and an Agent in the Same Contract

- An entity sells services to assist its customers in more effectively targeting potential recruits for open job positions.
- The entity performs several services itself, such as interviewing candidates and performing background checks.
- As part of the contract with a customer, the customer agrees to obtain a license to access a third party's database of information on potential recruits. The entity arranges for this license with the third party, but the customer contracts directly with the database provider for the license.
- The entity collects payment on behalf of the third-party database provider as part of its overall invoicing to the customer.
- The database provider sets the price charged to the customer for the license and is responsible for providing technical support and credits to which the customer may be entitled for service down-time or other technical issues.

Conclusion:

Entity is an *agent in the third-party's database service*, and a *principal in the recruitment services*.

To determine whether the entity is a principal or an agent, the entity identifies the specified goods or services to be provided to the customer and assesses whether it controls those goods or services before they are transferred to the customer.

For this Example, it is assumed that the entity concludes that its recruitment services and the database access license are each distinct based on its assessment.

Accordingly, there are two specified goods or services to be provided to the customer—access to the third-party's database and recruitment services.

Database:

The entity concludes that it *does not control the access to the database* before it is provided to the customer.

The entity does not at any time have the ability to direct the use of the license because the customer contracts for the license directly with the database provider.

The entity does not control access to the provider's database—it cannot, for example, grant access to the database to a party other than the customer or prevent the database provider from providing access to the customer.

As part of reaching that conclusion, the entity also considers the indicators. The entity concludes that these indicators provide further evidence that it does not control access to the database before that access is provided to the customer.

a. The entity is not responsible for fulfilling the promise to provide the database access service. The customer contracts for the license directly with the third-party database provider, and the database provider is responsible for the acceptability of the database access (for example, by providing technical support or service credits).

b. The entity does not have inventory risk because it does not purchase or commit to purchase the database access before the customer contracts for database access directly with the database provider.

c. The entity does not have discretion in setting the price for the database access with the customer because the database provider sets that price.

Thus, the entity concludes that it is an agent in relation to the third-party's database service. Thus, those revenues are recorded on a net basis.

Recruitment services:

In contrast, the entity concludes that it is the principal in relation to the recruitment services because the entity performs those services itself and no other party is involved in providing those services to the customer. Thus, the revenue from those services are recorded on a gross basis.

Example 6: Promise to Provide Goods or Services (Entity Is a Principal)

- An entity enters into a contract with a customer for equipment with unique specifications.
- The entity and the customer develop the specifications for the equipment, which the entity communicates to a supplier that the entity contracts with to manufacture the equipment.
- The entity also arranges to have the supplier deliver the equipment directly to the customer.
- Upon delivery of the equipment to the customer, the terms of the contract require the entity to pay the supplier the price agreed to by the entity and the supplier for manufacturing the equipment.
- The entity and the customer negotiate the selling price, and the entity invoices the customer for the agreed-upon price with 30-day payment terms. The entity's profit is based on the difference between the sales price negotiated with the customer and the price charged by the supplier.
- The contract between the entity and the customer requires the customer to seek remedies for defects in the equipment from the supplier under the supplier's warranty. However, the entity is responsible for any corrections to the equipment required resulting from errors in specifications.

Conclusion:

Entity is a principal and should record revenue gross.

To determine whether the entity's performance obligation is to provide the specified goods or services itself (that is, the entity is a principal) or to arrange for those goods or services to be provided by another party (that is, the entity is an agent), the entity identifies the specified good or service to be provided to the customer and assesses whether it controls that good or service before the good or service is transferred to the customer.

The entity concludes that it has promised to provide the customer with specialized equipment designed by the entity.

- Although the entity has subcontracted the manufacturing of the equipment to the supplier, the entity concludes that the design and manufacturing of the equipment are not distinct because they are not separately identifiable (that is, there is a single performance obligation).

- The entity is responsible for the overall management of the contract (for example, by ensuring that the manufacturing service conforms to the specifications) and thus provides a significant service of integrating those items into the combined output—the specialized equipment—for which the customer has contracted. In addition, those activities are highly interrelated.

- If necessary modifications to the specifications are identified as the equipment is manufactured, the entity is responsible for developing and communicating revisions to the supplier and for ensuring that any associated rework required conforms with the revised specifications. Accordingly, the entity identifies the specified good to be provided to the customer as the specialized equipment.

The entity concludes that *it controls the specialized equipment before that equipment is transferred to the customer.*

- The entity provides the significant integration service necessary to produce the specialized equipment and, therefore, controls the specialized equipment before it is transferred to the customer.

- The entity directs the use of the supplier's manufacturing service as an input in creating the combined output that is the specialized equipment.

- In reaching the conclusion that it controls the specialized equipment before that equipment is transferred to the customer, the entity also observes that even though the supplier delivers the specialized equipment to the customer, the supplier has no ability to direct its use (that is, the terms of the contract between the entity and the supplier preclude the supplier from using the specialized equipment for another purpose or directing that equipment to another customer).

- The entity also obtains the remaining benefits from the specialized equipment by being entitled to the consideration in the contract from the customer.

Thus, the entity concludes that it is a principal in the transaction because it controls the good before the good is transferred to the customer.

It is responsible for fulfilling the promise, has inventory risk, and has discretion in establishing prices.

Thus, the entity recognizes revenue in the gross amount of consideration to which it is entitled from the customer in exchange for the specialized equipment.

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.

1. Company L is an Internet startup company. The company wants to attract investors and possibly do an IPO. Which factor is likely to be most important in attracting capital:
   a. Profitability
   b. Revenue
   c. Debt level
   d. Quality of patents

2. The revenue recognition standard has a core principle based on which one of the following triggering events occurring:
   a. A contract being signed
   b. There must be a completion of the earnings process
   c. There must be a transfer of promised goods or services
   d. There must be a certain percentage of transaction completed

3. Dino's Wholesaler sells some goods and also provides certain services. The Company is evaluating how it should record its various revenue on a gross or net basis. In making the determination, the Company should perform the evaluation at what level:
   a. For each specified good or service
   b. For all goods combined, and for all services combined
   c. In the aggregate for all goods and services combined at the entity level
   d. For only goods as the evaluation does not apply to services

4. A principal recognizes revenue on a gross basis when _____:
   a. The principal satisfies the performance obligation
   b. The goods are shipped
   c. The principal receives consideration in full for the product supplied
   d. The transaction is recorded

5. Sharon Stone CPA is reviewing whether her client is a principal or an agent. Which of the following is an indicator that her client is a principal and should record revenue gross:
   a. Company is primarily responsible for fulfilling the contract promise
   b. Company pays for the product
   c. Company does not take responsibility for establishing prices
   d. Company's consideration is in the form of a commission

SUGGESTED SOLUTIONS

1. Company L is an Internet startup company. The company wants to attract investors and possibly do an IPO. Which factor is likely to be most important in attracting capital:
   a. Incorrect. With Internet companies, investors are looking for market share which is not necessarily indicated by profitability.
   b. Correct. Historically, investors in Internet companies have sought companies that have captured market share within a segment. Typically, revenue, not profitability, is a key indicator of market share.
   c. Incorrect. Although debt level may be important, it is not a driving factor from an investor's perspective when the entity is in a high-tech environment. Investors want to know how the company is going to grow and debt is not a factor measuring that growth.
   d. Incorrect. Although quality of patents might be important, it does not necessarily address how a company is capturing market share.

2. The revenue recognition standard has a core principle based on which one of the following triggering events occurring:
   a. Incorrect. A contract signed is not identified as a triggering event under the revenue recognition standard.
   b. Incorrect. The revenue standard does not address whether a completion of the earnings process must be satisfied in order for there to be revenue recognition.
   c. Correct. The core principle of the revenue standard is that an entity shall recognize revenue when the entity satisfies a performance obligation by transferring a promised good or service to a customer.
   d. Incorrect. The revenue standard does not deal with a percentage-of-completion approach to revenue recognition.

3. Dino's Wholesaler sells some goods and also provides certain services. The Company is evaluating how it should record its various revenue on a gross or net basis. In making the determination, the Company should perform the evaluation at what level:
   a. Correct. ASU 2016-08 provides that an entity must determine if it is a principal or agent for each specified good or service promised to a customer.
   b. Incorrect. The ASU does not permit combining all goods, and then combining all services. Instead, each specified good or service is evaluated individually.
   c. Incorrect. Goods and services must be evaluated separately for each item promised to a customer, not at the entity level.
   d. Incorrect. ASU 2016-08 applies to both goods and services making the answer incorrect.

4. A principal recognizes revenue on a gross basis when _____:
   a. Correct. Once the principal satisfies the performance obligation, the entity recognizes revenue.
   b. Incorrect. Although shipping of goods might be satisfaction of a performance obligation, there could be other obligations that are incomplete.
   c. Incorrect. Although payment received is typically considered completion of a transaction, there could be other elements outstanding.
   d. Incorrect. When a transaction is recorded, it has nothing to do with when the performance obligation is satisfied.

5. Sharon Stone CPA is reviewing whether her client is a principal or an agent. Which of the following is an indicator that her client is a principal and should record revenue gross:
   a. Correct. One indicator found in ASU 2016-08 is that the Company is primarily responsible for fulfilling the contract promise. Thus, it is an indicator supporting that the entity is a principal.
   b. Incorrect. The fact that the entity pays for the product does not mean it is a principal. ASU 2016-08 does not list payment of the product as an indicator to consider.
   c. Incorrect. The fact that the entity does not establish prices for the product or service, is an indicator that it is an agent, not a principal.
   d. Incorrect. One indicator removed by ASU 2016-08 is whether an entity's consideration is in the form of a commission. That indicator no longer is found in ASU 21016-08 and, therefore, is not necessarily considered in the assessment of whether an entity is a principal or an agent.

ASU No. 2016-04: Liabilities—Extinguishments of Liabilities (Subtopic 405-20) Recognition of Breakage for Certain Prepaid Stored-Value Products

Issued: March 2016

Effective date: ASU 2016-08 is effective as follows:

Public business entity, non-profit and employee benefit plans: fiscal years beginning after December 15, 2017, and interim periods within those fiscal years.

All others entities, including non-public entities: For financial statements issued for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019.

I. Objective

The objective of ASU 2016-04 is to address the current and potential future differences in practice related to the derecognition (removal) of a prepaid stored-value product liability for breakage.

II. Background

Prepaid stored-value products are products in physical and digital forms with stored monetary values that are issued for the purpose of being commonly accepted as payment for goods or services.

The typical form of a prepaid stored-value product is a prepaid gift card issued by a retail store but such products can consist of prepaid telecommunication cards and traveler's checks.

Recently, use of prepaid gift cards has become more popular as customers seek flexible gift and purchase arrangements, while businesses welcome the upfront cash flow that these products afford them.

When an entity sells a prepaid stored-value product that is redeemable at a merchant, it recognizes a liability for its obligation to provide the customer with the ability to purchase goods or services at that merchant.

At the date of sale of the prepaid store-valued product, the issuer makes the following entry:

Cash	XX	
Liability- prepaid cards		XX

When the customer redeems the prepaid stored-value product, the entity's liability (or part of that liability) to the customer is extinguished with the following entry:

Liability- prepaid cards	XX	
Sales		XX

Dealing with breakage

In a perfect situation, each customer timely redeems his or her prepaid card and the liability is extinguished to zero. Yet, the reality is that a portion of prepaid cards are never redeemed. This portion is referred to as breakage.

Customers fail to redeem prepaid cards for numerous reasons including:

- The cards are lost
- Customers forget to redeem them
- Cards are damaged
- Cards expire

In some cases, a prepaid stored-value product may be unused wholly or partially for an indefinite time period.

Some states require businesses to submit the portion of unredeemed cards as lost property so that the state receives the proceeds from breakage. Other states have no lost property law so that businesses may retain the breakage as sheer profit.

In states that do not require submission of unredeemed card proceeds as lost property, selling prepaid cards is a "can't lose" situation for the merchant or retail store:

a. If the card is redeemed, the business receives upfront working capital followed by a sales and profit from the sale, and

b. If the card is not redeemed, the business receives the entire proceeds are profit from breakage.

Either way, selling prepaid stored-value cards is a lucrative business and one that is expanding.

How to account for breakage

The accounting issues related to prepaid cards involve the accounting for breakage; that is, the portion of the proceeds that are estimated not to be redeemed by the customer.

The question is when and for how much should a portion of the liability be derecognized (removed) to reflect future breakage; that is, the portion of the liability that will never be redeemed by customers.

In terms of guidance on the accounting for breakage, which rules to follow depends on whether the prepaid stored-value product liability is a *financial liability* or a *nonfinancial liability*.

- Some users believe that the prepaid stored-value product liability is a financial liability

- Other entities support the view that a prepaid stored-value product liability is a nonfinancial liability.

A financial liability is defined as:

> *"A contract that imposed on one entity an obligation to do either of the following: a) Deliver cash or another financial instrument to a second entity, or b) Exchange other financial instruments on potentially unfavorable terms with the second entity."*

Even though ASC 405-20, *Liabilities-Extinguishments of Liabilities*, includes general derecognition guidance for both financial liabilities and nonfinancial liabilities, currently, differences exist as to how to account for breakage and recognize the portion of the dollar value of prepaid stored-value products that ultimately is unredeemed (that is, breakage).

To make things more complex, there is specific authoritative guidance on breakage found in ASC 606, *Revenue from Contracts with Customers*. However, financial liabilities are not covered under the scope of ASC 606.

There are *two conflicting issues* related to these prepaid card liabilities and the breakage related thereto:

a. How does an entity account for breakage related to prepaid cards?

b. Are the prepaid card liabilities considered financial or non-financial liabilities?

If the prepaid card is a nonfinancial liability, the guidance in ASC 606, *Revenue from Contracts with Customers*, can be followed. If, instead, it is considered a financial liability, that ASC 606 guidance does not apply and replacement guidance is needed.

What does ASU 2016-04 do?

ASU 2016-04 amends ASC 405-20, *Liabilities- Extinguishments of Liabilities* (Subtopic 405-20).

The goal of ASU 2016-04 is to fix the discrepancies on the scope and accounting for prepaid stored-value product liabilities once and for all as follows:

a. The amendments in ASU 2016-04 apply to all entities that offer certain prepaid stored-value products such as:

    1. Prepaid gift cards
    2. Prepaid telecommunication cards, and
    3. Traveler's checks.

b. The ASU clarifies that liabilities related to the sale of prepaid stored-value products are considered financial liabilities to which the guidance found in ASC 606, Revenue from Contracts with Customers, does not formally apply.

c. The ASU amends ASC 405 to provide a specific exception to its rules that requires that breakage for those liabilities be accounted for using rules similar to those found in ASC 606, even though the guidance in ASC 606 technically does not apply.

d. The new guidance from ASU 2016-04 provides rules to derecognize (remove) a portion of prepaid stored-value product cards liabilities for estimated breakage.

III. Rules: ASU 2016-04 Amendment of ASC 405

ASU 2016-04 makes the following amendments to ASC 405:

1. Prepaid stored-value product liabilities (prepaid gift cards) are *financial liabilities* in that it is likely to be settled and extinguished through payment of cash paid or product provided.

   a. ASU 606, *Revenue from Contracts with Customers*, does have breakage guidance for transactions within its scope. However, financial liabilities are excluded from the ASC 606 scope.

2. General rule for derecognizing (removing) all liabilities- ASC 405

   a. Unless addressed by other guidance, a debtor shall derecognize (remove) a liability if and only if it has been *extinguished*.

3. A liability has been *extinguished* if either of the following conditions is met:

   a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes the following:

      - Delivery of cash
      - Delivery of other financial assets
      - Delivery of goods or services, or
      - Reacquisition by the debtor of its outstanding debt securities

   b. The debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor.

4. Exceptions to the general rule for prepaid stored-value products:

   a. ASC 405 provide an exception to the general rule of derecognition with respect to breakage on prepaid stored-value products (prepaid gift cards).

   b. Prepaid stored-value products are defined as:

      Products in physical and digital forms with stored monetary values that are issued for the purpose of being commonly accepted as payment for goods or services.

   c. Examples of prepaid stored-value products include:

      - Prepaid gift cards issued on a specific payment network and redeemable at network-accepting merchant locations
      - Prepaid telecommunication cards, and
      - Traveler's checks.

   d. Exception to the general rule- breakage: The derecognition guidance does not apply to liabilities related to any of the following:

- *Prepaid stored-value products* (or portions of those products) for which any *breakage* (that is, the portion of the dollar value of prepaid stored-value products that ultimately is not redeemed by product holders for cash or not used to purchase goods and/or services) must be remitted in accordance with unclaimed property laws.

- Prepaid stored-value products that are attached to a segregated bank account like a customer depository account.

- Customer loyalty programs or transactions within the scope of other GAAP.

- Products that only can be redeemed by the product holder for cash (such as, nonrecourse debt, bearer bonds, or trade payables).

e. Breakage rules for prepaid stored-value products- ASC 405:

1) If an entity expects to be entitled to a breakage amount for a liability resulting from the sale of a prepaid stored-value product, the entity shall do the following:

   Derecognize (remove) from the liability the amount related to the expected breakage in proportion to the pattern of rights expected to be exercised by the product holder only to the extent that it is probable that a significant reversal of the recognized breakage amount will not subsequently occur.

2) The revised breakage rules found in ASC 405 follow the guidance for breakage previously issued in ASC 606.

3) If an entity does not expect to be entitled to a breakage amount for prepaid stored-value products, the entity shall derecognize the amount related to breakage when the likelihood of the product holder exercising its remaining rights becomes remote.

   Example: In a first year of business, a retail entity sells prepaid gift cards to customers and has no history of breakage amounts.

   Conclusion: Because there is no history of breakage in its first year, the entity cannot expect to be entitled to any breakage. Thus, it must wait to record derecognize (remove) a portion of the liability for breakage until the likelihood that customers will not use gift cards is remote. That remote threshold might not occur for several years in the future.

4) At the end of each period, an entity shall update the estimated breakage amount to reflect changes in circumstances during the period.

   - Changes to an entity's estimated breakage amount shall be accounted for as a change in accounting estimate.

What if the state in which an entity operates has an unclaimed property law for breakage on prepaid cards?

Many states have unclaimed property laws under which a company must remit to the state that portion of prepaid stored-value products (cards) that is not redeemed (e.g., breakage). ASU 2016-04 specifically states that the breakage rules created by ASU 2016-04 do not apply to prepaid stored-value products (prepaid gift cards) that must be remitted in accordance with unclaimed property laws.

That means that an entity is not permitted to derecognize (remove) a portion of the liability for breakage because the entity will be required to pay that liability portion to the state after a certain period of time.

IV. Disclosure

1. An entity that recognizes a breakage amount shall disclose the methodology used to recognize breakage and significant judgments made in applying the breakage methodology.

V. Effective Date and Transition

The amendments in ASU 2016-04 shall be implemented as follows:

1. A public business entity, 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, and an employee benefit plan that files or furnishes financial statements with or to the Securities and Exchange Commission, shall apply the ASU for financial statements issued for *fiscal years beginning after December 15, 2017*, and interim periods within those fiscal years.

2. All other entities (including nonpublic entities), shall apply the ASU for financial statements issued for *fiscal years beginning after December 15, 2018*, and interim periods within fiscal years beginning after December 15, 2019.

3. Earlier application is permitted, including adoption in an interim period.

4. An entity shall apply the amendments made by ASU 2016-04 by electing to use one of the following two methods:

   a. Retrospectively to each prior period presented in accordance with the guidance on accounting changes in paragraphs ASC 250, *Accounting Changes and Error Corrections*.

   b. Retrospectively by means of a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year in which the ASU is adopted.

5. An entity shall provide the disclosures required in ASC 250, *Accounting Changes and Error Corrections*, in the period the entity adopts the ASU.

VI. Examples- Application of ASU 2016-04

Example 1:

Jimmy Steak House (Jimmy) has been in business for ten years and has been selling gift cards to its customers.

Jimmy retains a history of the percentage of gift cards that are redeemed and the percentage of breakage representing those customers who do not redeem the cards.

Jimmy's state of Massachusetts does not have a requirement that unredeemed card proceeds must be remitted to the state as lost property.

During 20X1, Jimmy sells $100,000 of gift certificates.

Activity in 20X1 follows:

- Customers have redeemed $20,000 of the $100,000 of certificates that were issued in 20X1.
- At the end of 20X1, Jimmy estimates (based on history) that there is $10,000 of estimated breakage and it is probable that there will not be a reversal of the breakage in the future. That is, it is probable that customers will not redeem the certificates for the $10,000 of estimated breakage.

Conclusion:

In 20X1, Jimmy should record the $100,000 as a new liability and should record the $20,000 as a reduction of the liability reflective of the certificates redeemed in 20X1.

As for the breakage, Jimmy has a long history of tracking breakage percentages. It has estimated that out of the $100,000 of new 20X1 certificate sales, $10,000 represents breakage for which it is probable that there will not be a significant reversal (redemption). That is, if the company derecognizes (removes) $10,000 of the liability for breakage, it is probable that customers will not redeem the $10,000 of certificates in the future. That information is based on the company having a strong history of tracking the breakage percentages.

Entries in 20X1:	dr	cr
Cash	100,000	
Liability for gift cards		100,000
To record the issuance of the gift cards.		
Liability for gift cards	20,000	
Revenue		20,000
To record those gift cards that were redeemed by customers in 20X1 related to 20X1 gift card sales.		

	dr	cr
Liability for gift cards	10,000	
Breakage revenue		10,000
To record breakage on gift certificate sales for which it is probable the customers will not redeem the certificates in the future.		

After making the above 20X1 entries, the liability has a balance of $70,000 at December 31, 20X1 as follows:

20X1 liability for new 20X1 certificate sales	$100,000
Redeemed by customers	(20,000)
Estimated breakage	(10,000)
Balance 12-31-X1	$70,000

The $70,000 represents that portion of the $100,000 of sold certificates that the company expects will be redeemed by customers in the future.

Example 2:

Same facts as Example 1 except that Jimmy's Steak House is a new business started in 20X1 for which it has *no history* of percentage breakage on gift cards.

Therefore, it cannot estimate breakage for which it is probable that a significant reversal of the breakage amount will not subsequently occur.

Conclusion:

In 20X1, Jimmy's makes the entries for the $100,000 sale of gift cards and the $20,000 redemption of certificates.

However, Jimmy's cannot make an entry for estimated breakage because it cannot meet the probable threshold. That is, it cannot estimate an amount of breakage for which it is probable that a significant reversal (redemption) will not subsequently occur.

Thus, Jimmy's must follow the rule of ASU 2016-04 which states:

> *"If an entity does not expect to be entitled to a breakage amount for prepaid stored-value products, the entity shall derecognize the amount related to breakage when the likelihood of the product holder exercising its remaining rights becomes remote."*

That means that Jimmy's must wait until future years in which it becomes remote that any remainder liability will be exercised.

Entries in 20X1:	dr	cr
Cash	100,000	
Liability for gift cards		100,000
To record the issuance of the gift cards in 20X1.		
Liability for gift cards	20,000	
Revenue		20,000
To record those gift cards that were redeemed by customers in 20X1 related to 20X1 gift card sales.		

Assume further that in 20X4, $95,000 of the $100,000 of 20X1 certificates have been redeemed and there is a remainder of $5,000 unredeemed.

The company believes that the likelihood of the remainder $5,000 being redeemed is *remote.*

Conclusion:

In 20X4, the company should make the following entry to record the remainder of certificates issued in 20X1 that is breakage.

Entry in 20X4:	dr	cr
Liability for gift cards	5,000	
Breakage revenue		5,000
To record breakage on 20X1 gift certificate sales for which the likelihood of redemption is remote.		

How should one record the discount on the certificates/cards issued?

To entice customers to purchase their prepaid gift cards, many companies offer a purchase price that is a discount off the face value of the prepaid card.

For example, a customer may be able to purchase a $100,000 gift card at a discount price of $75,000.

How should a company record this transaction at inception?

The FASB has not addressed this issue. The author believes that the discount should be recorded as an expense (or contra revenue) at the date of purchase.

Example:

In 20X1, Outback Steak House issues $100,000 of gift cards at a discounted price to its customers of $75,000. That means that customers receive more than they paid for in the certificates.

What should Outback Steak House do with the $25,000 discount that occurs at the time the gift cards are issued?

Entries in 20X1:	dr	Cr
Cash	75,000	
Expense or contract revenue	***25,000***	
Liability for gift cards		100,000
To record the issuance of the gift cards at a discount.		

Conclusion:

The previous entry is non-authoritative as FASB has yet to address the discounts issue. The author suggests that the $25,000 discount be recorded either as an expense or as a contra revenue account similar to a sales discount.

Some commentators believe the discount should be deferred as an asset and matched against future breakage on the $100,000 liability. Such an approach ignores the concept of conservatism which requires that an unrealized loss be recorded at the time of the transaction.

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.

1. The amendments in ASU 2016-04 conclude that a prepaid stored-value product is a (an)_____.
   a. Nonfinancial liability
   b. Deferred revenue
   c. Element of other comprehensive income (OCI)
   d. Financial liability

2. Elana's Clothing Store has issued many gift cards to customers. Which of the following is an example of a prepaid stored-value product:
   a. Traveler's checks
   b. Nonrecourse debt
   c. Bearer bonds
   d. Trade payables

3. Stefano's Italian Restaurant Pizza opens its doors in January 20X1. In 20X1, it sells $100,000 of prepaid stored-value products. It has no history of what percentage of the $100,000 will be breakage. Under the ASU 2016-04 rules, how and when should Stefano's record breakage:
   a. It can record the breakage immediately because it is probable there will not be a significant reversal
   b. When the likelihood of the customer exercising the prepaid products is remote
   c. No breakage can ever be recorded as the business has no history
   d. When it is more likely than not that the breakage will not reverse

SUGGESTED SOLUTIONS

1. The amendments in ASU 2016-04 conclude that a prepaid stored-value product is a (an)_____.
   a. Incorrect. The ASU finally resolved the issue and concluded that a prepaid stored-value product is a financial liability because it is likely to be settled and extinguished through payment of cash or a product provided.
   b. Incorrect. Nothing in ASU 2016-04 permits the funds received from a prepaid stored-value product to be credited to deferred revenue as there is an obligation to repay the obligation either through payment of cash or by giving a product.
   c. Incorrect. Funds received from a customer for a prepaid stored-value product are not part of other comprehensive income (OCI) per the language found in ASU 2016-04. There are a limited number of specifically identified elements that are part of OCI and funds received from a prepaid stored-value product is not one of them.
   d. Correct. The ASU resolves the issue as to whether the prepaid product is a financial liability. The ASU categorizes it as a financial liability which means that it is not within the scope of ASC 606.

2. Elana's Clothing Store has issued many gift cards to customers. Which of the following is an example of a prepaid stored-value product:
   a. Correct. Traveler's checks are one category of prepaid stored-value products because they can be commonly accepted as payment for goods or services.
   b. Incorrect. The term "prepaid stored-value product" excludes any products that only can be redeemed for cash, which is the case with nonrecourse debt.
   c. Incorrect. Bearer bonds are an example of a product that can only be redeemed for cash, which is excluded from the definition of a prepaid stored-value product. A prepaid stored-value product must be accepted for payment for both goods and services.
   d. Incorrect. Trade payables can only be redeemed (paid) in cash which is not the definition of a prepaid stored-value product that is redeemable for cash or goods or services.

3. Stefano's Italian Restaurant opens its doors in January 20X1. In 20X1, it sells $100,000 of prepaid stored-value products. It has no history of what percentage of the $100,000 will be breakage. Under the ASU 2016-04 rules, how and when should Stefano's record breakage:
   a. Incorrect. Because the company is a new business, it is not possible for it to reach a probable threshold in 20X1. Thus, the immediate derecognition for breakage is not possible.
   b. Correct. Because the company is new, it has no history to support any conclusion other than it cannot be expected to be entitled to any breakage amount. Based on that fact, breakage is recorded only when the likelihood of the customer exercising the prepaid products is remote. Reaching the remote threshold is likely to occur in years after the first year of business.
   c. Incorrect. Even though it is a new business, it can ultimately derecognize a portion of the liability for estimated breakage once the likelihood of the customer exercising the prepaid products is remote. That is likely to occur sometime during a future year.
   d. Incorrect. ASU 2016-04 does not use a more likely than not threshold to measure breakage, making the answer incorrect.

ASU 2016-12: Revenue from Contracts with Customers (Topic 606) Narrow-Scope Improvements and Practical Expedients

Issued: May 2016

Effective date: ASU 2016-12 has the same effective date as the underlying guidance found in ASU 2014-09, *Revenue from Contracts with Customers (Topic 606), as amended by* ASU No. 2015-14, *Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date,* defers the effective date of ASU 2014-09.

The revised effective date of ASU 2014-09 is:

> *For public entities:* Effective for annual reporting periods *beginning after December 15, 2017*, including interim periods within that reporting period. Early application is not permitted.
>
> *All other entities*: (nonpublic entities): Effective for annual reporting periods *beginning after December 15, 2018*, and interim periods within annual periods beginning after December 15, 2019.

A nonpublic entity may elect to apply this guidance earlier, subject to certain restrictions.

I. Objective

The objective of ASU 2016-12 is to address certain issues related to revenue recognition including assessing collectibility, presentation of sales taxes, noncash consideration, and completed contracts and contract modifications at transition.

II. Background

On May 28, 2014, the FASB issued ASU 2014-09 and the IASB issued IFRS 15 (collectively, the new revenue guidance). ASU 2014-09 introduces new ASC 606, *Revenue from Contracts with Customers.*

The core principle of the guidance in ASC 606 is that:

> *"An entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services."*

To achieve that core principle, ASC 606 requires an entity to apply the following *five steps*:

1. Identify the contract(s) with a customer.
2. Identify the performance obligations in the contract.
3. Determine the transaction price.
4. Allocate the transaction price to the performance obligations in the contract.
5. Recognize revenue when (or as) the entity satisfies a performance obligation.

In June 2014, the FASB and the IASB announced the formation of the FASB-IASB Joint Transition Resource Group for Revenue Recognition (TRG).

The issues described in ASU 2016-12 were discussed at TRG meetings and include *four subtopics* of the revenue model found in ASU 2014-09:

1. Assessing collectibility
2. Presentation of sales taxes and other similar taxes collected from customers
3. Noncash consideration
4. Contract modifications at transition, completed contracts at transition, and technical correction

The amendments in ASU 2016-12 do not change the core principle of ASC 606. Rather, the amendments affect only the narrow aspects of ASC 606.

III. Changes made by ASU 2016-12

ASU 2016-12 makes changes to four subtopics of ASC 606, originally included in ASU 2014-09:

1. Assessing collectibility
2. Presentation of sales taxes and other similar taxes collected from customers
3. Noncash consideration
4. Contract modifications at transition, completed contracts at transition, and technical correction

Each of these changes is discussed below.

Issue 1: Assessing the Collectibility Criterion (Part of Step 1- Identify the Contract)

Existing language in ASU 2014-09:

Step 1 of the new revenue standard requires an entity to *identify the contract(s) with a customer*.

An entity shall satisfy Step 1 and account for a contract with a customer only when *all of the following five criteria are met*:

a. The parties to the contract have approved the contract (in writing, orally, or in accordance with other customary business practices) and are committed to perform their respective obligations.

b. The entity can identify each party's rights regarding the goods or services to be transferred.

c. The entity can identify the payment terms for the goods or services to be transferred.

d. The contract has commercial substance (that is, the risk, timing, or amount of the entity's future cash flows is expected to change as a result of the contract), and

e. It is <u>probable that the entity will collect</u> (collectibility criterion) the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer.

Changes made by ASU 2016-12:

ASU 2016-12 makes the following changes to ASC 606:

1. It clarifies the objective of the collectibility criterion in paragraph (e) above, is to determine whether a customer has the ability and intention to pay the promised consideration in exchange for the goods or services that will be transferred to the customer.

2. It adds a new criterion to clarify when revenue would be recognized for a contract that fails to meet the criteria in Step 1.

New language added by ASU 2016-12:

1. In evaluating the *<u>collectability criterion</u>*, an entity shall assess the collectability of the consideration promised in a contract *<u>for the goods or services that will be transferred</u>* to the customer, rather than assessing the collectability of the consideration promised in the contract for all of the promised goods or services

2. <u>Assessing collectability</u>

   a. The collectibility criterion requires an entity to *<u>assess whether it is probable</u>* that the entity will collect *<u>substantially all of the consideration</u>* to which it will be entitled in exchange for the goods or services that will be transferred to the customer.

   b. The assessment, which is part of Step 1 (identifying a contract with a customer), is based on whether the customer has the ability and intention to pay the consideration to which the entity will be entitled in exchange for the goods or services that will be transferred to the customer.

   c. In determining whether it is *<u>probable that the entity will collect</u>* substantially all of the consideration to which it will be entitled, the collectibility assessment is partly a forward-looking assessment and requires an entity to use judgment and consider all facts and circumstances including:

      - The entity's customary business practices, and,

      - Its knowledge of the customer

   d. When assessing whether a contract meets the collectibility criterion, an entity should:

- Determine whether the contractual terms and its customary business practices indicate that the entity's exposure to credit risk is less than the entire consideration promised in the contract because the entity has the ability to mitigate its credit risk.

e. Examples of contractual terms or customary business practices that might mitigate the entity's credit risk include the following:

- Payment terms: In some contracts, payment terms limit an entity's exposure to credit risk.

- The ability to stop transferring promised goods or services: An entity may limit its exposure to credit risk if it has the right to stop transferring additional goods or services to a customer in the event that the customer fails to pay consideration when it is due.

f. An entity's ability to repossess an asset transferred to a customer should not be considered for the purpose of assessing the entity's ability to mitigate its exposure to credit risk.

3. When a contract with a customer (Step 1) does not meet the *five criteria* and an entity receives consideration from the customer, the entity shall recognize the consideration received as revenue only when *one or more* of the following events have occurred:

   a. The entity has no remaining obligations to transfer goods or services to the customer, and all, or substantially all, of the consideration promised by the customer has been received by the entity and is nonrefundable.

   b. The contract has been terminated, and the consideration received from the customer is nonrefundable, or

   c. The entity has transferred control of the goods or services to which the consideration that has been received relates, the entity has stopped transferring goods or services to the customer (if applicable) and has no obligation under the contract to transfer additional goods or services, and the consideration received from the customer is nonrefundable. NEW

   Note: ASU 2016-04 adds item (c.) above in bold.

Issue 2: Presentation of Sales Taxes and Other Similar Taxes Collected from Customers (Part of Step 2- Determining the Transaction Price)

Existing language in ASU 2014-09:

Step 2 of the revenue model requires an entity to *determine the transaction price* of a contract. In making the determination, an entity shall consider:

- The terms of the contract, and
- Customary business practices to determine the transaction price.

The *transaction price* is defined to include:

> *"The amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, some sales taxes)."*

Thus, ASC 606 excludes from the transaction price, only taxes collected on behalf of third parties.

Changes made by ASU 2016-12:

ASU 2016-12 makes the following changes to ASC 606:

1. The amendments in ASU 2016-12 permit an entity, as an accounting policy election, to exclude amounts collected from customers for all sales (and other similar) taxes from the transaction price.

   - Thus, the ASU expands the taxes that may be excluded from the transaction price.

New language added by ASU 2016-12:

1. An entity may make an *accounting policy election* to *exclude from the measurement* of the transaction price *all taxes assessed* by a governmental authority that are both:

   a. Imposed on and concurrent with a specific revenue producing transaction, and

   b. Collected by the entity from a customer

   Examples of such taxes that may be excluded under the election consist of:

   - Sales tax
   - Use tax
   - Value-added tax, and
   - Certain excise taxes.

2. Taxes assessed on an entity's total gross receipts or imposed during the inventory procurement process shall be excluded from the scope of the election.

3. An entity that makes this election shall exclude from the transaction price all taxes in the scope of the election and shall comply with the applicable accounting policy guidance, including the disclosure requirements.

Issue 3: Noncash Consideration (Part of Step 2- Determining the Transaction Price):

Existing language in ASU 2014-09:

Step 3 of the new revenue model requires an entity to determine the transaction price of the contract.

a. Some contracts include promises of consideration in a form other than cash (that is, noncash consideration)

b. ASU 2014-09 states that noncash consideration is measured at fair value.

Existing language related to noncash consideration is not clear for two reasons:

a. The language in ASU 2014-9 does not specify the measurement date for noncash consideration.

b. It is unclear how the constraint on variable consideration is applied in circumstances in which the fair value of noncash consideration varies both because of the form of the consideration and for reasons other than the form of consideration.

Change made by ASU 2016-12:

The amendments in ASU 2016-12 specify that:

1. The measurement date for noncash consideration is the contract inception.

2. The variable consideration guidance applies only to variability resulting from reasons other than the form of the consideration.

New language added by ASU 2016-12:

1. The measurement date to be used for noncash consideration is the contract inception.

2. The fair value of the noncash consideration may vary *after contract inception* because of the form of the consideration (for example, a change in the price of a share to which an entity is entitled to receive from a customer).

   a. Changes in the fair value of noncash consideration after contract inception that are due to the form of the consideration are not included in the transaction price.

   b. If the fair value of the noncash consideration promised by a customer varies for reasons other than only the form of the consideration (for example, the exercise price of a share option changes because of the entity's performance), an entity shall apply the guidance on variable consideration found in ASC 606.

   c. If the fair value of the noncash consideration varies because of the form of the consideration and for reasons other than the form of the consideration, an entity shall apply the guidance on variable consideration only to the variability resulting from reasons other than the form of the consideration.

Issue 4: Contract Modifications at Transition, Completed Contracts at Transition, and Technical Correction

ASU 2016-12 makes changes to the language found in ASC 606 related to:

1. Contract Modifications at Transition
2. Completed contracts at Transition
3. Technical Correction

1. Contract Modifications at Transition

Existing language in ASU 2014-09: Contract modifications at transition

Existing language found in ASC 606 includes *two transition methods*:

a. Retrospectively to each prior reporting period presented, and

b. Retrospectively with the cumulative effect of initially applying ASC 606 at the date of initial application.

In applying either method, an entity is required to evaluate contract modifications that occurred before the beginning of the earliest period presented.

Change made by ASU 2016-12: Contract modifications at transition

The amendments in ASU 2016-12 provide a *practical expedient* that:

1. Permits an entity to reflect the aggregate effect of all modifications that occur before the beginning of the earliest period presented when identifying performance obligations, determining the transaction price, and allocating the transaction price to the satisfied and unsatisfied performance obligations.

New language added by ASU 2016-12: Contract modifications at transition

1. For contracts that were modified before the beginning of the earliest reporting period presented, an entity need not retrospectively restate the contract for those contract modifications.

   a. Instead, an entity shall reflect the aggregate effect of all modifications that occur before the beginning of the earliest period presented when:

      - Identifying the satisfied and unsatisfied performance obligations
      - Determining the transaction price, and
      - Allocating the transaction price to the satisfied and unsatisfied performance obligations.

2. Completed Contracts at Transition

Existing language in ASU 2014-09: Completed contracts at transition

ASC 606 offers two *transition methods* including practical expedients related to completed contracts.

a. Retrospectively to each prior reporting period presented, or

b. Retrospectively with the cumulative effect recognized at the date of initial application.

The transition guidance in ASC 606 explains that a completed contract is "a contract for which the entity has transferred all of the goods or services identified in accordance with revenue guidance that is in effect before the date of initial application."

Change made by ASU 2016-12: Completed contracts at transition

The amendments in ASU 2016-12:

a. Clarify that a completed contract for purposes of transition is a contract for which all (or substantially all) of the revenue was recognized under GAAP before the date of initial application.

b. State that the accounting for elements of a contract that do not affect revenue under legacy GAAP are irrelevant to the assessment of whether a contract is complete.

New language added by ASU 2016-12: Completed contracts at transition

For the purposes of the transition guidance:

a. The date of initial application is the start of the reporting period in which an entity first applies the amendments.

b. A completed contract is a contract for which the entity has transferred all of the goods or services identified all (or substantially all) of the revenue was recognized in accordance with guidance that is in effect before the date of initial application.

3. Technical Correction

Existing language in ASU 2014-09: Technical correction

ASC 606 requires that:

1. An entity that retrospectively applies the guidance in ASC 606 to each prior reporting period is required to provide the accounting change disclosures in ASC 250, Accounting Changes and Error Corrections, in the period of adoption.

ASC 250, Accounting Changes and Error Corrections (paragraph 250-10-50-1(b)(2)), requires an entity to disclose current-period financial information in the period of adoption under former GAAP.

Change made by ASU 2016-12: Technical correction

The amendments in ASU 2016-12 clarify that:

1. An entity that retrospectively applies the guidance in ASC 606 to each prior reporting period is not required to disclose the effect of the accounting change for the period of adoption.

2. An entity is still required to disclose the effect of the changes on any prior periods retrospectively adjusted.

New language added by ASU 2016-12: Technical correction

If an entity elects to apply transition retrospectively, the entity shall provide the disclosures required in ASC 250, Accounting Changes and Error Corrections, in the period of adoption, except as follows:

1. An entity need not disclose the effect of the changes on the current period, which otherwise is required by ASC 250, Accounting Changes and Error Corrections.

2. However, an entity shall disclose the effect of the changes on any prior periods that have been retrospectively adjusted.

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.

1. In applying Step 1 of the revenue recognition standard (identify the contract with a customer), which of the following is a criterion that must be met:
   a. The entity has not identified each party's rights, but plans to do so
   b. The entity expects to identify the payment terms
   c. The contract has commercial substance
   d. The parties to the contract are negotiating the final terms of the contract

2. ASU 2016-12 amends ASC 606 with respect to taxes assessed by a governmental authority and an election that can be made. Which of the following is correct with respect to this amendment:
   a. An entity may make an accounting policy election to include all taxes in the transaction price
   b. ASU 2016-12 excludes taxes imposed during the inventory procurement process from the election
   c. Any taxes for which the election is made are included in the transaction price
   d. The election and amendment apply to corporate income taxes

SUGGESTED SOLUTIONS

1. In applying Step 1 of the revenue recognition standard (identify the contract with a customer), which of the following is a criterion that must be met:
   a. Incorrect. One criterion is that the entity can identify each party's rights regarding the goods or services being transferred.
   b. Incorrect. The rules require that the entity actually can identify the payment terms, and not that the entity expects to.
   c. Correct. One criterion is that the contract has commercial substance, such that the risk, timing, or amount of the entity's future cash flows is expected to change as a result of the contract.
   d. Incorrect. The requirement is that the parties to the contract must have approved the contract, not merely negotiating the final terms of the contract.

2. ASU 2016-12 amends ASC 606 with respect to taxes assessed by a governmental authority and an election that can be made. Which of the following is correct with respect to this amendment:
   a. Incorrect. The election is to exclude, not include, taxes in the transaction price.
   b. Correct. Taxes assessed on an entity's total gross receipts or imposed during the inventory procurement process shall be excluded from the scope of the election.
   c. Incorrect. Any taxes for which the election is made are excluded, not included, in the transaction price, making the answer incorrect.
   d. Incorrect. The election and amendment apply to all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific revenue producing transaction and collected by the entity from a customer. Those taxes include sales, use, value added, and some excise taxes, but do not include corporate income taxes which are not collected from the customer.

ASU 2016-10: Revenue from Contracts with Customers (Topic 606) Identifying Performance Obligations and Licensing

Issued: April 2016

Effective date: ASU 2016-10 has the same effective date as the underlying guidance found in ASU 2014-09, *Revenue from Contracts with Customers (Topic 606), as amended by* ASU No. 2015-14, *Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date,* defers the effective date of ASU 2014-09.

The revised effective date of ASU 2014-09 which applies to ASU 2016-10 follows:

> *For public entities:* Effective for annual reporting periods *beginning after December 15, 2017*, including interim periods within that reporting period. Early application is not permitted.
>
> *All other entities*: (nonpublic entities): Effective for annual reporting periods *beginning after December 15, 2018*, and interim periods within annual periods beginning after December 15, 2019.

A nonpublic entity may elect to apply this guidance earlier, subject to certain restrictions.

I. Objective

The objective of ASU 2016-10 is to address certain issues related to revenue recognition including guidance on identifying performance obligations and licensing issues.

II. Background

On May 28, 2014, the FASB issued ASU 2014-09 and the IASB issued IFRS 15 (collectively, the new revenue guidance).

The core principle of the guidance in ASC 606 is that

> *"An entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services."*

To achieve that core principle, an entity should apply the following *five steps*:

1. Identify the contract(s) with a customer.
2. Identify the performance obligations in the contract.
3. Determine the transaction price.
4. Allocate the transaction price to the performance obligations in the contract.
5. Recognize revenue when (or as) the entity satisfies a performance obligation.

In June 2014, the FASB and the IASB announced the formation of the FASB-IASB Joint Transition Resource Group for Revenue Recognition (TRG).

Implementation questions submitted to the TRG and discussions at TRG meetings informed the FASB about a few issues in the guidance on identifying performance obligations and licensing.

Those issues include:

1. Identifying Performance Obligations (Step 2):

    a. Whether it is necessary to assess whether promised goods or services are performance obligations if they are immaterial in the context of the contract

    b. Whether promised goods and services are separately identifiable (that is, distinct within the context of the contract), and

    c. Whether shipping and handling activities are a separate promised service in a contract or are activities part of the fulfillment of an entity's other promises in the contract.

2. Licensing:

    a. Whether the nature of an entity's promise in a licensing arrangement is to:

        - Grant a license to provide a right to access the entity's intellectual property, which is satisfied over time and for which revenue is recognized over time, or

        - Provide a right to use the entity's intellectual property, which is satisfied at a point in time and for which revenue is recognized at a point in time.

    b. When to recognize revenue for sales-based or usage-based royalties promised in exchange for a license of intellectual property

    c. Distinguishing contractual provisions that require an entity to transfer additional licenses to a customer from contractual provisions that define the attributes of a promised license.

The amendments in ASU 2016-10 do not change the core principle of ASC 606. Instead, the ASU clarifies two aspects of ASC 606:

1. Identifying performance obligations (Step 2), and

2. The licensing implementation guidance

III. Amendments Made to ASC 606 by ASU 2016-10

A. Amendments to Identifying Performance Obligations (Step 2):

Background

In applying the new revenue standard, after an entity identifies the contract with a customer (Step 1), the next Step 2 is to identify the performance obligations in a contract.

Existing language found in ASC 606-10-25-14, *Identifying Performance Obligations*, states:

a. At contract inception, an entity shall assess the goods or services promised in a contract with a customer and shall identify as a performance obligation each promise to transfer to the customer either:

- A good or service (or a bundle of goods or services) that is distinct, or
- A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

Changes made by ASU 2016-10:

ASU 2016-10 adds the following language to ASC 606 related to identifying performance obligations:

1. An entity is not required to assess whether promised goods or services are separate performance obligations if *they are immaterial* to the contract with the customer.

   a. If the revenue related to an immaterial performance obligation is recognized before those immaterial goods or services are transferred to the customer, then the related costs to transfer those goods or services shall be accrued.

   b. An entity shall not apply this new immaterial guidance to a customer option to acquire additional goods or services that provides the customer with a material right.

2. If an entity performs *shipping and handling activities* related to a promised good, the following rules apply:

   a. If the shipping and handling activities are performed *before the customer obtains control* of the good, then the following shall apply:

      - The shipping and handling activities are not a separate promised service to the customer.
      - The shipping and handling are part of the activities to fulfill the entity's promise to transfer the good.

   b. If shipping and handling activities are performed *after a customer obtains control* of the good, then the following rules apply:

      1) The shipping and handling activities may be treated as a separate performance obligation, or

      2) The entity *may make an election to account for shipping and handling as part of the activities to fulfill the promise* to transfer the good.

         - The entity shall apply this accounting policy election consistently to similar types of transactions.

- An entity that makes this election required to evaluate whether shipping and handling activities are promised services to its customers.

- If revenue is recognized for the related good before the shipping and handling activities occur, the related costs of those shipping and handling activities shall be accrued.

- An entity that applies this accounting policy election shall comply with the accounting policy disclosure requirements in ASC 235, Notes to Financial Statements (paragraphs 235-10-50-1 through 50-6).

3. Assessing whether promises are separately identifiable:

   a. In assessing whether an entity's promises to transfer goods or services to the customer are *separately identifiable*, the objective is to determine whether the nature of the promise, within the context of the contract, is either:

      - To transfer each of those goods or services individually, or,

      - To transfer a combined item or items to which the promised goods or services are inputs.

   b. Factors that indicate that *two or more promises* to transfer goods or services to a customer *are not separately identifiable* include, but are not limited to, the following:

      - The entity provides a significant service of integrating the goods or services with other goods or services promised in the contract into a bundle of goods or services that represent the combined output or outputs for which the customer has contracted.

      - One or more of the goods or services significantly modifies or customizes, or are significantly modified or customized by, one or more of the other goods or services promised in the contract.

      - The goods or services are highly interdependent or highly interrelated.

B. Amendments to Licensing as part of a Performance Obligation (Step 2):

Background

ASC 606 provides guidance on situations in which a license is part of a performance obligation.

Step 5 of ASC 606 requires an entity to *Recognize Revenue When (or As) the Entity Satisfies a Performance Obligation* as follows:

1. An entity should recognize revenue when (or as) it satisfies a performance obligation by transferring a promised good or service to a customer. A good or service is transferred when (or as) the *customer obtains control* of that good or service.

2. The customer satisfies a performance obligation (customer obtains control) under one of two scenarios:

- Over time, or
- At a point in time

3. An entity is required to assess whether it obtains control over time or at a point in time:

   Over time: For each performance obligation, an entity should first determine whether the entity satisfies the performance obligation *over time by transferring control of a good or service over time*.

   At a point in time: If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied *at a point in time*.

4. Measuring revenue over time:

   a. ASC 606 requires an entity to recognize revenue for a performance obligation satisfied *over time* only if the entity can reasonably measure its progress toward complete satisfaction of the performance obligation.

   b. Methods that can be used to measure an entity's progress toward complete satisfaction of a performance obligation satisfied over time include the following:

      - Output methods
      - Input methods

   c. Output methods: An entity recognizes revenue based on direct measurements of the value to the customer of the goods or services transferred to date relative to the remaining goods or services promised under the contract, and include:

      - Surveys of performance completed to date
      - Appraisals of results achieved
      - Milestones reached, time elapsed, and
      - Units produced or units delivered.

   d. Input methods: An entity recognize revenue based on the entity's efforts or inputs to the satisfaction of a performance obligation, including:

      - Costs incurred
      - Resources consumed
      - Labor hours expended
      - Costs incurred (similar to percentage of completion method)
      - Time elapsed, or
      - Machine hours used, relative to the total expected inputs to the satisfaction of that performance obligation.

Changes made by ASU 2016-10: Licensing

Over time versus at a point in time revenue recognition- licensing revenue

ASU 2016-10 adds language to ASC 606 related to licensing revenue and, in particular, whether licensing revenue should be recognized at a point in time or over time.

1. The amendments focus on the following changes for licensing revenue:

    a. Over time or at a point of time revenue recognition: Whether the nature of an entity's promise in granting a license is:

        - To provide a right to access the entity's intellectual property for which revenue is recognized over time, or

        - To provide a right to use the entity's intellectual property for which revenue is recognized at a point in time.

    b. The scope and applicability of the guidance about when to recognize revenue for sales-based or usage-based royalties promised in exchange for a license of intellectual property.

    c. Distinguishing contractual provisions that require an entity to transfer additional licenses to a customer from contractual provisions that define the attributes of a promised license.

2. Licensing

    a. A license establishes a customer's rights to the intellectual property of an entity. Licenses of intellectual property may include, but are not limited to, licenses of any of the following:

        - Software and technology
        - Motion pictures
        - Franchises
        - Patents, trademarks, and copyrights

    b. ASU 2016-10 adds language to clarify that the category "software and technology" software *excludes* software subject to a hosting arrangement.

3. When a single performance obligation *includes a license (or licenses*) of intellectual property and one or more other goods or services, the entity should consider the following:

    a. The nature of the combined good or service for which the customer has contracted

    b. Whether the license for intellectual property that is part of the single performance obligation provides the customer with a:

        - Right to access, or
        - Right to use

    c. Whether the combined good or service is satisfied over time or at a point in time.

4. Promise to provide customer with right to access the entity's intellectual property:

a. A promise to provide a customer with a *right to access the entity's intellectual property* as a performance obligation is considered satisfied *over time.*

b. An entity should select an appropriate method to measure its progress toward complete satisfaction of that performance obligation to provide access to its intellectual property.

Note: The reason for the "over time" application is because the customer will simultaneously receive and consume the benefit from the entity's performance of providing access to its intellectual property as the performance occurs.

5. Promise to provide a customer with the right to use its intellectual property:

   a. A *promise to provide a customer with the right to use* its intellectual property is satisfied at a *point in time*.

   b. The entity should apply the guidance in ASC 606 to determine the point in time at which the license transfers to the customer.

6. To determine whether the entity's *promise is to provide a right to access its intellectual property* or a *right to use its intellectual property*, the entity should consider the nature of the intellectual property to which the customer will have rights.

   a. There are *two types of intellectual property* identified in ASU 2016-10. Intellectual property is either:

      - Functional intellectual property, or
      - Symbolic intellectual property.

      1) Functional intellectual property:

         - Has significant standalone functionality (for example, the ability to process a transaction, perform a function or task, or be played or aired).

         - Derives a substantial portion of its utility (that is, its ability to provide benefit or value) from its significant standalone functionality.

      2) Symbolic intellectual property:

         - Is not functional intellectual property

         - Does not have significant standalone functionality

           Note: Because symbolic intellectual property does not have significant standalone functionality, substantially all of the utility of symbolic intellectual property is derived from its association with the entity's past or ongoing activities, including its ordinary business activities.

7. A license to symbolic intellectual property:

a. A customer's ability to *derive benefit from a license* to symbolic intellectual property depends on the entity continuing to support or maintain the intellectual property.

b. A license to symbolic intellectual property grants the customer a right to access the entity's intellectual property, which is *satisfied over time* as the entity fulfills its promise to both:

- Grant the customer rights to use and benefit from the entity's intellectual property, and
- Support or maintain the intellectual property.

Note: An entity generally supports or maintains symbolic intellectual property by continuing to undertake those activities from which the utility of the intellectual property is derived and/or refraining from activities or other actions that would significantly degrade the utility of the intellectual property.

8. A license to functional intellectual property:

a. A license to *functional intellectual property* grants a *right to use* the entity's intellectual property as it exists at the *point in time* at which the license is granted *unless* both of the following criteria are met.

1) The functionality of the intellectual property to which the customer has rights is expected to substantively change during the license period as a result of activities of the entity that do not transfer a promised good or service to the customer.

- Additional promised goods or services (for example, intellectual property upgrade rights or rights to use or access additional intellectual property) are not considered in assessing this criterion.

2) The customer is contractually or practically required to use the updated intellectual property resulting from the activities in criterion (8)(a) above.

b. If both of the above criteria in (8)(a)(1) and (2) are met, then the license grants a right to access the entity's intellectual property and it is recognized over time instead of at a point of time.

Exception: If a license to functional intellectual property is a *separate performance obligation* and *does not* meet the *two criteria* in paragraph (8)(a)(1) and (2), it is still satisfied at a point in time.

9. Unless otherwise noted in the amendments to licensing made by ASU 2016-10, revenue cannot be recognized from a license of intellectual property before both:

a. An entity provides (or otherwise makes available) a copy of the intellectual property to the customer, and

b. The beginning of the period during which the customer is able to use and benefit from its right to access or its right to use the intellectual property.

Note: An entity does not recognize revenue before the beginning of the license period even if the entity provides (or otherwise makes available) a copy of the intellectual property before the start of the license period, or the customer has a copy of the intellectual property from another transaction. For example, an entity recognizes revenue from a license renewal no earlier than the beginning of the renewal period.

Sales-based or usage-based royalties

1. General rule:

   a. An entity should recognize revenue for a sales-based or usage-based royalty promised in exchange for a license of intellectual property only when (or as) the later of the following events occurs:

      1) The subsequent sale or usage occurs.

      2) The performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied).

2. The general rule for a sales-based or usage-based royalty applies when the royalty relates only to a license of intellectual property or when a license of intellectual property is the predominant item to which the royalty relates.

   Example: The license of intellectual property may be the predominant item to which the royalty relates when the entity has a reasonable expectation that the customer would ascribe significantly more value to the license than to the other goods or services to which the royalty relates).

   a. When the guidance in this paragraph (2) is met, revenue from a sales-based or usage-based royalty should be recognized wholly in accordance with the general rule.

   b. When the guidance in this paragraph (2) is not met, the guidance on variable consideration applies to the sales-based or usage-based royalty.

Contractual provisions to transfer additional licenses versus contractual provisions that define the attributes f a promised license

1. ASU 2016-10 makes minor changes to ASC 606 with respect to certain contract provisions as follows:

   a. In assessing a license, contractual provisions that explicitly or implicitly require an entity to transfer control of additional goods or services to a customer should be distinguished from contractual provisions that explicitly or implicitly define the attributes of a single promised license.

   b. Attributes of a promised license define the scope of a customer's right to use or right to access the entity's intellectual property and, therefore, do not define whether the entity satisfies its performance obligation at a point in time or over time and do not create an obligation for the entity to transfer any additional rights to use or access its intellectual property.

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.

1. Company Z sells goods to customers. As part of that activity, Z also performs shipping and handling activities related to the promise to provide the goods. Z does its shipping *after it obtains control* of the goods it is selling. Which of the following is correct with respect to an election Z may make in ASU 2016-10 and how the shipping and handling activities should be accounted for under the amendments made by ASU 2016-10:
   a. The shipping and handling are automatically activities to fulfill Z's promise to transfer the goods
   b. Z may make an election to account for the shipping and handling as part of the activities to fulfill the promise to transfer the goods
   c. If Z makes an election, it would still have to evaluate whether shipping and handling activities are promised services to customers
   d. Z must treat the shipping and handling as a separated promised good or service

2. Which of the following is a factor that indicates that *two or more promises* to transfer goods or services to a customer *are not separately identifiable*:
   a. The entity's service is separate and distinct from other goods and services
   b. A good or service significantly modifies another good or service
   c. All goods or services are highly independent
   d. None of the goods or services are highly interrelated

3. Company X obtains revenue by selling a promise to provide its customers with a right to access X's various intellectual property. In terms of recognizing revenue, how does the amendment made by ASU 2016-10 state that X's performance obligation (promise) should be satisfied:
   a. At a point in time
   b. Over time
   c. At the beginning of the contract
   d. Once the revenue is collected

4. The general rule is that revenue cannot be recognized from a license of intellectual property before certain dates or actions are satisfied. One of those dates or actions is:
   a. The date at the end of the period during which the customer is able to use the intellectual property
   b. The date on which the parties agree on a date on which the intellectual property will be supplied to the customer
   c. The date on which a copy of the intellectual property is given to the customer
   d. The date on which the contract is executed

5. The general rule is that an entity recognizes revenue for a sales-based royalty promised when the later of two dates or events occurs, one of which is:
   a. The performance obligation is satisfied
   b. The contract has been executed
   c. The subsequent sale has not yet occurred
   d. The intellectual property on which the royalty is generated is completed

SUGGESTED SOLUTIONS

1. Company Z sells goods to customers. As part of that activity, Z also performs shipping and handling activities related to the promise to provide the goods. Z does its shipping *after it obtains control* of the goods it is selling. Which of the following is correct with respect to an election Z may make in ASU 2016-10 and how the shipping and handling activities should be accounted for under the amendments made by ASU 2016-10:
   a. Incorrect. The shipping and handling are activities to fulfill Z's promise to transfer the goods only if an election is made to do so.
   b. Correct. ASU 2016-10 amends ASC 606 to permit an entity to elect to account for the shipping and handling as activities to fulfill the promise to transfer the goods.
   c. Incorrect. If Z makes an election, it would *not* be required to evaluation whether shipping and handling activities are promised services to customers.
   d. Incorrect. Because there is an election to account for shipping and handling as part of the activity to fulfill the promise to transfer the goods, Z is not required to treat the shipping and handling as a separate promised good or service. If Z does not make the election, the shipping and handling would be considered a separate promise.

2. Which of the following is a factor that indicates that *two or more promises* to transfer goods or services to a customer *are not separately identifiable*:
   a. Incorrect. The entity's service is integrated with other goods and services or bundled into one combined output. Being separate and distinct does not, by itself, support that two or more promises for goods or services are not separately identifiable.
   b. Correct. One factor identified in ASU 2016-10 is where one or more goods or services significantly modifies or customizes another good or service. In such a case, the goods or services are interrelated supporting that they are not separately identifiable.
   c. Incorrect. If the goods or services are highly interdependent, not independent, that would be a factor supporting that they are not separately identifiable.
   d. Incorrect. If the goods or services are interrelated, that is one factor to consider. The fact that none of them are interrelated suggests they are not separately identifiable.

3. Company X obtains revenue by selling a promise to provide its customers with a right to access X's various intellectual property. In terms of recognizing revenue, how does the amendment made by ASU 2016-12 state that X's performance obligation (promise) should be satisfied:
   a. Incorrect. The right to use the intellectual property warrants being satisfied at a point in time. However, the right to access the intellectual property is over time, making the answer incorrect.
   b. Correct. When a promise is to provide a customer with the right to access (rather than use) an entity's intellectual property, the performance obligation is deemed satisfied over time. The reason is because the customer will also receive and consume the benefit from the performance over time through access to the intellectual property.
   c. Incorrect. The revenue rules do not offer the option of satisfying a performance obligation based on the beginning of the contract date.
   d. Incorrect. There is generally no correlation between when a performance obligation is satisfied and the actual collection of the revenue provided that the revenue is collectible.

4. The general rule is that revenue cannot be recognized from a license of intellectual property before certain dates or actions are satisfied. One of those dates or actions is:
   a. In correct. A date at the beginning, not end, of the period during which the customer is able to use the intellectual property is one of the two requirements.
   b. Incorrect. One of the dates is the date on which the entity makes the intellectual property available to the customer, not the date the parties agree on the date.
   c. Correct. One of the dates is the date on which a copy of the intellectual property is given to the customer or made available to the customer.
   d. Incorrect. The date on which the contract is executed has nothing to do with the recognition of revenue and satisfying a performance obligation.

5. The general rule is that an entity recognizes revenue for a sales-based royalty promised when the later of two dates or events occurs, one of which is:
   a. Correct. One of the dates is that the performance obligation to which some or all of the sales-based royalty has been allocated has been satisfied.
   b. Incorrect. Executing a contract is not a date used for recognizing revenue as it has nothing to do with completing the performance obligation.
   c. Incorrect. One event or date is that the subsequent sale has occurred, making the answer incorrect.
   d. Incorrect. It is assumed that the intellectual property on which the royalty is generated is completed as inception. Thus, recognizing revenue is based on a later date.

CHAPTER 4:

Current Developments – Accounting and Financial Reporting

CURRENT DEVELOPMENTS- ACCOUNTING AND FINANCIAL REPORTING

A. Significant GAAP Changes in 2017 and Beyond

Years 2016 and the first part of 2017 have been very active periods at the FASB as several significant statements were issued after years of work and deliberations. Many, but not all, of the new statements were issued under the FASB-IASB joint convergence project. Even though the SEC has not required SEC companies to adopt international standards, the FASB and IASB continue to work on joint projects with the goal to minimize the differences between U.S. GAAP and IFRS.

Following are some of the more significant statements issued in 2016:

FASB Update Issued	What it does
Accounting for Financial Instruments- Recognition and Measurement	In January 2016, the FASB issued ASU 2016-1, *Financial Instruments- Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities,* which requires equity investments to be measured at fair value with the change recorded as income on the income statement.
Leases	In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*, which requires companies to capitalize most leases with a lease term of more than 12 months.
Not-for-Profit Organizations	In August 2016, the FASB issued ASU 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities*, which amends the financial reporting requirements of not-for-profit entities.
Financial Instruments- Credit Losses	In June 2016, the FASB issued ASU 2016-13, *Financial Instruments- Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, which changes the way in which the allowance for credit losses is measured.
Revenue from Contracts with Customers	In 2016, the FASB issued several updates to amend previously issued ASU 2014-09, *Revenue from Contracts with Customers (Topic 606).*

In addition to the amendments made in the previous chart, the FASB issued other accounting standards updates (ASUs) including those related to the presentation of deferred income taxes on the balance sheet, classification of certain transactions on the statement of cash flows, and recognition of breakage on certain prepaid store-valued products. among others.

Following is the status of the FASB's projects as of April 2017:

FASB PROJECT SCHEDULE- AS OF APRIL 2017	
Project	**Status**
FRAMEWORK PROJECTS	
Conceptual Framework: Measurement	Initial deliberations
Conceptual Framework: Presentation	Pending Exposure draft
Disclosure Framework: Board's Decision Process	Pending Exposure draft
RECOGNITION AND MEASUREMENT: BROAD PROJECTS	
Accounting for Financial Instruments: Hedging	Pending Exposure draft
Insurance: Targeted Improvements to the Accounting for Long-Duration	Pending Exposure draft
RECOGNITION AND MEASUREMENT: NARROW PROJECTS	
Accounting for Interest Income Associated with the Purchase of Callable	Pending Exposure draft
Clarifying the Scope of Subtopic 610-20 and Accounting for Partial Sales of Nonfinancial Assets	Final statement- 2017
Clarifying When a Not-for-Profit Entity That Is a General Partner Should Consolidate a For- Profit Limited Partnership (or Similar Entity)	Final statement pending
Collaborative Arrangements: Targeted Improvements	Initial deliberations
Consolidation Reorganization and Targeted Improvements	Initial deliberations
Determining the Customer of the Operation Services in a Service Concession Arrangement (EITF 16-C)	Pending Exposure draft
Liabilities & Equity: Targeted Improvements	Pending Exposure draft
Nonemployee Share-Based Payment Accounting Improvements	Final statement- 2017
Revenue Recognition of Grants and Contracts by Not-for-Profit Entities	Initial deliberations
Scope of Modification Accounting in Topic 718	Pending Exposure draft
Technical Corrections and Improvements	Initial deliberations
PRESENTATION & DISCLOSURE PROJECTS	
Disclosure Framework: Disclosure Review—Defined Benefit Plans	Pending Exposure draft
Disclosure Framework: Disclosure Review—Fair Value Measurement	Pending Exposure draft
Disclosure Framework: Disclosure Review—Income Taxes	Pending Exposure draft
Disclosure Framework: Disclosure Review—Inventory	Pending Exposure draft
Disclosure Framework: Disclosures—Interim Reporting	Pending Exposure draft
Disclosure Framework: Entity's Decision Process	Pending Exposure draft
Disclosures by Business Entities about Government Assistance	Pending Exposure draft
Employee Benefit Plan Master Trust Reporting (EITF 16-B)	Final statement- 2017
Financial Statements of Not-for-Profit Entities (phase 2)	Pending Exposure draft
Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost	Final statement- 2017
Simplifying the Balance Sheet Classification of Debt	Pending Exposure draft
Source: FASB, as modified by author	

In addition to the FASB projects noted in the previous table, the FASB has several research projects pending as follows:

- Accounting for Financial Instruments: Interest Rate Risk Disclosures
- Accounting for Identifiable Intangible Assets in a Business Combination for Public Business Entities and Not-for-Profit Entities
- Accounting for Income Taxes: Presentation of Tax Expense/Benefit
- Distinguishing Liabilities from Equity (including convertible debt)
- Financial Performance Reporting
- Intangible Assets, including research and development
- Inventory and Cost of Sales
- Pensions and Other Postretirement Employee Benefit Plans, and
- Subsequent Accounting for Goodwill for Public Business Entities and Not-for-Profit Entities.

B. FASB Starts Up Financial Performance Reporting Project

The FASB has started its financial statement presentation project which 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.

Previously, 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.*

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

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.

In August 2016, the FASB issued a document entitled, *Agenda Consultation*, in which it addresses some of the issues related to the financial performance project.

The FASB notes that the financial performance project will be focused more on improving the structure and content of the income statement, than other statements. Other topics such as segment reporting, other comprehensive income, and cash flows will be addressed but will not be the main focus of the project.

The FASB has observed that stakeholders have stated the following with respect to existing financial performance:

Stakeholders' comments and suggestions

a. Aside from a total amount for net income, there are limited requirements in current GAAP to organize the income statement into structured categories, and aggregated into only a few primary lines in the income statement.

   Note: In contrast, the statement of cash flows is structured into three categories (operating, investing, and financing), and the balance sheet is structured into groups of assets, liabilities, and equity.

b. There is limited guidance on aggregating performance information on the income statement into lines and the display of revenues, expenses, gains, and losses. Under existing GAAP, entities have considerable latitude in making their presentation decisions.

c. Both the absence of structured information and the limited transparency of infrequent items within net income have contributed to the increased use of non-GAAP performance metrics.

d. Organizing information within net income into categories would improve an investor's understanding of both the individual lines and the information as a whole.

e. Less aggregation of information to show the different sources and characteristics of earnings would provide more decision-useful information.

Categorize the income statement into operating and nonoperating activities

One area of focus for the project on financial performance reporting is whether to further categorize net income into operating and nonoperating activities.

The FASB is evaluating <u>three alternatives</u> for determining which transactions and events are reported within operating and nonoperating activities.

a. Under Alternative A, the FASB would describe, not define, operating activities, and would allow for management to determine its composition through an accounting policy. This approach would provide flexibility for management to categorize items in a way that reflects the circumstances of the entity.

b. Under Alternative B, the FASB would define operating activities with a standardized definition that would be supported with detailed descriptions and examples. This approach would increase comparability because the definition would be standardized.

   Note: Under both Alternative A and B, the FASB would consider nonoperating activities to be the residual category, which would be items that are not part of operating activities.

c. Under Alternative C, the FASB would describe or define the composition of nonoperating activities, and the operating activities category would be the residual earnings category.

Combining or separating earnings components and presenting discrete lines

A second area of focus for the project on financial performance reporting is how to combine or separate performance information in the income statement related to how revenues, expenses, gains, and losses are displayed. To date, the FASB has considered three alternatives.

a. Under Alternative A, the FASB would reexamine and redefine the current definition of infrequency of occurrence to apply a more conventional understanding of this term.

   Note: The objective of this approach would be to display the effects of infrequently occurring transactions and events separately from other performance components.

b. Under Alternative B, there would be a requirement to identify and define a type of earnings component that is termed a remeasurement, which would isolate changes in the carrying amounts of existing assets and liabilities that are recognized in net income (for example, fair value gains and losses).

c. Under Alternative C, functional lines would be disaggregated into natural components. This alternative includes describing the characteristics of both natural and functional lines to separate a functional line into natural components.

The financial performance 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.

1. Which of the following is <u>not</u> 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. Per the sample financial statements, the business section would consist of operating and investing transaction.
   b. Incorrect. The proposal would include a financing section. Per 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 to cash only.**
   d. Incorrect. Cash and short-term investments is not a category recommended by the FASB.

C. 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 2017:

- 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.

2015-2017- 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 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:

    a. U.S. companies would be required to adopt International Financial Reporting Standards (IFRS).

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

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

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

    a. There are certain standards within IFRS that are not acceptable to many U.S. companies such as IFRS's disallowance of the use of LIFO inventories.

    b. Much of IFRS is based on a principles-based system while the U.S. GAAP is generally based on a rules-based system which is more litigation proof.

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

    The following chart summarizes some of the key differences between U.S. GAAP and international standards:

Key Differences- U.S. GAAP and IFRS		
Element	**Treatment under IFRS**	**Treatment under U.S. GAAP**
LIFO inventory	Does not permit use of LIFO	Permits use of LIFO
Impairment of long-lived assets	Uses a one-step approach	Uses a two-step approach
	Permits companies to reverse impairment losses back to the amount of the basis when the reason for the impairment no longer exists	Does not permit a reversal of impairment losses
Property plant and equipment	Permits a company to evaluate its property, plant and equipment if the entire class is revalued	Does not permit such a revaluation
	Requires use of component depreciation in certain cases where the individual components can be separated and there are significant differences in the useful lives of the components	Permits, but does not require, use of component depreciation
Uncertain tax positions	Uncertain tax positions are not specifically addressed by IFRS	The tax benefit of a tax position is recognized only if it is more likely than not that the position will be sustained upon examination
Revenue recognition	IFRS guidance on revenue recognition is limited	Has significant guidance on revenue recognition albeit scattered throughout GAAP
R&D	IFRS permits development costs to be capitalized if certain criteria are met, while research costs must be expensed	Requires R&D costs to be expensed in most cases
Disclosures	More extensive disclosures exist due to principles-based standards	Less extensive disclosures exist due to rules-based standards
Source: Author		

Unless there is divine intervention, the goal of requiring U.S. companies to adopt international accounting standards is over.

D. Proposed Repeal of LIFO

More than a decade ago, when it looked like U.S. companies would be required to adopt international standards, the repeal of LIFO was a target of discussion for two reasons:

1. International accounting standards (IFRS) did not permit use of LIFO while U.S. GAAP does.

2. Congress was targeting use of LIFO for repeal.

Although it now looks like international standards will not be adopted by U.S. companies, the repeal of LIFO is still likely due to tax reform. Let's look at the rules and where LIFO is headed.

LIFO Conformity Requirement- IRC 472

Although some companies argue that they use LIFO to better match revenues and expenses, the reality is that LIFO is used for U.S. GAAP because it saves taxes. In a perfect situation, companies would prefer to use LIFO for tax purposes and use a higher-valued FIFO or average cost for GAAP. In doing so, they could have the best of both situations: a lower taxable income and a higher GAAP income.

However, use of LIFO is one of the few examples of accounting methods where the Internal Revenue Code interferes with GAAP by way of the IRC Section 472's *LIFO Conformity Requirement*.

In general, the LIFO Conformity Requirement states the following:

> *If an entity uses LIFO for income tax purposes, it must also use it for GAAP to clearly reflect its income.*

Over the years, the Section 472 regulations have watered down the LIFO Conformity Requirement to allow the issuance of non-LIFO disclosures and supplementary information. However, the current regulations allow for the following for U. S. GAAP, if LIFO is also used for tax purposes:

- The primary income statement must be presented on LIFO.
- The balance sheet may be presented on a non-LIFO (e.g., FIFO) basis.
- Supplementary information and footnotes can present non-LIFO information such as in the case of presenting an income statement on a FIFO basis as a supplementary schedule.
- Interim income statements may be presented on a non-LIFO basis if the total of the interim statements does not aggregate to one annual non-LIFO statement (e.g., three, quarterly non-LIFO income statements may be presented, but not four quarterly statements).

One study suggested that 36 percent of U.S. companies use LIFO and that a conversion from LIFO for income tax purposes would have the following impact based on a sample of 30 U.S. firms reviewed.

Impact of Converting from LIFO to Non-LIFO:
Sample 30 U.S. Companies

Change in	Average Change Increase (decrease)
Pre-tax income	11.9%
Net income	7.4%
Inventory- % of total assets	46.0%
Stockholder's equity	34.2%
Current ratio	26.2%
Debt/equity ratio	(23.1) %

Source: The Potential Consequences of the Elimination of LIFO as a Part of IFRS Convergence (Georgia Tech College of Management).

In addition, there would be other impacts including the fact that financial covenants, compensation plans, and contracts driven by income would be affected by higher non-LIFO income. Some of the drawbacks of using LIFO, such as the ability to manage earnings through liquidating LIFO layers, would be eliminated through a conversion to a non-LIFO method.

Will Congress repeal or save LIFO?

Although a conversion from LIFO to a non-LIFO inventory method would clearly result in financial statement improvement as shown in the previous table, the negative tax effects would severely impact cash flow. In essence, companies would be required to pay federal and state income taxes on the entire LIFO reserve.

The overall tax revenue pickup from companies converting from LIFO to a non-LIFO basis would be sizeable and welcomed by Congress at a time when the U.S. Treasury desperately seeks additional tax revenue.

Although there are plenty of groups that will challenge the LIFO repeal, the political landscape points toward repeal of LIFO with a 10-year (or 4-year) phase-in (payback) of the LIFO reserve.

The politics of LIFO repeal- Trump tax reform

The impetus for the repeal of LIFO started in 2010 and has continued into 2017. Now, LIFO repeal is likely in light of the Trump administration tax reform slated for 2017. That reform is expected to reduce corporate and business tax rates from 35% to 15% or 20%. As part of the reduction, there are several anticipated changes to inventory accounting that might include:

- Repeal of LIFO, and
- Repeal of lower of cost or market

For tax purposes, both proposals would apply a change in accounting method with a four- or ten-year spread of the LIFO reserve into income. For GAAP purposes, most companies would convert from LIFO to FIFO with a restatement of prior years' financial statements required.

If there is corporate tax reform in 2017, expect that LIFO repeal will be at the top of the list.

The shrinking LIFO reserve: a look at the integrated oil companies

Congress and the White House have anticipated collecting about $81 billion over ten years[27], if there is a repeal of LIFO. A large portion of that recovery was the fact that historically, oil and gas companies have held sizeable LIFO reserves.

Now, it is evident that the amount of tax revenue to be collected from LIFO repeal is likely to be much smaller than anticipated because, in part, to the decline in oil and gas prices.

In April 2016, the Georgia Tech Institute published a study entitled, *The Shrinking LIFO Reserve: A Look at the Integrated Oil Companies.* The purpose of the study was to evaluate the impact that reduced oil prices has had on LIFO reserves of oil companies.

It has been well know that oil companies have held sizeable LIFO reserves (difference between FIFO and LIFO inventories) as oil prices have risen over decades thereby resulting in oil inventories being valued at the older, lower oil costs.

Over the past few years, oil prices have plummeted as well as inventory levels. The result has been that the FIFO-LIFO inventory difference (the LIFO reserve) has declined.

Although this is the case with any company that uses LIFO in a deflationary environment, the impact with oil companies has been extreme as oil prices have dropped so significantly as compared with historical levels.

Georgia study:

The Georgia Institute study is based on a sample of twelve integrated oil companies that use the LIFO method.

Results of the study:

The LIFO reserve has declined significantly.

- For five of the twelve firms, it has declined to zero. Across the entire sample, the LIFO reserve has declined to .91% of total assets at 2015 from 9.44% in 2007.

- Oil companies have generated phantom income by reducing LIFO reserves and sending low cost, current costs to cost of sales. During 2015, the decline in the LIFO reserve had a positive effect on earnings. In an absence of the decline in the LIFO reserve, 2015 pre-tax income would be lower by 15%.

[27] Based on the White House 2016 budget which shows a 10-year tax revenue pickup of $81 billion from repeal.

- While a rise in oil prices will replenish the LIFO reserve once again, at least for now, for the integrated oil companies, the LIFO reserve has been all but eliminated.

- With the reduction or elimination of the LIFO reserves, oil companies have also eliminated the significant future tax bills related to the LIFO reserve.

The Georgia Institute study compared the LIFO reserves of certain oil companies in 2007, at the height of oil prices, with 2015, after oil prices had plummeted. There has been little increase in oil prices from 2015 to 2017.

LIFO Reserves- Selected Oil Companies
2007 vs. 2015 (in millions)

Company	2015 LIFO Reserve	2007 LIFO Reserve
Alon US Energy	$18	$137
Chevron	3,700	7,000
Delek	51	48
Exxon	4,500	25,400
Hollyfrontier	0	199
Imperial Oil	427	1,953
Marathon Petrol	0	4,034
PBF Energy	0	NA
Phillips 66	1,300	6,668
Tesoro	0	1,400
Valero	0	6,200
Western Refining	198	256
Total LIFO Reserve	**$10,194**	**$53,295**
Federal tax on LIFO reserve (35%)	**$3,568**	**$18,653**
Median % of total assets	**.91%**	**9.44%**

Source: The Shrinking LIFO Reserve: A Look at the Integrated Oil Companies, Georgia Tech Financial Analysis Lab

The study shows that the significant tax windfall that existed from the LIFO reserves in 2007 ($18.6 billion), has dwindled down to about $3.5 billion in 2015. That decline has occurred in part due to the decline in oil prices.

Observation: The Whitehouse 2016 budget showed that a repeal of LIFO would yield approximately $81 billion of additional tax revenue over a ten-year period. That number fails to reflect the dramatic decrease in LIFO reserves for oil companies, which make up a significant portion of the overall LIFO reserves held by U.S. companies. If LIFO is repealed due to tax reform in 2017, the amount of tax revenue to be recovered from the oil companies is likely to be de minimis.

E. Big GAAP-Little GAAP

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 substantive 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.

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.

To 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

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.

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 2017, the PCC Members consist of the following:

PCC Members

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

PCC passes its first four statements:

To date, the PCC has issued four statements, with two others pending.

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

Description of new ASU for Nonpublic Entities	What the New ASU Does
ASU No. 2014-02: *Intangibles-Goodwill and Other (Topic 350) Accounting for Goodwill* (Issued January 2014)	Allows a nonpublic (private) entity to amortize goodwill on a *straight-line basis over 10 years*, or less if another shorter life is more appropriate. Goodwill is tested for impairment when a triggering event occurs that indicates that the fair value of the entity may be below the carrying amount. The automatic annual goodwill impairment test is eliminated if a nonpublic entity elects to amortize goodwill under this ASU.
ASU No. 2014-03: *Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps- Simplified Hedge Accounting Approach* (Issued January 2014)	Allows a nonpublic (private) entity to use a simplified hedge accounting approach to account for swaps that are entered into for the purpose of economically converting a variable-rate borrowing into a fixed-rate borrowing. Under this approach, the income statement charge for interest expense is similar to the amount that would result if the entity had directly entered into a fixed-rate borrowing instead of a variable-rate borrowing and a receive-variable, pay-fixed interest swap.
ASU 2014-07: *Consolidation (Topic 810)- Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements* (Issued March 2014)	Allows a nonpublic (private) company lessee to elect an accounting alternative not to consolidate a variable interest entity (VIE) if certain criteria are met.
ASU 2014-18: *Business Combinations (Topic 805): Accounting for Identifiable Intangible Assets in a Business Combination* (Issued December 2014)	Allows a nonpublic (private) company to elect an accounting alternative not to allocate a portion of the acquisition cost of a business combination to certain intangible assets other than goodwill.

Pending PCC statements

As of March 2017, the PCC has two projects on its agenda as follows:

- Definition of a Public Business Entity (phase 2)
- Applying Variable Interest Entity Guidance to Entities under Common Control

Note: The PCC was off to a good start by issuing four statements in 2014. Since that time, the PCC's pace has lagged with only two projects on the docket.

F. Going Concern Assessment by Management- ASU 2014-15

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

With the introduction of ASU 2014-15, now *both management and the auditor* must perform their own separate going-concern assessments of the same entity. This section addresses the interrelation of the new GAAP rules in ASU 2014-15 with the auditing standards found in AU-C 570.

Background- going concern

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

In January 2016, Audit Analytics issued a report in which it performed a 15-year study of going- concern opinions.

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

1. 2014 going-concern report modifications were at the lowest level over a 15-year period.

Year	Going-concern opinions
2014	2,233
2013	2,403
2012	2,565
2011	2,670
2010	2,988
2009	3,102
2008	3,355

Source: Audit Analytics

2. 15.8% of auditor opinions filed in 2014 contained a going-concern report modification. [The highest percentage was 21.1% in 2008, and lowest was 14.2% in 2000.]

3. Going-concern report modifications peaked at 3,355 in 2008 and dropped to 2,233 in 2014.

What percentage of companies recover from a going-concern report modification?

Interestingly, only a small percentage (ranging from 5% to 9%) of companies that had going concern report modifications rebounded with a clean opinion in the subsequent year.

The following table shows the details:

Number of Clean Opinions in Subsequent Year to Going-Concern Report Modification			
Current year	# going concerns prior year	# clean opinions current year, going concern prior year	% recovery in subsequent year
2014	2,403	200	8.3%
2013	2,565	188	7.3%
2012	2,670	144	5.4%
2011	2,988	208	7.0%
2010	3,102	276	8.9%
2009	3,355	265	7.9%
2008	3,309	200	6.0%
2007	2,878	253	8.8%
Source: Audit Analytics, as modified by Author.			

Observation: The previous table illustrates a key point with respect to going-concern report modifications. If such a report modification is made, it can be the "kiss of death" for a company in the subsequent years. A very low percentage of companies subsequently survive a going-concern report modification.

Going Concern- GAAP - FASB issues ASU 2014-15

In August 2014, the FASB issued ASU 2014-15, *Presentation of Financial Statements- Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern.*

ASU 2014-15 provides guidance about *management's responsibility* to evaluate an entity's ability to continue as a going concern and to provide related disclosures. Previously, no such guidance existed in GAAP.

ASU 2014-15 is effective for the annual period *ending after December 15, 2016*, and for annual periods and interim periods thereafter. Early application is permitted.

The objective of ASU 2014-15 is to provide guidance for evaluating whether there is substantial doubt about an entity's ability to continue as a going concern and about related footnote disclosures.

ASU 2014-15 does the following:

a. Requires management to make an evaluation of going concern every reporting period, including interim periods.

b. Defines the term substantial doubt about an entity's ability to continue as a going concern (substantial doubt) as follows:

   "Substantial doubt about an entity's ability to continue as a going concern exists when conditions and events, considered in the aggregate, indicate that it is probable that the entity will be unable to meet its obligations as they become due within one year after the date that the financial statements are issued (or within one year after the date that the financial statements are available to be issued when applicable)."

   Note: The term "probable" is used consistently with its use in Topic 450 on contingencies.

c. Provides that management should consider the mitigating effect of management's plans only to the extent it is probable the plans will be effectively implemented and mitigate the conditions or events giving rise to substantial doubt.

d. Requires certain disclosures when substantial doubt is alleviated as a result of consideration of management's plans

e. Requires an explicit statement in the notes that there is substantial doubt and other disclosures when substantial doubt is not alleviated, and

f. Requires an evaluation for a period of one year after the date that the financial are issued (or available to be issued if a nonpublic entity).

Auditing Standards Board clarifies its going concern rules

After the issuance of ASU 2014-15, there were certain inconsistencies between the GAAP and auditing rules for dealing with going concern.

In particular, the one-year period of time for evaluating going concern was different as follows:

a. AU-C 570 uses a reasonable period of time as the period for which an auditor should evaluate going concern. Generally, in practice, that period is one-year period from the balance sheet date.

b. ASU 2014-15 uses a one-year period from the date the financial statements are issued or available to be issued.

Thus, after the FASB issued ASU 2014-15, the GAAP going concern period extended several months beyond the one-year period used by auditors under AU-C 570.

In response, in January 2015, the Auditing Standards Board (ASB) issued an interpretation to address conflicting issues related to GAAP's recently issues, ASU 2014-15, *Presentation of Financial Statements- Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern* and, going concern rules found in AU-C 570.

The purpose of this audit interpretation is to clarify how AU-C 570's requirements for an auditor addressing going concern interrelate with the new GAAP rules found in ASU 2014-15.

The auditing interpretation brings the auditing rules for dealing with going concern in parity with the new GAAP rules found in ASU 2014-15.

The auditing interpretation states the following:

1. When an applicable financial reporting framework (such as GAAP) includes a definition of *substantial doubt* about an entity's ability to continue as a going concern, that definition would be used by the auditor when applying AU-C section 570.

   For example, if an entity is required to comply with, or has elected to adopt, ASU 2014-15, the definition of substantial doubt about an entity's ability to continue as a going concern found in GAAP would be used by the auditor.

2. When the applicable financial reporting framework (such as GAAP) requires management to evaluate whether there are conditions and events that raise substantial doubt for a period of time *greater than one year* from the date of the financial statements, the auditor's assessment of management's *going concern evaluation would be for the same period of time as required by the applicable financial reporting framework* (such as GAAP).

   For example, if an entity is required to comply with, or has elected to adopt, ASU 2014-15, the auditor's assessment of management's going concern evaluation would need to be for the *same period of time as required by ASU 2014-15* (that is, *one year after the date that the financial statements are issued or available to be issued*).

3. When the applicable financial reporting framework (such as GAAP) provides disclosure requirements related to management's evaluation of substantial doubt, the auditor's assessment of the financial statement effects under AU-C section 570 would be based on the disclosure requirements of the applicable financial reporting framework (such as GAAP).

Observation: The auditing interpretation essentially states that in evaluating going concern, an auditor should follow the same rules found in GAAP with respect to the period of time to which the evaluation should be applied. That period of time is *one year from the date the financial statements are issued or available to be issued (if a nonpublic entity).* Thus, the period of time that has been used for auditors previously (one year from the balance sheet date) is extended to be one year from the date the financial statements are either issued (public entities) or available to be issued (nonpublic entities). This change adds a few months to the going concern assessment period for an auditor. It also means that it is important that the auditor conclude his or her audit and ensure that the financial statements are issued so that the one-year period commences. The later the financial statements are issued, the later the one- year going-concern period is extended.

Going concern in a review engagement

In connection with a review engagement, Paragraph .65 of AR-C 90, SSARS No. 21 states:

> "The accountant should consider whether, during the performance of review procedures, evidence or information came to the accountant's attention indicating that *there could be an uncertainty* about an entity's ability to continue as going concern for a *reasonable period of time."*

SSARS No. 21 defines a *reasonable period of time* to be:

> *"the same period of time required of management to assess going concern when specified by the applicable financial reporting framework."*

a. For a GAAP framework, the reasonable period of time is *one year from the date the financial statements are available to be issued* (one year from the review report date).

   Note: Under SSARS No. 21, for a compilation or review engagement on GAAP financial statements, the accountant should consider whether an uncertainty exists using the same one-year window that GAAP uses under ASU 2014-15.

   That window for a nonpublic entity is *one-year from the date the financial statements are available to be issued.*

b. For a non-GAAP framework (such as tax basis), if that non-GAAP framework *does not specify* a period of time for management's assessment, a reasonable period of time is *one year from the date of the financial statements being reviewed* (which is one year from the balance sheet date).

   The result of the previous analysis is that the one-year going concern assessment period is now the same among GAAP, audit and review engagements.

   That one-year period is *one year from the date the financial statements are issued (available to be issued for nonpublic entities*).

G. Sustainability Standards Is a Hot Issue

If keeping up with GAAP standards is not difficult enough, now there is a new set of standards that deal with "sustainable" accounting standards.

In 2011, the *Sustainability Accounting Standards Board (SASB)* was created with a goal to develop sustainability accounting standards that would "guide" SEC companies in disclosing material factors that the SEC requires companies to address in their filings.

According to the SASB, the Board is a non-profit organization funded by several private foundations. Some of its supporters include:

- Bloomberg Philanthropies
- Kresge Foundation
- Rockefeller Foundation
- FB Heron

The SASB notes the following based on information published on its website (www.sasb.org):

- Through the first half of 2017, 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[28], 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.

[28] Regulation S-X deals with the form, content and requirements of financial statements issued by public companies.

***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.

LEGAL Q&A (SASB):

Are companies required to disclose material sustainability information under current regulations, rules, or case law?

Corporations subject to SEC filing requirements must disclose material information in their SEC filings, such as the Form 10-K. Several rules and regulations, including Regulation S-K and the Sarbanes-Oxley Act, arguably require the disclosure of *material sustainability information* on Form 10-K and other periodic SEC filings in some circumstances (e.g., as discussed in the SEC Guidance on Disclosures Regarding Climate Change[8] and the SEC's Disclosure Guidance on Cybersecurity).

Securities Act Rule 408 and Exchange Act Rule 12b-20 require a registrant to disclose, in addition to the information expressly required by line-item requirements, "*such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading.*" For example, if a pharmaceutical company states that its continued success depends on maintaining a strong reputation for safety, then the company should consider disclosing information regarding Drug Safety and Side Effects, Safety of Clinical Trial Participants, and Counterfeit Drugs, all of which are SASB disclosure topics in the Pharmaceutical industry. Making the disclosures about Drug Safety and Side Effects, Safety of Clinical Trial Participants, and Counterfeit Drugs can help the company satisfy Rule 12b-20. Depending on the company's performance on the SASB disclosure topics, shareholders could allege that the disclosure about reputation for safety, by itself, is materially misleading. Further, the SEC explains that a company's disclosure controls and procedures should not be limited to disclosure specifically required, but should also ensure timely collection and evaluation of "information potentially subject to [required] disclosure," "information that is relevant to an assessment of the need to disclose developments and risks that pertain to the [company's] businesses," and "information that must be evaluated in the context of the disclosure requirement of Exchange Act Rule 12b-20.

Source: SASB Legal Q&A

Following is an excerpt from the SASB Sustainability Accounting Standard related to the Containers & Packaging industry.

SUSTAINABILITY ACCOUNTING STANDARD
RESOURCE TRANSFORMATION SECTOR
CONTAINERS & PACKAGING
Sustainability Accounting Standard

1. Industry-Level Sustainability Disclosure Topics

For the Containers & Packaging industry, SASB has identified the following sustainability disclosure topics:

- Greenhouse Gas Emissions
- Air Quality
- Energy Management
- Water Management
- Waste Management
- Product Safety
- Product Lifecycle Management
- Materials Sourcing

Guidance on Accounting for Material Sustainability Topics

For each sustainability topic included in the *Containers & Packaging industry* Sustainability Accounting Standard, SASB identifies accounting metrics.

SASB recommends that each company consider using these sustainability accounting metrics when preparing disclosures on the sustainability topics identified herein;

As appropriate—and consistent with Rule 12b-206—when disclosing a sustainability topic identified by this Standard, companies should consider including a narrative description of any material factors necessary to ensure completeness, accuracy, and comparability of the data reported.

Where not addressed by the specific accounting metrics, but relevant, the registrant should discuss the following, related to the topic:

- The registrant's **strategic approach** to managing performance on material sustainability issues;
- The registrant's **relative performance** with respect to its peers;
- The **degree of control** the registrant has;
- Any **measures the registrant has undertaken** or **plans to undertake** to improve performance; and
- Data for the registrant's **last three completed fiscal years** (when available).

SASB recommends that registrants use SASB Standards specific to their primary industry as identified in the Sustainable Industry Classification System (SICS™). If a registrant generates significant revenue from multiple industries, SASB recommends that it also consider sustainability topics that SASB has identified for those industries and disclose the associated SASB accounting metrics.

In disclosing to SASB Standards, it is expected that registrants disclose with the same level of rigor, accuracy, and responsibility as they apply to all other information contained in their SEC filings.

SEC created the impetus for sustainability disclosures

The SASB could not exist unless the SEC gave its sustainability (climate change) agenda credibility.

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.

2016 SEC Release- Business and Financial Disclosure Required by Regulation S-K

Once again, the SEC provided support for the SASB's sustainability-climate change agenda with its April 2016 issuance of a concept release[29] addressing the adequacy of disclosures by SEC companies. Although the public comment period has expired, the SEC has not finalized the concept release as of early 2017.

According to the concept release:

1. The Commission seeks public comment on modernizing certain business and financial disclosure requirements in Regulation S-K, which serve as the foundation for the business and financial disclosure in registrants' periodic reports.

2. As part of the concept release, the SEC has sought public comment as to whether additional disclosure regarding climate change and sustainability should be required in Regulation S-K.

SASB comments on 2016 SEC proposal

On July 1, 2016, the SASB continued its effort to put pressure on the SEC to require more disclosures about sustainability.

In a letter to the SEC in response to the SEC's concept release, the SASB noted the following:

1. **Today's reasonable investors use sustainability disclosures.** There has been an enormous increase in investor interest in sustainability related information since the SEC last evaluated the requirements on disclosure of sustainability-related information. In a 2015 CFA Institute survey, 73 percent of institutional investors indicated that they take environmental, social and governance (ESG) issues into account in their investment analysis and decisions, to help manage investment risks.

2. **While Regulation S-K already requires disclosure of material sustainability information, the resulting disclosure is insufficient.** More than 40 percent of all 10-K disclosure on sustainability topics consists of boilerplate language. This preponderance of vague language does not help investors to understand or price risk or to evaluate performance on the topics disclosed.

3. **Line-item disclosure requirements are not appropriate for sustainability issues.** Sustainability issues are not material for all companies, and when they are material, they manifest in unique ways and require industry-specific metrics. Requiring generally applicable line item disclosures would result in additional corporate reporting burden and a large volume of information that is immaterial to investors.

[29] SECURITIES AND EXCHANGE COMMISSION 17 CFR Parts 210, 229, 230, 232, 239, 240 and 249 Release No. 33-10064; 34-77599; File No. S7-06-16 RIN 3235-AL78 BUSINESS AND FINANCIAL DISCLOSURE REQUIRED BY REGULATION S-K

4. **To evaluate sustainability performance, an industry lens is needed.** Sustainability issues impact financial performance in specific ways that vary by topic and industry. As such, investors need guidance on which sustainability issues are material to which industries, and they need industry-specific metrics by which to evaluate and compare performance in the context of industry characteristics and value drivers.

5. **Effective sustainability disclosure requires a market standard.** A market standard for the industry-specific disclosure of sustainability related information would provide a market-informed process that allows for future evolution of investor needs and issuers' business models more efficiently than governmentally-mandated, universal line-item disclosure.

6. **The Commission should acknowledge SASB standards as an acceptable disclosure framework for use by companies preparing their SEC filings.** SASB, through extensive research, analysis, and due process, issues standards for 79 industries, consistent with the definition of "materiality" under the federal securities laws. SASB standards enable companies to make better disclosures on material sustainability-related information to investors consistent with SEC requirements, without the need for rulemaking. SASB standards are designed to be cost-effective for issuers and decision-useful for analysts and investors, providing the ability to compare and benchmark performance, which is essential for informing investment decisions.

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	
SEC	**GAAP**
SEC Regulation S-K requires disclosure of: *Risk factors (Item 503)*: Requires disclosure of the most *significant factors* that make an investment in the registrant speculative or risky.	*ASC 275, Risks and Uncertainties (formerly SOP 94-6) requires disclosure of:* *Current Vulnerability Due to Certain Concentrations:* Requires disclosure of the concentrations if, based on information known to management before the financial statements are issued or are available to be issued, and all of the following criteria are met: • The concentration exists at the date of the financial statements. • The concentration makes the entity vulnerable to the risk of a ***near-term severe impact (within one year).*** • It is at least *reasonably possible* that the events that could cause the severe impact will occur in the near term.

SEC puts pressure on SEC companies to expand climate change/risk disclosures:

In looking at the GAAP and SEC disclosures related to climate issues, the rules that push companies to expand climate change/risk disclosures are found within the SEC rules, not the GAAP rules.

Recapping, Regulation S-K requires companies to disclose environmental issues as they relate to:

a. Description of business (Item 101)
b. Legal proceedings (Item 103)
c. Risk factors (Item 503)
d. Management Discussion and Analysis (Item 303)

Notice that the author highlighted "risk factors" because this is the section of the Regulation S-K rules that the SASB and SEC are using the force companies to expand their environmental and climate risk disclosures.

What is the future of climate change (sustainability) disclosures?

SEC companies continue to be under pressure from environmental groups and the SEC to expand their disclosures of the potential risks associated with climate change and sustainability. Expansion of disclosures related to climate change/sustainability is just a symptom of a much larger challenge. In some instances, companies are being sued for not having effective climate change/sustainability disclosures.

Although the FASB does not have a specific project in the works to enhance disclosures 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 requirements do not encompass risks and uncertainties that might be associated with any of the following:

- Management or key personnel
- Proposed changes in government regulations
- Proposed changes in accounting principles
- Deficiencies in the internal control structure
- The possible effects of acts of God, war, or sudden catastrophes.

Out of the four disclosures required for risks and uncertainties, the only one that could require a nonpublic entity to make general climate change disclosures would be the disclosure about the "*current vulnerability due to certain concentrations.*"

Current vulnerability due to certain concentrations disclosure and climate/sustainability risk

ASC 275 states that the vulnerability from concentrations arises because an entity is exposed to risk of loss greater than it would have had it mitigated its risk through diversification.

Financial statements shall disclose the concentrations if, based on information known to management before the financial statements are issued or are available to be issued, all of the following criteria are met:

1. The concentration exists at the date of the financial statements.

2. The concentration makes the entity vulnerable to the risk of a *near-term severe impact*.

3. It is at least *reasonably possible* that the events that could cause the severe impact will occur in the near term.

In order for there to be a concentration that exposes an entity to a *near-term severe impact,* it must be at least *reasonably possible* that such a severe impact will occur in the near term.

ASC 275 defines *near term*, and *severe impact* as the following:

> **Near term:** is defined as a period of time *not to exceed one year* from the date of the financial statements.
>
> **Severe impact:** is defined as a *significant financially disruptive effect on the normal functioning of an entity*. Severe impact is a higher threshold than material. Matters that are important enough to influence a user's decisions are deemed to be material, yet they may not be so significant as to disrupt the normal functioning of the entity.

Examples of group concentrations:

Concentrations can fall into the following categories, among others:

a. Concentrations in the volume of business transacted with a particular customer, supplier, lender, grantor, or contributor.

b. Concentrations in revenue from particular products, services, or fund-raising events.

c. Concentrations in the available sources of supply of materials, labor, or services, or of licenses or other rights used in the entity's operations.

d. Concentrations in the market or geographic area in which an entity conducts its operations.

So, do the concentration of risk rules under ASC 275 require a nonpublic company to make general risk disclosures about climate change?

The author believes there is *no concentration of risk* that requires disclosure pertaining to climate change or overall climate risk.

Here is the reason.

First, in order to have a concentration of risk and uncertainty disclosure under ASC 275, there must be a concentration of some kind.

Then, *three conditions* must be satisfied:

a. The concentration must exist at the date of the financial statements.

b. The concentration must make the entity vulnerable to the risk of a ***near-term severe impact.***

c. It must be at least *reasonably possible* that the events that could cause the severe impact will occur in the near term.

As to climate change or general environmental disclosures, in order to the disclosure rules of ASC 275 to apply, *three requirements* must be satisfied:

First, the concentration (exposure to climate change) must exist at the date of the financial statements. There could certainly be a concentration, particularly if an entity operates in an industry that is exposed to the risks from climate change.

Second, the concentration (e.g., exposure to climate or environmental change) must make the entity vulnerable to a risk of a *near term, severe impact*. That means that the concentration (climate change) must expose the company to a *significant financially disruptive effect on the normal operations*, and it must be reasonably possible that it will occur *within one year* from the balance sheet date.

Third, it must be *reasonably possible* (less than probable and greater than remote) that the events that could occur (e.g., climate change) could cause a near term severe impact.

The problem with climate change is that if it is real, it has its effect gradually over time and not necessarily within one year from the balance sheet. Thus, the ASC 275 rule that discloses that it is reasonably possible that the concentration of risk could cause a near-term severe impact, is not likely to apply.

There is one additional point that supports that climate change disclosures are not required for nonpublic entities under ASC 275. Specifically, ASC 275's disclosure requirements do not apply to risks and uncertainties that might be associated with any of the following:

- Management or key personnel
- Proposed changes in government regulations
- Proposed changes in accounting principles
- Deficiencies in the internal control structure
- ***The possible effects of acts of God, war, or sudden catastrophes.***

Notice that the fifth exception is a concentration related to "*the possible effects of acts of God, war, or sudden catastrophes*." There is an argument that climate change is an act of God for which GAAP (ASC 275) exempts disclosure of the risks and uncertainties.

In conclusion, unless a nonpublic entity is exposed to a short-term (one year or less) severe impact on its business due to climate change, there is no disclosure required for that nonpublic entity.

AICPA is getting into the sustainability game

It appears that sustainability engagements are becoming big business as more SEC companies are either compelled or motivated to engage in sustainability reporting.

In December 2012, the AICPA created a *Sustainability Task F*orce to address sustainability issues. The Task Force was created under the guidance of the AICPA Assurance Services Executive Committee (ASEC).

More recently, the AICPA has developed guidance on its web site entitled "*Sustainability Reporting and Assurance"* to provide reporting, assurance and other resources for CPAs to service client sustainability needs.

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.

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.

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. Prior to the issuance of ASU 2014-15, the going concern assessment was done by _____.
   a. The auditor
   b. Management
   c. Board of directors
   d. No assessment is done

4. Which of the following is <u>not</u> 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

5. 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

6. 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. Prior to the issuance of ASU 2014-15, the going concern assessment was done by _____.
   a. **Correct. Prior to the FASB issuing ASU 2014-15, the going concern assessment was found only in auditing literature in AU-C 570, and not GAAP.**
   b. Incorrect. Prior to the issuance of ASU 2014-15, there was no requirement for management to assess going concern.
   c. Incorrect. There has never been a requirement for the board of directors to assess going concern.
   d. Incorrect. Auditing standards have required that an auditor perform a going concern assessment, making the answer incorrect.

4. 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.**

5. 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.**

6. Which of the following is correct with respect to the requirement for nonpublic companies to make disclosures about climate change:
   a. Incorrect. GAAP does not require such disclosures in all cases. In fact, the author suggests that such disclosures would be required in rare cases.
   b. Incorrect. The author does not address the climate change debate and instead states that such a disclosure is not required for other reasons.
   c. **Correct. One of the reasons why the author believes that such a disclosure is not required is because there is no concentration where it is reasonably possible that there could be a near-term severe impact. Thus, there is no disclosure required under GAAP.**
   d. Incorrect. Although a plant on the water could have additional risks of damage to operations from rising water levels, the location on the water is not likely to severely impact the entity's operations within one year. Moreover, any impact from rising water levels is likely to be considered an act of God for which GAAP has a disclosure exemption.

H. Recent Developments- Accounting for Income Taxes

ASC 740 *Income Taxes* (formerly FASB No. 109), has been around for almost two decades. Yet, there are several key issues related to deferred income taxes that exist because of the recent economic climate and changes proposed by health care reform. In the section, the author addresses those issues which consist of:

1. Fixing the disclosures in uncertain tax positions for nonpublic entities

The rules for recording uncertain tax benefit liabilities under FASB Interpretation 48 (FIN 48) have been around since 2006.

Yet, these rules continue to be controversial and reach far beyond the financial statements.

The purpose of this section is to address FIN 48 disclosures related to nonpublic entities.

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:

a. 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.

b. If it is *not more likely than not* (not more than 50% probability) that the tax position will be sustained upon an IRS or state tax examination, all of the tax effect of the tax position is eliminated in the financial statements by recording a liability for the hypothetical additional tax that will be paid when the tax position is disallowed upon IRS or state examination.

The rules for uncertain tax positions apply to *federal, state and local and foreign income taxes, but do not apply to* sales and use taxes, franchise taxes, real estate and personal property taxes, and fees that are not taxes. Moreover, it is assumed that a company goes through an IRS or state tax examination, including, if applicable, appeals.

Disclosures in uncertain tax positions for nonpublic entities

Since the issuance of FIN 48, the FASB has issued additional guidance with FASB Staff Position (FSP) FIN 48-1, and ASU 2009-6: *Income Taxes: Implementation Guidance on Accounting for Uncertainty in Income Taxes and Disclosure Amendments for Nonpublic Entities (ASC 740).*

ASU 2009-6 amends FIN 48 to eliminate certain disclosures for non-public companies and to clarify the scope to which FIN 48 applies.

FIN 48, as amended by ASU 2009-6, requires numerous disclosures related to tax positions.

Among those disclosures are *three specific disclosures* that have caused controversy in practice, particularly with respect to those companies that have no unrecognized tax positions recorded on their balance sheets.

Those three disclosures are:

a. The company's policy on classification of interest expense and penalties assessed by taxing authorities

b. 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

c. A description of tax years that remain open subject to examination by major tax jurisdictions

Following are sample disclosures.

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:

a. The Company's policy on classification of interest expense and penalties assessed by taxing authorities

b. 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

c. A description of tax years that remain open subject to examination by major tax jurisdictions

As the author just reviewed, if an entity has no material unrecognized tax positions, the third disclosure (description of tax years open) is not required.

But what about the other two disclosures related to interest and penalties? Are they required if an entity has no interest and penalties related to taxes?

Remember that Paragraph B14 of ASU 2009-6 states:

> BC14. One respondent asked if a disclosure would be required *if management determined that there are no unrecognized tax benefits to record*. The Board concluded that *such a disclosure would not be required because it will set a precedent* for requiring a similar disclosure for all accounting standards for which there was no material effect on the financial statements.

The FASB notes that a disclosure is not required (of open tax years) if there are no unrecognized tax obligations or benefits. The FASB goes on to state that to require such an irrelevant disclosure would not be required because it will "*set a precedent*" meaning it would result in entities including disclosures on elements that do not exist.

In other words, the FASB is saying that it does not want to set a precedent for requiring disclosures where an item to which the disclosure relates is not material to the financial statements.

The same conclusion should apply to disclosures (1) and (2) above involving interest and penalties on taxes. If an entity has no interest or penalties related to their taxes, there is no requirement to disclose item (1) (the company's policy to record interest expense and penalties assessed, and item (2) (The total amounts of interest and penalties recognized in the statement of operations and the total amounts of interest and penalties recognized in the statement of financial position assessed by taxing authorities).

Are any of the unrecognized tax benefit obligation disclosures required for an entity using tax basis financial statements?

As to the disclosure of the number of years open for examination, no disclosure is required if using tax basis financial statements. The reason is because such a disclosure is not required unless an entity has an unrecognized tax benefit liability, which is not recorded for tax basis financial statements.

As to the disclosures about interest and penalties, such disclosures would only be required in a year in which an entity that uses the tax basis of accounting, has interest and penalties related to a tax obligation that are either recorded as expense or accrued. Otherwise, no disclosures would be required.

2. Trump tax cuts- Impact of reduction in tax rates on deferred taxes

The Trump Administration has announced that corporate tax reform is at the forefront of their economic agenda in 2017. All indication is that Congress has the votes to push through a significant corporation tax reform that is likely to include:

- A reduction in the corporate statutory rate from 35% to 15-20%, and
- A discounted rate for companies that repatriate their off-shore profits.

Advocacy for corporation tax return is nothing new. 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,*[30] the committee recommended that the top corporate Federal tax rate be reduced from 35% to a rate within the range of 23-29%. Recently, the Treasury and White House mentioned a 25% 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:[31]

- 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

[30] Report issued by the National Commission on Fiscal Responsibility and Reform
[31] Tax Foundation, *Corporate Income Tax Rates Around the World, 2014*

highest federal corporate income tax rate (among the 34 industrialized nations of the Organization for Economic Cooperation and Development (OECD).

- The worldwide average top corporate income tax rate is 22.6% (30.6% weighted by GDP).
- By region, Europe has the lowest average corporate tax rate at 18.6% (26.3% weighted by GDP); Africa has the highest average tax rate at 29.1%.
- Larger, more industrialized countries tend to have higher corporate income tax rates than developing countries.
- The worldwide (simple) average top corporate tax rate has declined over the past decade from 29.5% to 22.6%.
- Every region in the world has seen a decline in their average corporate tax rate in the past decade.

Corporate Tax Rates By Country

Country	Corporate Tax Rate
United Arab Emigrates	55%
Chad	40%
United States	**35%**
Japan*	37%
France	34.4%
India	34%
Australia	30%
UK	21%
Italy	27.5%
Greece	26%
Mexico	30%
Spain	28%
Austria	25%
Israel	26.5%
Sweden	22%
Ireland	12.5%
Switzerland	8.5%
Bahamas	0%
British VI	0%
Bermuda	0%
Worldwide average	**22.6%**

* Japan has approved tax reform that will lower its corporate rate.

Source: Tax Foundation and Source: Organization for Economic Co-operation and Development (*OECD*)

As corporate tax revenues decline and U.S. companies continue to hold more than $2 trillion of cash offshore, there is impetus to reduce the U.S. corporate tax rate from 35% to a rate that is in the 15% to 20% range.

Background

ASC 740 (formerly FASB 109), *Income Taxes*, is the GAAP authority for the accounting for income taxes:

The basic rules are as follows:

1. Total income taxes consist of the current portion and the deferred portion:

   Current portion: Recognized based on the estimated taxes payable or refundable on tax returns for the current year as a tax liability or asset.

   Deferred portion: Recognized as a deferred tax liability or asset for the estimated future tax effects attributable to temporary differences and carryforwards.

2. Temporary differences are the difference between the book and tax basis of an asset or liability that will result in taxable or deductible amounts in future years when the reported amount is recovered or settled.

3. Deferred tax assets and liabilities are computed based on *enacted tax rates expected to apply* to taxable income in the periods in which the deferred tax liability or asset is expected to be settled or realized.

Example 1: Company X is a C corporation is a first year entity and has the following M-1 reconciliation:

Pretax book income	$5,000,000
M-1:	
Depreciation	(1,000,000)
Taxable income	4,000,000
	35%
Current federal income tax	$1,400,000
Accumulated depreciation: 12-31-20X1:	
Book	$2,000,000
Tax	3,000,000
Temporary difference	1,000,000
Tax rate	35%
Deferred tax liability	$350,000

Entry:	dr	cr
Income tax expense- current	1,400,000	
Income tax expense- deferred	350,000	
Accrued FIT		1,400,000
Deferred FIT		350,000

Example 2: Company Z has the following information for year ended 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 company had federal tax losses in the two carryback years (2013 and 2015) which were carried back to earlier years to obtain a federal tax refund. There is no portion of the 2016 NOL available for carryback.

The temporary difference related to accumulated depreciation (AD) will reverse in years 2017 through 2036. 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)

What would be the impact of a reduction in the corporate tax rate from 35% to 28%?

Putting aside the political aspects of corporate tax rates, the question is what happens to deferred income tax balances if corporate rates decline from 35% to 28%?

In February 2015, the Georgia Tech Financial Analysis Lab issued a study entitled, *The Effects of Tax Reform on Deferred Taxes: The Winners and Losers.*

In the study, the authors examined 809 U.S. companies and the impact of US corporate income tax reform on deferred taxes and which companies and industries will gain and lose if tax reform were to come to fruition.

The focus of the study was to address the adjustment, if any, that would occur to deferred tax assets and liabilities if tax rates were to be reduced from 35% to 28%.

Deferred tax assets and liabilities are recorded at the margin tax rate expected to be in effect when the temporary differences that create the deferred taxes reverse in future years.

A change in the corporate rate to 28% would result in a reduction in both deferred tax assets and liabilities, resulting a change in assets, liabilities and stockholders' equity in most companies.

For a sample of 809 U.S. companies with revenue greater than $500 million with reported deferred tax balances, the authors of the study present the financial statement effects of lowering the corporate income tax rate from 35% to 28%.

The results of the study reveal the following:

1. If rates were to decline from 35% to 28%, the 809 sampled companies would receive an overall *net increase in stockholders' equity of $104 billion* broken out as follows:

    a. 548 of the companies sampled with deferred tax liabilities would receive a $142 billion reduction in liabilities and increase in stockholders' equity.

        - Liabilities would decline by 2%
        - Stockholders' equity would increase by 3.3%
        - Financial leverage (liabilities to equity ratio) would decline by 5.5%

    b. 261 of the companies would see a decline of $38 billion in deferred tax assets and decrease in stockholders' equity.

        - Assets would decline by .4%
        - Stockholders' equity would decrease by 1.2%
        - Financial leverage (liabilities to equity ratio) would increase by 1.2%

2. Winners and losers from tax reform:

    a. Winners from tax reform, consisting of industries with large deferred tax liabilities that will be reduced include:

        - Utilities and Energy sectors
        - Electric, gas and water utilities
        - Oil and gas exploration
        - Transportation, including railroad companies

    b. Losers from tax reform, consisting of industries with large deferred tax assets that will be reduced include:

- Mortgage, finance and banking sectors:
- Financial companies
- Commercial banks
- Consumer finance companies
- Leisure equipment
- Durables
- Pharmaceuticals
- Biotechnology
- Auto components
- Computer hardware and software

3. Companies that are net losers from tax reform (e.g., deferred tax assets and stockholders' equity would decline) could violate existing loan covenants.

4. Entities with the largest reduction in liabilities (winners) follows:

Biggest Winners from Reduction in Corporate Rates to 28%			
Company	**Reduction in deferred tax liabilities**	**% reduction in total liabilities**	**Increase in stockholders' equity**
Comcast	$(6.3) billion	(5.9)%	12.5%
Time Warner	(2.3) billion	(5.7)%	33.9%
Hilton International	(967) million	(4.4)%	22.2%
Hertz	(584) million	(2.7)%	21.1%
N star	(303) million	(6.8)%	12.2%
Median- all sampled		**(2.0)%**	**3.3%**

Source: Georgia Tech Financial Analysis Lab study, *The Effects of Tax Reform on Deferred Taxes: The Winners and Losers.*

Biggest Losers from Reduction in Corporate Rates to 28%			
Company	**Reduction in deferred tax Assets**	**% reduction in total assets**	**Decrease in stockholders' equity**
Fannie Mae	$9.5 billion	(.3)%	(99.7)%
Orbitz	32 million	(2.9)%	(77)%
Federal Home Loan Mtg	4.5 billion	(.2)%	(35.4)%
Delta	1.3 billion	(2.6)%	(11.6)%
Citigroup	10.6 billion	(.6)%	(5.2)%
Median all sampled		**(.4)%**	**(1.2)%**

Source: Georgia Tech Financial Analysis Lab study, *The Effects of Tax Reform on Deferred Taxes: The Winners and Losers.*

Question: If the corporate tax rate were to decline from 35% to 28%, where would the adjustment of the deferred tax asset or liability be presented on financial statements?

Response: ASC 740-10-45-15 states "when deferred tax accounts are adjusted as required by paragraph 740-10-35-4 for the effect of a change in tax laws or rates, the effect shall be *included in income from continuing operations* for the period that includes the enactment date."

Therefore, if the corporate tax rate is reduced to 28%, the deferred tax asset and/or liability would be adjusted to the lower rate with the offsetting entry to income tax expense.

Consider the following example:

Example: Company Z has the following information for year ended 2016:

2016 tax net operating loss	$(1,000,000)
Temporary difference:	
Accumulated depreciation at 12-31-16:	
Book	$2,000,000
Tax	3,500,000
Temporary difference	$1,500,000

The $(1,000,000) 2016 net operating loss is available for carryforward to 2036 (20 years).

The temporary difference related to accumulated depreciation (AD) will reverse in years 2017 through 2026. There are no other temporary differences.

There are no state income taxes.

A deferred income tax asset and liability was recorded with balances at 12-31-16 as follows:

Deferred income tax asset (federal):	
2016 federal tax net operating loss $1,000,000 x 35%	$350,000
[NOL expires in 2036, twenty years]	
Deferred income tax liability:	
Temporary difference: AD $1,500,000 x 35%	$(525,000)

Effective January 1, 2017, the U.S. corporate tax rate is reduced from 35% to 28%.

Conclusion: Effective January 1, 2017, the deferred tax asset and liability are recomputed at the new 28% rate as follows:

Deferred tax asset:		
Originally computed:	$1,000,000 x 35%	$350,000
Revised	$1,000,000 x 28%	280,000
Adjustment		**$70,000**

Deferred tax liability:	Originally computed 35%	Revised 28%
Temporary difference:		
Accumulated depreciation at 12-31-16:		
Book	$2,000,000	$2,000,000
Tax	3,500,000	3,500,000
Temporary difference	1,500,000	1,500,000
	35%	28%
	$525,000	$420,000
Adjustment	**$105,000**	

Entry: (January 1, 2017)	dr	cr
Deferred tax liability	105,000	
Deferred tax asset		70,000
Income tax expense- deferred		(1) 35,000

(1) shown as a separate component of income tax expense

In 2017, the $35,000 deferred tax adjustment is shown as a separate component of income tax expense as follows:

NOTE X: Income Taxes:

A summary of the current and deferred portions of federal income tax expense follows:

Current portion	$XX
Deferred	XX
Adjustment due to change in tax rates	***(35,000)***
Total income tax expense	$XX

If there is a valuation allowance account, it too should be adjusted to reflect the reduction in the federal marginal tax rate with the offset to income tax expense as part of continued operations.

What is the impact of reducing the corporate tax rate from 35% to 20%?

The Georgia Tech study was based on corporate rates declining from 35% to 28% and resulted in a net increase in stockholder's equity of $104 billion for 809 sampled companies.

Using simple interpolation, if a reduction of 7% in the corporation rate (35% - 28%) yields an increase of $104 billion in stockholders' equity for the sampled entities, a reduction of 15% (35% - 20%) would yield $223 billion.

Computation: 15%/7% x $104 billion = $223 billion.

Note further that the $223 billion is based on a sample of 809 public entities and does not reflect all public entities nor nonpublic entities. The overall point to take away from the analysis is that a reduction in the corporation rate from 35% to 15-20% will have a significant impact on companies' stockholders' equity and cash flows.

I. Accounting, Auditing and Tax Issues Related to Marijuana

In the November 2016 elections, seven states voted to legalize the use of marijuana in some form, either for recreational or medical use.

That brings the total to 28 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.

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 2017, several states have authorized the use and sale of marijuana at some level as presented in the following table:

Legalization of Marijuana- Selected States	
State	**Status**
Colorado- Legalized recreational use	Legalized recreational use
Washington State	Legalized recreational use
Alaska	Legalized recreational use
Oregon	Legalized recreational use
Washington D.C.	Decriminalized recreational use
Guam	Legalized recreational use
Massachusetts	Legalized for medical use
California	Legalized recreational use
Maine	Legalized recreational use
Nevada	Legalized recreational use
Arkansas	Legalized for medical use
Florida	Legalized for medical use
North Dakota	Legalized for medical use
Source: *An Issue Brief on State Marijuana Laws and the CPA Profession*, AICPA, January 2015, as modified by the results of the November 2016 election.	

The trend is toward more states legalizing the sale of marijuana is some form due to the attractive tax revenues that states can derive from their sale.

The result is that the marijuana business is quickly becoming a high-growth segment in several state economies. As the demand for business services grows, CPAs are being asked to perform accounting, auditing, tax and consulting services for marijuana growers and sellers.

Because the marijuana business is certainly not main stream, there are certain risks inherent in the business that accountants must be aware of.

What are some of the issues an accountant or auditor must contend with in servicing a marijuana client?

The accountant must be aware of some of the industry-specific risks:

Federal illegality despite being legal at the state level

Although certain states have made the use and sale of marijuana legal, it is still *illegal at the Federal level* as a Schedule I drug under the Controlled Substances Act of 1970. The Supreme Court has ruled that federal law takes precedent over state law.

There is always the risk that the Federal government could enforce the federal laws by raiding the business. Further, being illegal provides an overall cloud of illegality on an interstate level with suppliers, and users out of state.

Note: The Justice Department under the current administration is generally taking a hands-off approach to these state law experiments, but the Obama administration has expressed no strong desire to change the legal status of marijuana at the federal level and has warned of possible enforcement activity if the marijuana activities involve criminal elements, sales to minors, sales across state lines, other illegal drugs, or use of public lands or federal property.

The Internal Revenue Service follows the federal law in viewing these businesses as illegal businesses for tax purposes. This creates a number of tax issues for representing these clients, as well as criminal exposure and possible ethical issues with respect to the professional licenses that a particular tax advisor may hold.

Doing business without a bank account or credit cards

Most banks will not accept bank accounts or provide credit card services related to the marijuana business because of the federal law and money laundering regulations. Consequently, it is difficult to open bank accounts or utilize credit card services.

The result is that:

1. Most marijuana businesses are working on a literal cash basis and retaining large sums of cash.

2. Security issues are always a concern with that much cash being held outside a bank account.

3. Many marijuana businesses must pay their bills, including payroll, with money orders and cash.

Congress seeks to allow banking for marijuana businesses

In January 2017, the members of the Senate Banking Committee commenced efforts to address the lack of banking services for marijuana businesses. Now that marijuana business receipts exceed $7 billion per year, Congress is seeking a solution to the banking problem. Ten senators sent a letter to a key regulator, the Financial Crimes Enforcement Network, calling for it to provide guidance to banks who seek to offer services to marijuana shop vendors and vendors who provide ancillary services to the marijuana industry.[32]

In 2015, the U.S. Department of Treasury gave banks permission to do business with legal marijuana entities under certain conditions. That latitude has resulted in 301 banks doing business with marijuana vendors as of the end of 2016.

Additional banking guidance is likely to occur as there are now 28 states that have legalized marijuana use in some form.

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.

[32] *Sen. Elizabeth Warren wants to pull pot shops out of banking limbo,* Los Angeles Times, January 7, 2017.

1. Under federal law, a person who aids, abets, counsels, commands, induces or procures the commission of a federal offense is punishable as a principal.

2. What has not been determined is whether rendering tax advice or preparing tax returns, or performing accounting services qualifies as aiding or abetting an illegal activity.

   Note: The Obama administration and the Justice Department have taken a hands-off approach to addressing the illegal nature of the marijuana business that is legal is certain statements. That approach has continued and there are no signs that the Justice Department is likely to change its focus. What is unknown is what would happen under the next administration in 2017.

3. There is the risk that CPAs (and lawyers) who service clients in legal states such as Colorado, Washington and others, could receive cancellation notices for their professional liability insurance.

4. Contracts can be deemed unenforceable for being against public policy and involving an illegal activity at the federal level.

5. There is the ongoing risk of dealing in a cash business including the risk of embezzlement and underreporting income.

Marijuana ethics issues for the CPA

In January 2015, the AICPA issued a white paper entitled, *An Issue Brief on State Marijuana Laws and the CPA Profession.*

In the Brief, the AICPA addresses some of the ethical issues surrounding accountants who choose to service clients in the marijuana business.

The AICPA notes the following:

1. CPAs should check with their State Board of Accountancy when they consider providing services to a marijuana-related business due to the fact that the business is illegal at the federal level.

   According to the AICPA:

   > "It is possible that a CPA from a state that allows marijuana use who has provided services to a 'marijuana business' could face licensing difficulties if he or she seeks a reciprocal license in a state where marijuana is illegal. It's not yet clear how State Boards of Accountancy will apply "*good moral character*" requirements or impose discipline when it comes to supporting marijuana-related businesses, or if they will take a position at all."

2. CPAs who are contemplating providing services to marijuana-related businesses should consider whether a State Board would consider it to be an "*act discreditable*" when a CPA provides services to businesses that violate federal drug laws, even in a state that allows those businesses to operate legally.

   Note: The AICPA Brief observes that in the states that have passed laws or referendums allowing medicinal or recreational marijuana use, State Boards of Accountancy have not yet provided any

guidance for CPAs looking to provide services to businesses that grow/sell marijuana. This dynamic puts CPAs in a gray legal area. They need to satisfy the requirements of their State Boards of Accountancy for 'good moral character' and the 'acts discreditable' requirements in their respective states, while at the same time considering the potential business opportunities."

Tax risks

One of the greatest risks that an accountant can encounter with a marijuana client is the risk from IRS and state audits and the misapplication of Section 280E of the Internal Revenue Code.

1. IRC Section 280E *denies tax credits and deductions* to businesses who traffic *in controlled substances* such as marijuana.

   a. The exception is that such businesses *may deduct cost of goods* sold for growing and selling marijuana under 280E but *cannot deduct other expenses*.

      Note: Costs are capitalized to inventory (and deductible as cost of goods sold) under Section 471 (inventory) and 263A (uniform capitalization rules). Companies are incentivized to fully capitalize costs are these sections using full absorption so that such costs are ultimately deductible as part of cost of goods sold.

   b. Other costs for selling, marketing and G&A (that are not capitalized under 263A) are not deductible under 280E.

   Note: In January 2015, the IRS issued an internal legal memorandum that addresses how Section 280E should be applied to the marijuana industry. Its focus is to explain how the IRS should determine cost of goods sold for purposes of Section 280E deductibility.

   In the memorandum, the IRS noted that marijuana retailers and producers must compute cost of goods sold under the pre-Section 280E inventory rules (e.g., pre 263A). Those rules mean that the business is permitted to deduct the purchase price of the marijuana (net of discounts), plus transportation and other costs necessarily as part of the acquisition. In addition, the producer may include in cost of goods sold any direct costs such as seeds, direct labor related to planting, harvesting, sorting, and cultivating the plants. Certain indirect costs may be included in cost of goods sold provided they are "incidental and necessary to production", along with depreciation, factory insurance, and other factory costs.

   Such businesses may not allocate to cost of goods sold any costs associated with purchasing, handling, storage, and administrative costs to COGS.

2. There is a difficulty paying certain taxes electronically due to lack of a bank account or credit cards.

   Note: The IRS requires certain taxes to be paid electronically such as C corporation estimates. However, it is difficult for marijuana businesses to get bank accounts or utilize credit cards from which to pay the taxes. The IRS has tried to impose substantial penalties on marijuana businesses that tried to pay their taxes in cash, even though the businesses state that that they could not file electronically.

Allgreens LLC sued the IRS in Tax Court challenging the IRS's determination that the inability to get a bank account did not excuse the failure to pay employee withholding taxes electronically. In a settlement of the case, the IRS agreed to abate the penalties, but stated that the settlement should not be viewed as precedent for future cases.

3. No medical expense deduction:

    a. For the individual utilizing marijuana for medical purposes, the federal law treatment of marijuana also creates problems for the medical expense deduction. Revenue Ruling 97-9 determined that amounts paid for marijuana for medicinal use are not deductible, even if permitted under state law, since they were not legally procured under federal law. A similar analysis would probably apply to health flexible spending accounts, health savings accounts, health reimbursement accounts, and Archer Medical Savings Accounts.

4. The difficulties of performing a complete and accurate tax return:

    a. With a pure cash business, there is the risk of:

        - Failure to issue 1099s
        - Having underreported income
        - Client underreporting sales tax due to missing cash deposits
        - Client taking deductions that should not be taken under 280E

Accounting and auditing issues

If an accountant is required to audit, review or compile the financial statements of a marijuana retailer or producer, there are certain issues that are peculiar to the engagement as follows:

1. Planning and client acceptance:

    a. Because the marijuana business is an emerging market, it is important for the accountant/auditor to do the following:

        - <u>Client acceptance</u>: Evaluate the reputation risk, professional liability and overall risk of performing the engagement.

        - <u>Understand the entity and business:</u> Including the legal and regulatory environment, uncertainties and estimates, cash issues, and financing issues.

        - <u>Scope limitations</u>: If an audit, any scope limitations particularly with respect to inventory and revenue.

2. Accounting issues:

    a. The financial statements should have the following disclosures:

        - Nature of business including a description that the business is legal at the state level, but illegal at the federal level.

- Concentration of risks and uncertainties related to:
  - The illegal nature of the business and regulatory environment in which it operates, and
  - The fact that the business is a cash business
  - The fact that the business has no bank account yet has a concentration of cash that is not protected and deposited in a bank.
- Contingency- reasonably possible that the business could be shut down by the federal government due to its illegal nature.

3. Reporting issues:

   a. *Noncompliance with laws and regulations*: The accountant or auditor should address the issue as to whether the business is in compliance with laws and regulations and its impact on the financial statements.

   b. *Emphasis of matter or other matter paragraph*. The accountant or auditor may wish to include an emphasis-of-matter or other-matter paragraph in his or her report describing the business.

4. Management representation letter:

   a. If a review or audit is performed, the accountant or auditor should obtain a representation letter from management that specifically confirms that the *business is not in compliance with laws and regulations*, it is engaged in an illegal activity, revenues and inventories are complete, etc.

5. Engagement letter:

   a. In the accountant's/auditor's engagement letter, the letter should have language that indemnifies the accountant for known misrepresentations by management.

6. Possible scope limitations: Because of the cash business, it might be difficult to:

   a. Measure the completeness of revenue.

   b. Determining the completeness of inventory.

7. Going concern

   a. In limited cases, due to the fact that the entity is engaged in an illegal activity, going concern could be an issue because the business could be shut down at any point in time.

Is an accountant or auditor permitted to issue a report on an illegal activity?

Nothing in compilation, review or auditing standards precludes an accountant from performing an engagement and issuing a report on an illegal activity as long as there is no scope limitation.

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect. To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow.

1. According to the author, which of the following would be the impact of lowering the corporate tax rate:
   a. Deferred tax assets would be adjusted downward
   b. Deferred tax assets would be adjusted upward
   c. There would be no effect on deferred tax assets, but there is an impact on the accrued federal tax liability
   d. A larger valuation account would be required for deferred tax assets

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 in all 50 states and also at the federal level

SUGGESTED SOLUTIONS

1. According to the author, which of the following would be the impact of lowering the corporate tax rate:
   a. **Correct. If the federal rate were to be reduced, all deferred tax assets that were previously recorded at a higher 35% tax rate would have to be adjusted downward to reflect the lower tax benefit that would be received in future years.**
   b. Incorrect. Deferred tax assets would be adjusted downward, not upward. If rates increase, the deferred tax assets would be adjusted upward.
   c. Incorrect. The deferred tax asset would be reduced making the statement incorrect.
   d. Incorrect. Reducing the deferred tax asset would affect the asset directly and not the valuation account.

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 some of the 50 states making the answer incorrect.

J. Selected Accounting Standards Updates (ASUs)

Following is an analysis of selected ASUs that were recently issued.

ASU 2016-15: Statement of Cash Flows (Topic 230), Classification of Certain Cash Receipts and Cash Payments

Issued: August 2016

Effective date: The ASU is effective as follows:

Public business entities: fiscal years beginning after December 15, 2017, and interim periods within those fiscal years.

For all other entities (including non-public entities): for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019.

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

Objective: The ASU clarifies the treatment of certain transactions on the statement of cash flows.

Background: More than 25 years after the issuance of FASB No. 95, *Statement of Cash Flows*, the classification of certain transactions within the statement of cash flows continues to be an unresolved issue.

In November 1987, FASB issued FASB No. 95, *Statement of Cash Flows*, which is now codified in ASC 230, Statement of Cash Flows.

The FASB staff's research indicates that:

- There is diversity in practice with respect to the classification of certain cash receipts and payments.
- The primary reasons for the diversity in classification is the result of lack of specific accounting guidance and inconsistent application of the existing principles within ASC 230.

According to Audit Analytics, more than 600 companies have filed restatements in the past five years that involve classifications on the statement of cash flows.

In 2009, only 65 restatements (8.7% of the total) were attributable to cash flow statement errors, while that number has increased to a total of 174 in 2013, more than 20% of all restatements.[33]

In December 2014, the SEC noted its concern about the number of restatements pertaining to cash flow statement errors.

[33] Per Audit Analytics as reported by Compliance Week, April 2015.

In a speech[34], an SEC representative observed the following:

a. While the total number of restatements over the past five years has been relatively consistent, restatements due to errors in the statement of cash flows continue to increase year over year.

b. The SEC staff noted that the majority of errors were due to relatively less complex applications of GAAP such as failure to appropriately account for capital expenditures purchased on credit.

c. The SEC suggested that companies take a new look at their controls in preparing and reviewing the statement of cash flows, including risk assessment and monitoring.

At its April 28, 2014 meeting, the FASB voted to add a project to its agenda. The project, *Clarifying Certain Existing Principles on Statement of Cash Flows*, was intended to reduce diversity in practice in financial reporting by clarifying certain principles in ASC 230.

At its April 1, 2015 meeting, the FASB decided that clarifying certain existing principles within ASC 230 would only incrementally reduce diversity in practice about the classification of cash receipts and cash payments.

In August 2016, the FASB issued ASU 2016-15, *Statement of Cash Flows (Topic 230), Classification of Certain Cash Receipts and Cash Payments.*

The ASU address <u>specific cash flows related to:</u>

1. Debt prepayment or extinguishment costs
2. Settlement of zero coupon bonds
3. Contingent Consideration Payments Made after a Business Combination
4. Proceeds from the Settlement of Insurance Claims
5. Proceeds from the Settlement of Corporate-Owned Life Insurance Policies
6. Distributions Received from Equity Method Investees
7. Beneficial Interests in Securitization Transactions
8. Separately Identifiable Cash Flows and Application of the Predominance Principle

The following chart summarizes the conclusions reached in ASU 2016-15 with respect to the eight specific transaction:

[34] Remarks Before the 2014 AICPA National Conference on Current SEC and PCAOB Developments, Kirk Crews, SEC, December 8, 2014.

Cash Flow Issue	Amendment Made by ASU 2016-15
1. Debt Prepayment or Debt Extinguishment Costs	Cash payments for debt prepayment or debt extinguishment costs should be classified as cash outflows for financing activities.
2. Settlement of Zero-Coupon Debt Instruments or Other Debt Instruments with Coupon Interest Rates That Are Insignificant in Relation to the Effective Interest Rate of the Borrowing	At the settlement of zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing, the issuer should classify the portion of the cash payment attributable to the accreted interest related to the debt discount as cash outflows for operating activities, and the portion of the cash payment attributable to the principal as cash outflows for financing activities.
3. Contingent Consideration Payments Made after a Business Combination	Cash payments not made soon after the acquisition date of a business combination by an acquirer to settle a contingent consideration liability should be separated and classified as cash outflows for financing activities and operating activities. Cash payments up to the amount of the contingent consideration liability recognized at the acquisition date (including measurement-period adjustments) should be classified as financing activities; any excess should be classified as operating activities. Cash payments made soon after the acquisition date of a business combination by an acquirer to settle a contingent consideration liability should be classified as cash outflows for investing activities.
4. Proceeds from the Settlement of Insurance Claims	Cash proceeds received from the settlement of insurance claims should be classified on the basis of the related insurance coverage (that is, the nature of the loss). For insurance proceeds that are received in a lump sum settlement, an entity should determine the classification on the basis of the nature of each loss included in the settlement.
5. Proceeds from the Settlement of Corporate-Owned Life Insurance Policies, including Bank-Owned Life Insurance Policies	Cash proceeds received from the settlement of corporate-owned life insurance policies should be classified as cash inflows from investing activities. The cash payments for premiums on corporate-owned policies may be classified as cash outflows for investing activities, operating activities, or a combination of investing and operating activities.

6. Distributions Received from Equity Method Investees	When a reporting entity applies the equity method, it should make an accounting policy election to classify distributions received from equity method investees using either of the following approaches: a. Cumulative earnings approach: Distributions received are considered returns on investment and classified as cash inflows from operating activities, unless the investor's cumulative distributions received less distributions received in prior periods that were determined to be returns of investment exceed cumulative equity in earnings recognized by the investor. b. Nature of the distribution approach: Distributions received should be classified on the basis of the nature of the activity or activities of the investee that generated the distribution as either a return on investment (classified as cash inflows from operating activities) or a return of investment (classified as cash inflows from investing activities) when such information is available to the investor.
7. Beneficial Interests in Securitization Transactions	A transferor's beneficial interest obtained in a securitization of financial assets should be disclosed as a noncash activity, and cash receipts from payments on a transferor's beneficial interests in securitized trade receivables should be classified as cash inflows from investing activities.
8. Separately Identifiable Cash Flows and Application of the Predominance Principle	The classification of cash receipts and payments that have aspects of more than one class of cash flows should be determined first by applying specific guidance in GAAP. In the absence of specific guidance, an entity should determine each separately identifiable source or use within the cash receipts and cash payments on the basis of the nature of the underlying cash flows. An entity should then classify each separately identifiable source or use within the cash receipts and payments on the basis of their nature in financing, investing, or operating activities. In situations in which cash receipts and payments have aspects of more than one class of cash flows and cannot be separated by source or use, the appropriate classification should depend on the activity that is likely to be the predominant source or use of cash flows for the item.

Interest and income taxes paid

The ASU states that if the indirect method is used, amounts of interest paid (net of amounts capitalized), including the portion of the payments made to settle zero coupon debt instruments that is attributable to accreted interest related to the debt discount or the portion of the payments made to settle other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the

borrowing that is attributable to accreted interest related to the debt discount, and income taxes paid during the period shall be disclosed.

Acquisition by a not-for-profit entity- statement of cash flows

The ASU addresses certain cash flows related to not-for-profit entities:

a. An NFP acquirer shall report the entire amount of any net cash flow related to an acquisition (cash paid as consideration, if any, less acquired cash of the acquiree) in the statement of cash flows as an investing activity, except for cash payments made to settle a contingent consideration liability arising from the acquisition that are not paid soon after the business combination.

b. Cash payments made soon after the acquisition date of the business combination by an acquirer to settle a contingent consideration liability shall be classified as investing activities.

c. Cash payments, or the portion of the payments, not made soon after the acquisition date of a business combination by the NFP acquirer to settle a contingent consideration liability up to the amount of the contingent consideration liability recognized at the acquisition date, including measurement period adjustments, less any amounts paid soon after the acquisition date to settle the contingent consideration liability shall be classified as cash outflows for financing activities.

d. Cash payments, or the portion of the payments, not made soon after the acquisition date of a business combination by the NFP acquirer to settle a contingent consideration liability that exceed the amount of the contingent consideration liability recognized at the acquisition date, including measurement-period adjustments, less any amounts paid soon after the acquisition date to settle the contingent consideration liability shall be classified as cash outflows for operating activities.

ASU 2015-05: Intangibles – Goodwill and Other -Internal-Use Software (Subtopic 350-40) Customer's Accounting for Fees Paid in a Cloud Computing Arrangement

Issued: April 2015

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

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

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

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

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

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

Examples of cloud computing arrangements include:

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

The FASB received input from stakeholders that the absence of explicit guidance has resulted in some diversity in practice and has created unnecessary costs and complexity to evaluate the accounting for those fees.

Because 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* the following characteristics:

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

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

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

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

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

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

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

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

Rules:

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

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

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

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

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

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

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

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

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

Note: The ASU states that some cloud computing arrangements include one or more licenses to software as well as a promise to provide services, in which case the customer should allocate the contract consideration between the license(s) and the service element(s).

Note: In determining the two criteria in (1)(a) and (b), the FASB followed the guidance found in ASC 985-605, *Software*, with respect to revenue recognition by software vendors. Those two criteria are:

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

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

ASU 2015-03: Interest- Imputation of Interest (Subtopic 835-30)- Simplifying the Presentation of Debt Issuance Costs

Issued: April 2015

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

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

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

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

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

- Issuing bonds
- Closing a bank or private loan

Such costs may include:

- Legal fees
- Commissions or financing fees
- Appraisal costs
- Accounting and auditing fees
- Points
- Title insurance
- Any other costs incurred to complete specific financing

Debt issuance costs generally *exclude* internal general and administrative costs and overhead of the borrowing entity.

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

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

Rules:

1. ASU 2015-03 *does not apply* to the following:

a. The amortization of premium and discount of assets and liabilities that are reported at *fair value*, and

b. The debt issuance costs of liabilities that are reported at *fair value*.

2. The following elements shall be reported in the balance sheet as a *direct deduction from the face - amount of a note*:

   a. The discount or premium resulting from the determination of present value in cash or noncash transactions, and

   b. Debt issuance costs related to a note (NEW)

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

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

4. Amortization of discount or premium and debt issuance costs shall be reported as follows on the income statement:

   a. Amortization of discount or premium: As *interest expense* in the case of liabilities or as *interest income* in the case of assets.

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

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

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

   b. The face amount of the note.

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.

1. Company X makes a cash payment two days after the acquisition date of its acquisition of Company Y. The payment is made to settle a contingency which is part of the acquisition. How should the payment be classified on the statement of cash flows under ASU 2016-15.
   a. As an operating activity
   b. As a financing activity
   c. As an investing activity
   d. Disclosed only

2. Alice is the CEO of Company C. There is good news and bad news. The bad news first: Alice dies. The good news is that company receives a $5 million check for key man life insurance policy on the life of Alice. How should the Company classify the $5 million cash proceeds on the statement of cash flows.
   a. Operating activities
   b. Investing activities
   c. Financing activities
   d. Split it between financing and investing activities

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

4. Debt issuance costs exclude which of the following:
   a. Legal fees
   b. Commissions
   c. Appraisal fees
   d. Administrative costs

5. Company Z has debt issuance costs related to a $5 million loan. How should Z present the debt issuance costs on its balance sheet in accordance with ASU 2015-03:
   a. Nowhere as the costs should be expensed as incurred
   b. As an asset
   c. Netted against the debt
   d. As a contra- equity account

SUGGESTED SOLUTIONS

1. Company X makes a cash payment two days after the acquisition date of its acquisition of Company Y. The payment is made to settle a contingency which is part of the acquisition. How should the payment be classified on the statement of cash flows under ASU 2016-15.
   a. Incorrect. A cash payment *not made* soon after the acquisition date may be separated and classified as an operating and financing activity, but not one made soon after the acquisition.
   b. As a financing activity. Incorrect. The ASU states that for the payment to be classified as both financing and operating activities, it must not be made soon after the acquisition, making the answer incorrect.
   c. Correct. The ASU provides that that a cash payment made soon after the acquisition to settle a contingent consideration liability must be classified as investing activity, making the answer correct.
   d. Incorrect. The ASU does not provide for disclosure only because there is a cash outflow. Thus, the answer is incorrect.

2. Alice is the CEO of Company C. There is good news and bad news. The bad news first: Alice dies. The good news is that company receives a $5 million check for key man life insurance policy on the life of Alice. How should the Company classify the $5 million cash proceeds on the statement of cash flows.
   a. Incorrect. ASU 2016-15 states that the cash proceeds from settlement of corporate-owned life insurance should be classified as cash flows from investing activities not operating activities.
   b. Correct. ASU 2016-15 provides for classifying the cash proceeds as an inflow from investing activities. The theory is that the entity receives excess proceeds from an investment, which is the life insurance policy.
   c. Incorrect. Because the life insurance policy is an asset of the entity, clearly it is not classified as a cash inflow pertaining to financing activities. The transaction is not related to financing by the company.
   d. Nothing is ASU 2016-15 provides for split it between financing and investing activities, making the answer incorrect.

3. 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.

4. Debt issuance costs exclude which of the following:
   a. Incorrect. Legal fees are third-party incremental costs directly attributable to issuing a debt instrument and are considered debt issuance costs.
   b. Incorrect. Commissions are directly attributable to the issuance of the debt issuance and are debt issuance costs.

c. Incorrect. Appraisal fees are specific third-party incremental costs directly attributable to the issuance of the debt instrument and are included in the definition of debt issuance costs.

d. Correct. Administrative costs are not third-party incremental costs and are not directly attributable to issuing a debt instrument. Thus, they are not debt issuance costs.

5. Company Z has debt issuance costs related to a $5 million loan. How should Z present the debt issuance costs on its balance sheet in accordance with ASU 2015-03:
   a. Incorrect. Debt issuance costs are capitalized and amortized, and not expensed as incurred
   b. Incorrect. The previous rules required the debt issuance costs to be recorded as an asset and amortized. Under ASU 2015-03, recording those costs as an asset is no longer an option.
   c. **Correct. The ASU requires that the debt issuance costs be presented as a net amount against the underlying debt.**
   d. Incorrect. The ASU does not permit the costs to be presented as a contra- equity account as they have nothing to do with equity.

CHAPTER 5:

ASU 2015-17:
Income Taxes (Topic 740) –
Balance Sheet Classification of Deferred Taxes

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ASU 2015-17- Income Taxes (Topic 740)
Balance Sheet Classification of Deferred Taxes

Issued: November 2015

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

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

All other entities: (nonpublic entities) : the amendments in this Update are effective for financial statements issued for annual periods *beginning after December 15, 2017*, and interim periods within annual periods beginning after December 15, 2018.

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

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

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

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

I. Objective

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

II. Background

The FASB issued ASU 2015-17 as part of its *Simplification Initiative*. The objective of the Simplification Initiative is to identify, evaluate, and improve areas of GAAP for which cost and complexity can be reduced while maintaining or improving the usefulness of the information provided to users of financial statements.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

III. Rules

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

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

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

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

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

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

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

IV. Transition

1. The ASU is effective as follows:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Company X
Balance Sheet
December 31, 2017

ASSETS

Current assets:	
Cash	$100,000
Trade receivables	2,000,000
Inventories	2,900,000
Total current assets	5,000,000
Property, plant and equipment:	
Cost	8,000,000
Accumulated depreciation	(5,000,000)
Total property, plant and equipment	3,000,000
	$8,000,000

LIABILITIES AND STOCKHOLDER'S EQUITY

Current liabilities:	
Accounts payable	$2,500,000
Accrued expenses and other liabilities	500,000
Current portion of long-term debt	200,000
Deferred tax liability	**100,000**
Total current liabilities	3,300,000
Long-term debt (net of current portion)	2,700,000
Stockholder's equity:	
Common stock	200,000
Retained earnings	1,800,000
Total stockholder's equity	2,000,000
	$8,000,000

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

Company X
Balance Sheets
December 31, 2018 and 2017

	2018	2017
ASSETS		
Current assets:		
Cash	$200,000	$100,000
Trade receivables	3,000,000	2,000,000
Inventories	3,300,000	2,900,000
Total current assets	6,500,000	5,000,000
Property, plant and equipment:		
Cost	8,400,000	8,000,000
Accumulated depreciation	(5,200,000)	(5,000,000)
Total property, plant and equipment	3,200,000	3,000,000
	$9,700,000	$8,000,000
LIABILITIES AND STOCKHOLDER'S EQUITY		
Current liabilities:		
Accounts payable	$3,200,000	$2,500,000
Accrued expenses and other liabilities	850,000	500,000
Current portion of long-term debt	200,000	200,000
Deferred tax liability	**0**	**100,000**
Total current liabilities	4,250,000	3,300,000
Long-term liabilities:		
Long-term debt (net of current portion)	2,500,000	2,700,000
Deferred tax liability	**150,000**	**0**
	2,650,000	2,700,000
Stockholder's equity:		
Common stock	200,000	200,000
Retained earnings	2,600,000	1,800,000
Total stockholder's equity	2,800,000	2,000,000
	$9,700,000	$8,000,000

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

Note X: Income Taxes

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

Observation: Example 1 illustrates the adoption of the ASU prospectively under which the deferred tax liability for 2017 in the amount of $100,000 is not restated to reflect the new ASU.

The ASU requires that if the prospective application is elected, the note disclosure must have two elements as follows:

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

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

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

Company X
Balance Sheets
December 31, 2018 and 2017

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

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

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

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

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

Should companies adopt the ASU early?

The ASU is effective:

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

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

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

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

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

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

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect. To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow.

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

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

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

4. Company X is adopting ASU 2015-17 with respect to its deferred tax assets and liabilities. X is adopting the new ASU effective in 2018 and will present a comparative balance sheet for 2017. X wants to adopt the ASU prospectively. Which of the following is correct:
   a. X must restate the 2017 balance sheet
   b. Is does not restate the 2017 balance sheet
   c. X should reverse off the 2017 liability under the ASU
   d. X should revise the 2017 balance sheet to gross up the asset and liability for that year

SUGGESTED SOLUTIONS

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

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

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

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

CHAPTER 6:

ASU 2015-11:
Inventory (Topic 330) –
Simplifying the Measurement of Inventory

_____

ASU 2015-11: Inventory (Topic 330)
Simplifying the Measurement of Inventory

Issued: July 2015

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

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

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

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

I. Objective

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

The objective of the Simplification Initiative is to identify, evaluate, and improve areas of U.S. GAAP for which cost and complexity can be reduced while maintaining or improving the usefulness of the information provided to users of financial statements.

The FASB received comments from users that the current guidance on the measurement of inventory is unnecessarily complex because there are *three potential outcomes* to determine market.

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

II. Background

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

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

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

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

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

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

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

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

Assume the following fact pattern:

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

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

The previous example illustrates the complexity of the current model.

Market can be any *one of three outcomes*:

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

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

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

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

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

A summary of the key provisions of the ASU follows:

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

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

3. An entity should measure inventory measured on FIFO or average cost at the *lower of cost and net realizable value*.[34]

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

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

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

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

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

III. Scope

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

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

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

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

IV. Definitions

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

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

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

V. Rules

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

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

   b. Inventory measured using LIFO or the retail inventory method

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

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

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

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

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

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

Inventory measured using LIFO or the retail inventory method:

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

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

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

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

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

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

4. Subsequent measurement guidance applicable to all inventory:

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

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

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

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

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

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

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

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

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

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

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

7. Market decline in interim period

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

Examples:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Entry at December 31, 2017:

	dr	cr
Cost of goods sold- inventory write-down	226,000	
Allowance for inventory write-down		226,000[35]

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

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

Entry at December 31, 2017:

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

How should a manufacturer apply ASU 2015-11?

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

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

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

Consider the following:

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

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

Raw materials (RM)	$5,000,000
Work in process (WIP)	1,000,000
Finished goods (FG)	4,000,000
	$10,000,000

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

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

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

Costs of completion are as follows:

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

Conclusion:

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

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

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

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

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

Entry at December 31, 2017:

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

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

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

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

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

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

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

Two examples follow:

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

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

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

But what if raw materials inventory is significant?

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

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

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

If raw material inventory is a significant component of finished goods and work in process inventory, it would appear that an entity could avoid testing that raw material inventory as part of an overall lower of cost and net realizable value *<u>if evidence exists that the finished goods and work-in-process inventory has no write-down when tested</u>*.
After all, the raw materials inventory ultimately becomes part of the work in process and finished goods inventory. If an entity first tests work in process and finished goods inventory for lower of cost and net realizable value and there is no write-down, that would suggest that a component of that inventory (materials cost) should have no impairment, as well.

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

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

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

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

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

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

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

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

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

In particular, IRC 471.4 defines *market* as:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Critics suggest the following:

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

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

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

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

VI. Disclosures

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

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

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

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

Examples of disclosures:

- Assume an entity adopts the ASU for calendar year 2017.

- The company uses the lower of cost and net realizable value which results in a write-down in the amount of $100,000.

- There was no write-down in 2016.

2017 disclosures:

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

Note XX: Summary of Significant Accounting Policies:

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

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

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

Observation: The ASU requires disclosure of the following items:

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

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

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

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

VII. Implementation of ASU 2015-11

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

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

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

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

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

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

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

Implementing the ASU- pre-adoption write-downs

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

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

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

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

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

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

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

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

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

Continuing with the example:

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

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

Conclusion:

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

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

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

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

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

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

The SEC affirms this treatment

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

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

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

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect. To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow.

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

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

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

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

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

SUGGESTED SOLUTIONS

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

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

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

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

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

GLOSSARY

Agent: An entity who entity's performance obligation is to arrange for the provision of specified good or service by another party and *does not control* the specified good or service provided by another party before that good or service is transferred to the customer.

Amortized cost basis: The amortized cost basis is the amount at which a financing receivable or investment is originated or acquired, adjusted for applicable accrued interest, accretion or amortization of premium, discount, and net deferred fees or costs, collection of cash, writeoffs, foreign exchange, and fair value hedge accounting adjustments.

Available-for-sale securities: Debt securities that are not categorized as either held to maturity or trading securities, are automatically categorized as available-for-sale. In this category, management has essentially not decided what it plans to do with the securities.

Breakage: The portion of the proceeds from prepaid stored-value products that is estimated not to be redeemed.

Carryforwards: Deductions or credits that cannot be utilized on the tax return during a year that may be carried forward to reduce taxable income or taxes payable in a future year.

Class of financing receivable: A group of financing receivables determined based on both of the following: a) Risk characteristics of the financing receivable b) An entity's method for monitoring and assessing credit risk.

Commencement date: The date on which a lessor makes an underlying asset available for use by a lessee.

Contract: An agreement between two or more parties that creates enforceable rights and obligations.

Credit quality indicator: A statistic about the credit quality of a financial asset.

Debt issuance costs: Specific third-party incremental costs that are directly attributable to issuing a debt instrument.

Debt security: Any security representing a creditor relationship with an entity.

Debt securities held to maturity: Debt securities that management plans to hold until maturity.

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

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

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

Direct financing lease: From the perspective of a lessor, a lease that meets none of the criteria to be a sales-type lease or an operating lease.

Discount rate for the lease: The discount rate for the lease is 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.

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.

Effective interest rate: The rate of return implicit in the loan financial asset, that is, the contractual interest rate adjusted for any net deferred loan fees or costs, premium, or discount existing at the origination or acquisition of the financial asset loan. For purchased financial assets with credit deterioration, however, to decouple interest income from credit loss recognition, the premium or discount at acquisition excludes the discount embedded in the purchase price that is attributable to the acquirer's assessment of credit losses at the date of acquisition.

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.

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.

Finance lease: From the perspective of a lessee, a lease that meets one or more of the five criteria and results in the lease obligation and right-of-use asset being recorded on the lessee's balance sheet.

Financial asset: Cash, evidence of an ownership interest in an entity, or a contract that conveys to one entity a right to do either of the following: a. Receive cash or another financial instrument from a second entity, or b. Exchange other financial instruments on potentially favorable terms with the second entity.

Financial liability: A contract that imposed on one entity an obligation to do either of the following: a) Deliver cash or another financial instrument to a second entity, or b) Exchange other financial instruments on potentially unfavorable terms with the second entity.

Financing receivable: A financing arrangement that has both of the following characteristics: a. It represents a contractual right to receive money in either of the following ways: 1. On demand 2. On fixed or determinable dates. b. It is recognized as an asset in the entity's statement of financial position.

Functional intellectual property: Intellectual property that has significant standalone functionality (for example, the ability to process a transaction, perform a function or task, or be played or aired).

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 receivable: A lessor's right to receive lease payments arising from a sales-type lease or a direct financing lease plus any amount that a lessor expects to derive from the underlying asset following the end of the lease term to the extent that it is guaranteed by the lessee or any other third party unrelated to the lessor, measured on a discounted basis.

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.

Leveraged lease: From the perspective of a lessor, a lease that was classified as a leveraged lease in accordance with the leases guidance in effect before the effective date and for which the commencement date is before the effective date.

Licensing: Contract that establishes a customer's rights to the intellectual property of an entity.

LIFO Conformity Requirement: A provision within Section 472 of the Internal Revenue Code which requires an entity that uses LIFO for income tax purposes to also use it for GAAP to clearly reflect its income.

Loan: A contractual right to receive money on demand or on fixed or determinable dates that is recognized as an asset in the creditor's statement of financial position. Examples include but are not limited to accounts receivable (with terms exceeding one year) and notes receivable.

Management Discussion and Analysis: 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 include known trends, events, demands, commitments, and uncertainties that are reasonably likely to have a material effect on financial condition or operating performance.

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

More likely than not: More than 50 percent probability.

Near term: is defined as a period of time not to exceed one year from the date of the financial statements.

Net investment in the lease: For a sales-type lease, the sum of the lease receivable and the unguaranteed residual asset. For a direct financing lease, the sum of the lease receivable and the unguaranteed residual asset, net of any deferred selling profit.

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

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

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.

Orderly transaction: A transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale).

Over time: Satisfying a performance obligation over time by transferring control of a good or service over time.

Performance obligation: A promise in a contract with a customer to transfer to the customer either: a) A good or service (or a bundle of goods or services) that is distinct, or b) A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

Period of Use: The total period of time that an asset is used to fulfill a contract with a lessee (customer) (including the sum of any nonconsecutive periods of time).

Prepaid stored-value products: Products in physical and digital forms with stored monetary values that are issued for the purpose of being commonly accepted as payment for goods or services.

Principal: An entity that controls the specified good or service before that good or service is transferred to a customer.

Private company: An entity other than a public business entity, a not-for-profit entity, or an employee benefit plan.

Probable: The future event or events are likely to occur.

Protective rights: Are typically terms and conditions in a contract designed to protect certain rights of a lessor.

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.

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.

Purchased financial assets with credit deterioration acquired: Individual financial assets (or acquired groups of financial assets with similar risk characteristics) that, as of the date of acquisition, have experienced a more-than-insignificant deterioration in credit quality since origination, as determined by an acquirer's assessment.

Rate implicit in the lease: The rate of interest that, at a given date, causes the aggregate present value of: (a) the lease payments and (b) the amount that a lessor expects to derive from the underlying asset following the end of the lease term to equal the sum of (1) the fair value of the underlying asset minus

any related investment tax credit retained and expected to be realized by the lessor and (2) any deferred initial direct costs of the lessor.

Residual value guarantee: A guarantee made to a lessor that the value of an underlying asset returned to the lessor at the end of a lease will be at least a specified amount.

Remote: The change of the future event or events occurring is slight.

Right-of-use asset: An asset that represents a lessee's right to use an underlying asset for the lease term.

Sales-type lease: From the perspective of a lessor, a lease that meets one or more of five criteria.

Security: A share, participation, or other interest in property or in an entity of the issuer or an obligation of the issuer that has all the following characteristics: a) It is either represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer. b) It is of a type commonly dealt on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt as a medium for investment. c) It is either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.

Securities and Exchange Commission (SEC) Filer: An entity that is required to file or furnish its financial statements with either of the following: a. The Securities and Exchange Commission (SEC) b. With respect to an entity subject to Section 12(i) of the Securities Exchange Act of 1934, as amended, the appropriate agency under that Section. Financial statements for other entities that are not otherwise SEC filers whose financial statements are included in a submission by another SEC filer are not included within this definition.

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.

Short-term lease: A lease that, at the commencement date, has a lease term of 12 months or less and does not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise.

Standalone price: The price at which a lessee (customer) would purchase a component of a contract separately.

Sublease: A transaction in which an underlying asset is re-leased by the lessee (or intermediate lessor) to a third party (the sublessee) and the original (or head) lease between the lessor and the lessee remains in effect.

Symbolic intellectual property: Intellectual property that is not functional intellectual property (that is, intellectual property that does not have significant standalone functionality).

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."

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

Trading securities: Debt securities that are bought and held for the purpose of selling them in the near term (generally within one year).

Transaction price: The amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties.

Underlying asset: An asset that is the subject of a lease for which a right to use that asset has been conveyed to a lessee. The underlying asset could be a physically distinct portion of a single asset.

Unguaranteed residual asset: The amount that a lessor expects to derive from the underlying asset following the end of the lease term that is not guaranteed by the lessee or any other third party unrelated to the lessor, measured on a discounted basis.

Variable lease payments: Payments made by a lessee to a lessor for the right to use an underlying asset that vary because of changes in facts or circumstances occurring after the commencement date, other than the passage of time.

CHANGES YOU NEED TO KNOW – THE 2017 FASB REVIEW

FINAL EXAM

1. One key change under the new lease standard is:
   a. A small portion of operating leases, but not capital leases, will be brought onto the balance sheet
   b. Existing capital leases, but not operating leases, will be brought onto the balance sheet
   c. No leases will be capitalized
   d. All leases with a lease term more than 12 months must be capitalized

2. Under new ASU 2016-02, which of the following is a type of lease for a lessee:
   a. Finance lease (Type A)
   b. Sales-type lease (Type C)
   c. Direct finance lease (Type D)
   d. Capital lease (Type B)

3. Which of the following is a type of lease for which the ASU 2016-02 rules *do not* apply:
   a. Lease of retail space
   b. Lease of equipment
   c. Lease of intangible asset
   d. Lease of motor vehicle

4. Captain Kirk is a CPA for Company X. Kirk is assessing whether a contract that X has meets the definition of a lease for purposes of ASU 2016-02. Which of the following is true. A lease conveys the right to _____identified property, plant, or equipment:
   a. Sell
   b. Purchase at the end of the lease
   c. Control the use of
   d. Convert

5. In determining whether a contract has a lease, there is a general rule. If there is no _____, there is no lease:
   a. Identified asset
   b. Lease term
   c. Fixed lease payment
   d. Signed agreement

6. Company L executes a lease agreement with a lessor. L is trying to determine whether the agreement qualifies to be a lease under ASU 2016-02. L *does not* have the right to use the leased asset if the lessor has the substantive right to _____:
   a. Retain the asset at the end of the lease
   b. Substitute the asset
   c. Sell the asset at the end of the lease
   d. Insure the asset throughout the lease

7. With respect to the new lease rules, a component of a contract includes only those items or activities that _____.
   a. Transfer a good or service to a lessee
   b. Are otherwise incurred by the lessor
   c. Are easily separable from other components
   d. Are clearly identified separately within the contract

8. With respect to a lessee, for a lease term to be a *major part* of the remaining economic life of the underlying asset, which one of the following thresholds must be satisfied:
   a. Present value of the lease payments must exceed 50% of the fair value of the leased asset
   b. Lease term is 75% or more of the remaining economic life of the leased asset
   c. There is a bargain purchase option
   d. There must not be any transfer of ownership during the lease term

9. At the commencement date of a lease, how should a lessee account for initial direct costs:
   a. Include them as part of the right-of-use asset
   b. Expense them as incurred
   c. Capitalize them as an intangible asset and amortize them
   d. Net them against the lease obligation

10. ASU 2016-02 provides that if it is _____ that a lessee will exercise the option to purchase the leased asset, the amount of the purchase is included as part of the lease payments:
    a. Probable
    b. More likely than not
    c. Reasonably certain
    d. Reasonably possible

11. Company Z pays $1 million for leasehold improvements for space it leases. The remaining lease term is 10 years. There is no option to purchase the real estate at the end of the lease. The useful life of the leasehold improvements is 30 years. The useful life of the underlying real estate is 40 years. Over what period should Z amortize the leasehold improvements:
    a. 10 years
    b. 30 years
    c. 40 years
    d. Tax life of 39 years

12. Jones Company is a lessee who has classified its lease as a finance (Type A) lease. How should the repayment of the principal portion of a finance (Type A) lease be presented on the statement of cash flows:
    a. Operating activities
    b. Financing activities
    c. Investing activities
    d. Disclosed only

13. If a lessor's lease does *not* qualify for a sales-type lease or a direct financing lease, it is classified as which of the following:
    a. Capital lease
    b. Finance lease
    c. Operating lease
    d. Leveraged lease

14. In a sales-type lease, a lessor should reassess a lease term if _____:
    a. The lease is modified
    b. The original discount rate changes
    c. It appears the underlying asset has a longer economic live than originally anticipated
    d. Lessor receives a bona fide offer to sell or transfer the underlying leased asset

15. How should a lessor initially account for initial direct costs for a lease classified as an operating lease from the lessor's perspective:
    a. Defer initial direct costs
    b. Expense the initial direct costs
    c. Capitalize the costs as part of the right of use asset
    d. Record the costs as part of other comprehensive income in stockholders' equity

16. With respect to a lessor lease classified as an operating lease, how should lease payments received be recorded on the income statement:
    a. On a straight-line basis over the lease term
    b. On an accelerated basis over the lease term
    c. On a straight-line basis over the useful life of the underlying leased asset
    d. On an accelerated basis over the useful life of the underlying leased asset

17. Company X, a lessee, is implementing ASU 2016-02 for its leases. All its existing leases on the implementation date have lease terms more than 12 months and do not qualify for the short-term lease exception. Which of the following is true as it relates to X's existing leases on the implementation date of ASU 2016-02:
    a. All of X's existing leases will be grandfathered from having to comply with the new lease standard
    b. All of X's capital leases only will be grandfathered from having to comply with the new lease standard
    c. All of X's existing operating leases only will be grandfathered from having to comply with the new lease standard
    d. None of X's existing leases are grandfathered from implementing ASU 2016-02

18. Company X is implementing ASU 2016-02 for its leases. How should X record any

implementation adjustment:
a. As an adjustment to equity
b. As a cumulative effect on the income statement
c. As a separate component of other comprehensive income
d. There is no adjustment required

19. Under the new 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 leased asset recorded
d. Lease terms are likely to get longer to reduce the amount of the leased asset recorded

20. One potential impact from the new lease standard for lessee's finance (Type A) leases will be that EBITDA will likely 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

21. ASU 2016-01 splits the accounting for investments between which of the following:
a. Debt securities and equity securities
b. Long-term debt and short-term debt
c. Non-public equity investment and public company equity investment
d. Equity securities categorized as trading and debt securities held to maturity

22. ASU 2016-01 retains the three categories for which of the following:
a. Debt securities
b. Equity securities
c. Debt and equity securities
d. No securities. The three categories rule has been removed from GAAP altogether

23. One of the changes made by ASU 2016-01 is that it:
a. Eliminates the requirement to disclose the fair value of financial instruments measured at amortized cost for nonpublic entities
b. Adds the requirement to disclose the fair value of financial instruments measured at amortized cost for nonpublic entities
c. Expands the requirement to disclose the fair value of financial instruments measured at amortized cost for nonpublic entities
d. Creates a new requirement for a public entity to disclose the fair value of financial instruments measured at amortized cost

24, ASU 2016-01 provides that available for sale debt securities should be measured on the statement of financial position at _____:
a. Fair value
b. Amortized cost
c. Lower of cost or market
d. Liquidation value

25. Under ASU 2016-01, debt securities classified as held to maturity are measured on the statement of financial position at _____:
a. Amortized cost
b. Liquidation value
c. Fair value
d. Lower of cost or market

26. ASU 2016-01 provides that there are certain events that may cause an entity to sell or transfer a held-to-maturity security. Which of the following is a condition that must be met to avoid tainting the intent to hold the remainder debt securities to maturity:
a. The event occurs frequently
b. The event is a usual event that occurs for the reporting entity
c. The company had ample time to plan the event and reasonably anticipate it.
d. The event is nonrecurring

27. Company X has an investment in a debt security that has an impairment. X determines the impairment is *temporary*. Under ASU 2016-01, how should the impairment be accounted for:
a. No impairment loss is recorded
b. An impairment loss is recorded as part of other comprehensive income
c. An impairment loss should be recorded to expense
d. A partial loss is recognized with the remainder not recorded to the extent the fair value exceeds amortized cost

28. For which one of the following do the new ASC 321 equity securities rules apply:
a. Cooperatives and mutual entities, such as credit unions and mutual insurance entities
b. Brokers and dealers in securities (ASC 940)
c. Defined benefit pension and other postretirement plans (ASC 960, 962, and 965)
d. Investment companies (ASC 946)

29. Company Z has an investment in an equity security sold on a public exchange for which fair value is readily determinable. How should the equity securities investment be recorded on Z's balance sheet:
a. At fair value
b. At amortized cost
c. At lower of cost or market
d. At liquidation value

30. Company K has an investment in an equity security sold on a public exchange for which fair value is readily determinable. How should K present any unrealized gain or loss on the investment:
    a. Included in earnings
    b. Included in stockholder's equity, net of applicable taxes
    c. Nowhere. Unrealized gains are not recorded
    d. As a deferred credit on the balance sheet until the asset is sold

31. In accordance with the changes made by ASU 2016-01, an equity security *without a readily determinable fair value* shall be tested for impairment using which of the following methods:
    a. A qualitative assessment
    b. A quantitative assessment
    c. No methods because the impairment rules do not apply to an equity security
    d. A combination of a qualitative and quantitative assessment

32. An entity records an equity security at fair value under ASU 2016-01. In 20X9, the entity sells the security. Which of the following is true:
    a. No realized gain or loss is recorded at the time of the sale
    b. A realized gain or loss is recorded based on the difference between the carrying amount and fair value
    c. The carrying amount is not adjusted to fair value as of the sale date
    d. A partial realized gain is recorded at the date of sale

33. Company X has an investment in a mutual fund (equity security). The fund invests in various assets including U.S. government debt securities and equity securities. In determining how to measure the investment in the mutual fund, X should consider the investment in the mutual fund to be a (an) _____:
    a. Equity security
    b. Debt security
    c. Hybrid security consisting of attributes of both an equity and debt security
    d. X should look through the form of the investment to determine whether to classify it as a debt or equity security

34. With respect to the fair value disclosure for trade receivables and payables, ASU 2016-01 amends ASC 310 to change the exemption for the fair value disclosure with respect to trade receivables and payables. The disclosure of fair value for trade receivables or payables is *not required* if _____:
    a. The carrying amount exceeds the fair value
    b. The trade receivables or payables are due in one year or less
    c. The trade receivables and payables are due in more than one year
    d. The fair value approximates the carrying amount

35. With respect to the exception to measurement of fair value, ASU 2016-01 eliminates the exception for _____:
    a. Application
    b. Practicability
    c. Implementation
    d. Valuation

36. Which of the following does ASC 326-20 (as amended by ASU 2016-13) <u>not apply to</u>:
    a. Financing receivables
    b. Held-to-maturity debt securities
    c. Off-balance sheet credit exposures not accounted for as insurance
    d. Policy loan receivables of an insurance entity

37. Jean Claude CPA is implementing the ASU 2016-13 credit loss model for his client, Company Z. Which of the following models does ASU 2016-13 use in dealing with credit losses:
    a. Incurred loss model
    b. Expected credit loss model
    c. Probable loss model
    d. Measured loss model

38. Which of the following is true with respect to ASU 2016-13's new rules for credit losses related to available-for-sale debt securities:
    a. Credit losses should be recorded through a direct writedown of the asset
    b. Credit losses should be recorded through an allowance for credit losses
    c. Credit losses should be recorded based on an other-than-temporary threshold
    d. Once a credit loss is recorded, it cannot be reversed

39. John Mitchell CPA is preparing the new disclosures required for his client to implement new ASU 2016-13 with respect to credit losses. Which of the following disclosures is *<u>not</u>* a new disclosure required by ASU 2016-13:
    a. Disclosure of the balance in the allowance for credit losses at the balance sheet date
    b. Reasons for significant changes in the amount of writeoffs
    c. The amount of any significant purchases of financial assets during the reporting period
    d. Disclosures of the activity in the allowance for credit losses

40. Sally Green CPA is implementing ASU 2016-13 for her client, Big Ed's Hard Money Lender. Big Ed has some financial assets recorded at amortized cost. How should Sally account for the implementation of ASU 2016-13 with respect to credit losses involving financial assets recorded at cost:
    a. As a cumulative-effect adjustment to the income statement
    b. As a restatement of financial statement presented
    c. As a cumulative-effect adjustment to the opening retained earnings
    d. As a disclosure only

41. Which of the following is one of the five steps in applying the revenue standard:
    a. Deliver the goods or services
    b. Collect the consideration
    c. Determine the transaction price
    d. Recognize revenue once the contract is signed

42. Company Z is determining whether it should record certain revenue on a gross or net basis. Which of the following is the general rule that Z should follow:
    a. If Z is a principal, it should record revenue at the gross amount
    b. If Z is a principal, it should record revenue on a net amount of any fee or commission
    c. If Z is an agent, it should record revenue at the gross amount
    d. If Z is an agent, it has the choice of recording revenue at a gross or net amount of any fee or commission

43. Ed's Distribution Company receives revenue from certain transactions. For purposes of determining whether revenue should be recorded gross or net, the Company is a principal if it _____ the specified good or service:
    a. Controls
    b. Owns
    c. Sells
    d. Acquires

44. Alice Cooper CPA is reviewing whether its client should record certain revenue as gross or net. Alice is considering various indicators identified in ASU 2014-09 and amendments by ASU 2016-08: Which of the following is an indicator <u>removed by ASU 2016-08</u> that was previously in ASU 2014-09:
    a. The entity is exposed to credit risk
    b. The entity has inventory risk
    c. The entity has discretion establishing prices
    d. The entity is primarily responsible for fulfilling the contract

45. If an entity <u>does not</u> control a specified good or service, that entity is considered a(an) _____:
    a. Principal
    b. Agent
    c. Wholesaler
    d. Intermediary

46. Which of the following is an example of a prepaid stored-value product:
    a. Prepaid stored-value products attached to a segregated bank account
    b. Product that only can be redeemed for cash
    c. Customer loyalty program
    d. Prepaid gift card

47. Big Willy Ribs issues prepaid stored-value product certificates and wants to make an entry to derecognize (remove) a portion of its prepaid stored-value product liability for expected breakage. Under the rules, breakage should be recorded only to the extent that it is _____ that a significant reversal of the breakage amount will not subsequently occur:
    a. Probable
    b. Reasonably possible
    c. More likely than not
    d. Unlikely

48. Macy's is implementing the changes required by ASU 2016-04 related to prepaid stored-value products. Which of the following is a method that Macy's can use to apply the amendments:
    a. Prospective application
    b. Retrospectively by means of a cumulative effect adjustment to retained earnings
    c. Retroactively by using a cumulative effect adjustment to net income
    d. As a disclosure only

49. Company X is applying Step 1 of the revenue recognition standard, which is to identify the contract with a customer. One of the criteria in Step 1 is that it is _____ that the entity will collect the consideration to which it will be entitled in exchange for the goods or services.
    a. Probable
    b. Likely
    c. Possible
    d. Remote

50. Big Al is working on the implementation of the new revenue standard and is reading the amendments made by ASU 2016-12 to noncash transaction. The measurement date that Al should use for the noncash consideration is _____:
    a. Date the contract is signed
    b. Date on which the first revenue is generated
    c. Contract inception date
    d. The implementation date of ASU 2016-12

51. Lucy Lu CPA is assisting Company X with implementing the new revenue standard. One of the requirements is that X must perform Step 2 which is to identify the performance obligation in each contract. In identifying performance obligations, X <u>is not</u> required to assess whether promised goods or services are performance obligations if they are _____ the contract.
    a. Not relevant to
    b. Not homogeneous with
    c. Unrelated to
    d. Immaterial to

52. Under Step 5 of ASC 606, an entity is required to recognize revenue when (or as) the entity satisfies a performance obligation. Which of the following is a time for which a customer might satisfy a performance obligation:
    a. At a point in time
    b. On a systematic and rational basis
    c. At inception
    d. When title passes

53. Gino's Construction is implementing the new revenue standard. Which of the following is an example of an <u>input method</u> that the company might use to recognize revenue over time:
    a. Surveys of performance
    b. Appraisals of results achieved
    c. Units produced
    d. Costs incurred

54. Which of the following is a type of intellectual property that has significant standalone functionality:
    a. Symbolic intellectual property
    b. Functional intellectual property
    c. Interrelated intellectual property
    d. Combined intellectual property

55. How should a license to symbolic intellectual property that grants a customer a right to access an entity's intellectual property be satisfied under ASU 2016-10:
    a. At a point in time
    b. Over time
    c. At the end of the contract
    d. At the beginning of the contract

56. Implications of a drastic change in the format of financial statements would include all of the following *<u>except:</u>*
    a. Tax return M-1 reconciliation would differ
    b. Contract formulas for bonuses would have to be rewritten
    c. The cost would be significant
    d. The use of the term cash equivalents would remain intact

57. Which of the following is a reason why U.S. convergence with international standards <u>has not</u> 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

58. Which of the following is true as it relates to how certain elements are accounted for under U.S. GAAP as compared with IFRS:
    a. U.S. GAAP has more extensive disclosures using a principles-based system than IFRS
    b. IFRS uses a one-step approach versus a two-step approach for impairment of long-lived assets
    c. Both the IFRS and U.S. GAAP deal with uncertain tax positions
    d. U.S. GAAP guidance on revenue recognition is limited while IFRS has significant guidance

59. Which of the following is true:
    a. IFRS permits use of LIFO inventory in most cases
    b. IFRS does not permit use of LIFO inventory
    c. IFRS permits use of LIFO inventory in all cases
    d. IFRS follows U. S. GAAP in determining whether LIFO is permitted and when

60. If LIFO is used for tax purposes, the LIFO Conformity Requirement _____.
    a. Permits that the primary income statement be presented on FIFO or average cost
    b. Requires that the primary income statement and balance sheet must be presented on LIFO
    c. Permits the balance sheet to be presented on a non-LIFO basis
    d. Does not require either the income statement or balance sheet to be presented on a LIFO basis

61. 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

62. 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

63. 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

64. 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

65. Company X is a nonpublic entity that has no uncertain tax positions liability. Which of the following is correct:
    a. X must disclose the number of tax years open for tax examination
    b. X must include an abbreviated disclosure of the number of tax years open for examination
    c. The exclusion of the disclosure only applies if X is SEC registered and not a nonpublic entity
    d. X is not required to disclose the number of tax years open for examination

66. 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 most banks will accept deposits from marijuana businesses
    d. Marijuana businesses are permitted to make payroll tax deposits by check instead of cash

67. Company Z makes a cash payment to prepay debt. Where should that payment be presented on the statement of cash flows in accordance with ASU 2016-15 amendments:
    a. Cash inflow for operating activities
    b. Cash outflow for financing activities
    c. As a non-cash disclosure
    d. As a cash outflow for investing activities

68. Per ASU 2015-05, which of the following is not an example of a cloud computing arrangements include:
    a. Platform as a service
    b. Infrastructure as a service, and
    c. Other similar hosting arrangements
    d. Installable software such as Microsoft Office Suite

69. 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

70. Company Z is amortizing its debt issuance costs. To which expense account should it record the amortization:
    a. Interest expense
    b. Amortization expense
    c. Miscellaneous expense
    d. None as the costs are not amortized to an expense account

71. Company L has notes payable and debt issuance costs. Which of the following rates must L disclose regarding its note payable:
    a. Effective interest rate
    b. Market interest rate
    c. Replacement interest rate
    d. Risk-free interest

72. Company Z has a deferred tax asset that relates to a temporary difference that is presented as current on the balance sheet. How should the deferred tax asset be presented on the balance sheet under new ASU 2015-17:
    a. Current
    b. Long-term
    c. Split current and long-term
    d. The asset is not recorded, but is disclosed only

73. Company C presents an unclassified balance sheet so that assets and liabilities are not classified as current and long-term. Which of the following is true:
    a. The changes made by ASU 2015-17 do not apply to C because it does not have a classified balance sheet
    b. C must convert its unclassified balance sheet to a classified one to comply with the new ASU 2015-17 rules
    c. ASU 2015-17 requires C to make changes to C's deferred tax asset and liability
    d. ASU 2015-17 applies to unclassified balance sheets and not to classified balance sheets

74. Company K is adopting ASU 2015-17 for deferred taxes effective in 2018 and will present a comparative balance sheet for 2017. If X adopts the ASU retrospectively, what should K do to the comparative 2017 balance sheet presentation of the deferred tax asset or liability:
    a. X should not restate the 2017 balance sheet
    b. X should reverse off the 2017 liability
    c. X must restate the 2017 balance sheet
    d. X should gross up the asset and liability for 2017

75. Company J is adopting ASU 2015-17 and applying it prospectively. Which of the following should J disclose in the first annual period of adoption:
    a. The computation of the deferred tax amount
    b. A reconciliation of the effective tax rate to the statutory rate
    c. The nature of and reason for the change in accounting principle
    d. Quantitative information about the effects of the accounting change on the three prior periods

76. With respect to FIFO inventory, ASU 2015-11 replaces the concept of "market" with which of the following:
    a. Replacement cost
    b. Fair value
    c. Normal profit
    d. Net realizable value

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

78. Company L wrote down its inventory to lower of cost and net realizable value last year. This year, it appears that there is a recovery of the write-down. Which of the following is true with respect to U.S. GAAP:
    a. L is permitted to reverse the previous year's write-down
    b. L cannot reverse the previous year's write-down under U.S. GAAP
    c. L is permitted to reverse the previous year's write-down above original cost
    d. If L were using international standards (IFRS), L would still not be permitted to reverse the prior year's write-down

79. A company is performing a lower of cost and net realizable value test on its year-end inventory. The company's inventory has about 1,000 individual items and two major categories of products. Which of the following *would not* be an appropriate approach to perform the test:
    a. Directly on each of the 1,000 individual items
    b. To the total inventory in each of the two major categories
    c. To the total inventory
    d. Perform the test on only 5 percent of the total inventory

80. Company Q is implementing ASU 2015-11. How should Q apply the changes in the ASU:
    a. Retroactively
    b. Retrospectively
    c. Prospectively
    d. As a change in estimate