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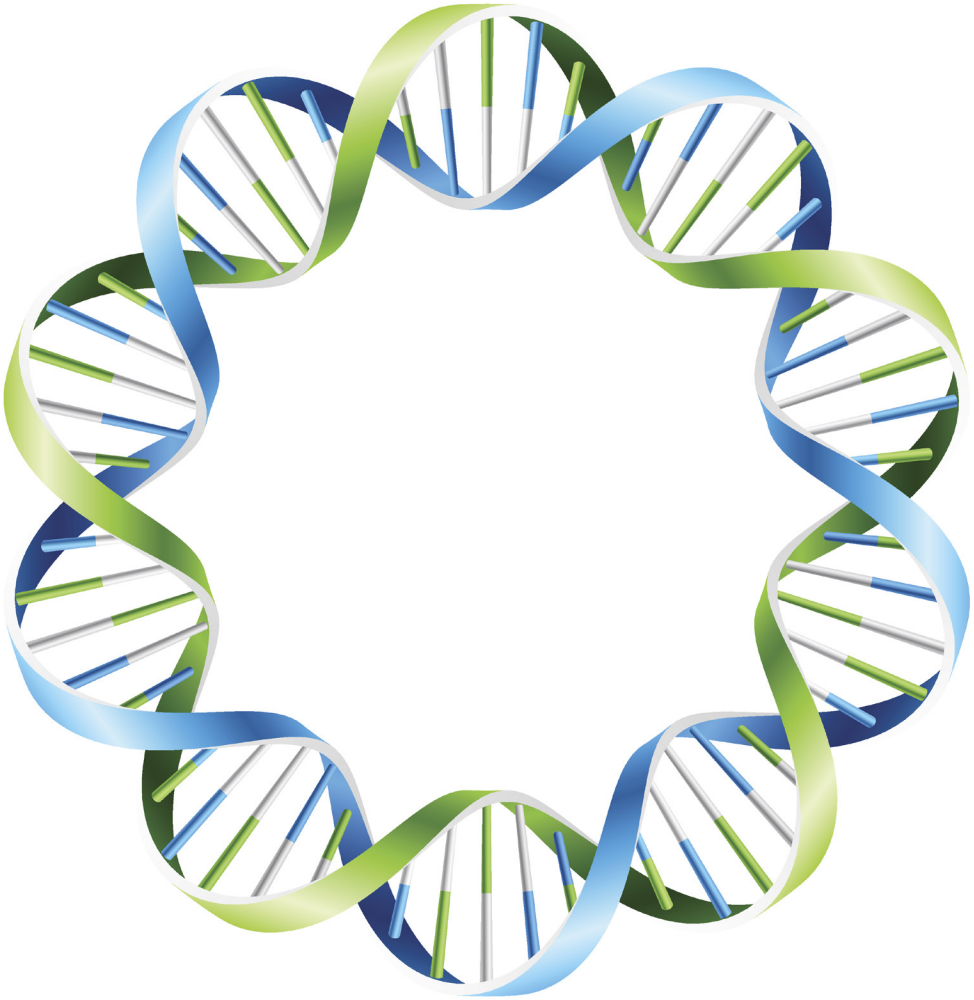


Life Sciences

Accounting and Financial Reporting Update — Interpretive Guidance on Financial Instruments

March 2019

Contacts

If you have any questions about this publication or ways in which we can help your organization, please contact the following Deloitte industry specialists.

Jeff Ellis
U.S. Audit Leader — Life Sciences and Health Care
Life Sciences Industry Professional Practice Director
Deloitte & Touche LLP
+1 412 338 7204
jeellis@deloitte.com

Dennis Howell
Senior Consultation Partner, Accounting and Reporting Services
Life Sciences Deputy Industry Professional Practice Director
Deloitte & Touche LLP
+1 203 761 3478
dhowell@deloitte.com

Preface

March 2019

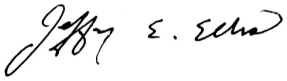
To our clients, colleagues, and other friends:

The life sciences industry represents entities that discover, develop, and manufacture health care products. Such entities include pharmaceutical manufacturers; biotechnology companies; medical device, diagnostic, and medical equipment manufacturers; and service companies such as drug distributors, contract research organizations (CROs), contract manufacturing organizations (CMOs), and health technology companies.

Finance and accounting professionals in the industry face complex issues and must exercise significant judgment in applying existing rules related to research and development (R&D) costs, acquisitions and divestitures, consolidation, contingencies, revenue recognition, income taxes, financial instruments, and financial statement presentation and disclosure. The full life sciences accounting and financial reporting update, our 10th edition, addresses these and other topics affecting the industry in 2019. It includes updated interpretive guidance as well as new sections that discuss initial public offerings (IPOs), accounting considerations for health technology companies, and the latest developments in standard setting. In addition, it discusses the outlook for the life sciences industry in 2019.

Appendix A lists the titles of standards and other literature we cited, and Appendix B defines the abbreviations we used.

Sincerely,



Jeff Ellis
U.S. Audit Leader — Life Sciences and Health Care
Life Sciences Industry Professional
Practice Director
Deloitte & Touche LLP

Dennis Howell
Senior Consultation Partner, Accounting
and Reporting Services
Life Sciences Deputy Industry Professional
Practice Director
Deloitte & Touche LLP

Contents

Chapter 10 — Financial Instruments

10.1 Introduction

Drug development is challenging, complex, time-consuming and costly. Every year, billions of dollars are spent developing new drugs, with some studies showing that the cost of bringing an asset to market increased to record levels in 2018, even as R&D returns have fallen to the lowest level in years.[1] To fund the cost of drug development, life sciences entities frequently seek external financing. Many of the financing transactions include complex terms and conditions that require a careful accounting analysis.

The SEC staff historically has focused on the classification of liabilities and equity on the balance sheet when equity instruments have redemption provisions or financial instruments possess characteristics of both liabilities and equity. For example, classification of convertible debt instruments and freestanding warrants is often scrutinized since they may contain both liability and equity components under U.S. GAAP.

In addition, prospective SEC registrants in the life sciences industry may have previously outstanding instruments with characteristics of both liabilities and equity at the time they are approaching a potential initial public offering (IPO), or life sciences entities may issue new instruments in connection with a potential IPO. Even if certain instruments are already outstanding before an IPO, it may be appropriate for an instrument to be classified outside of permanent equity in accordance with SEC rules when public financial statements are initially filed. Further, for a life sciences entity that becomes a public company, there can be other accounting consequences that did not exist while the entity was private.

10.2 Industry Issues

The discussion below highlights guidance on the accounting for financial instruments that frequently affects life sciences entities. The guidance cited is not intended to be all-inclusive or comprehensive; rather, the discussion focuses on targeted considerations related to the application of the guidance most relevant to the industry. To complete an analysis of the accounting for financial instruments, entities must consider all facts and circumstances and use significant judgment. For additional guidance on the topics highlighted below, see Deloitte's *A Roadmap to Distinguishing Liabilities From Equity* and *A Roadmap to Accounting for Contracts on an Entity's Own Equity*.

[1] See, for example, the Deloitte Centre for Health Solutions' ninth annual pharmaceutical study, "Embracing the Future of Work to Unlock R&D Productivity: Measuring the Return From Pharmaceutical Innovation 2018."

10.2.1 Sequence of Decision-Making

Upon the issuance of an equity instrument, a life sciences entity should first evaluate whether the instrument meets the definition of a liability in accordance with ASC 480-10. ASC 480-10 applies to both PBEs (including SEC registrants) and private companies that are issuers of financial instruments within its scope. ASC 480-10 provides guidance on determining whether (1) certain financial instruments with both debt-like and equity-like characteristics should be accounted for "outside of equity" (i.e., as liabilities or, in some cases, assets) by the issuer and (2) SEC registrants should present certain redeemable equity instruments as temporary equity. Contracts and transactions that may require evaluation under ASC 480-10 include:

- Redeemable shares.
- Redeemable noncontrolling interests.
- Forward contracts to repurchase own shares.
- Forward contracts to sell redeemable shares.
- Written put options on own stock.
- Warrants (and written call options) on redeemable equity shares.
- Warrants on shares with deemed liquidation provisions.
- Puttable warrants on own stock.
- Equity collars.
- Share-settled debt.
- Preferred shares that are mandatorily convertible into a variable number of common shares.
- Unsettled treasury stock transactions.
- Accelerated share repurchase programs.
- Hybrid equity units.

However, ASC 480-10 does not apply to legal-form debt, which is always classified as a liability by the issuer. If the legal form of an instrument is equity, further evaluation is necessary.

ASC 480-10 applies only to items that have all of the following characteristics:

- They embody one or more obligations of the issuer. An obligation can be either unconditional or conditional. An obligation is unconditional if no condition needs to be satisfied (other than the passage of time) to trigger a duty or responsibility for the obligated party to perform. The following items are examples of unconditional obligations:
    - Mandatorily redeemable financial instruments (as defined in ASC 480-10-20).
    - Physically settled forward contracts that require the issuer to repurchase equity shares by transferring assets or a variable number of shares.
    - Preferred stock that mandatorily converts into a variable number of common shares.

An obligation is conditional if the obligated party only has a duty or responsibility to perform if a specified condition is met (e.g., the occurrence or nonoccurrence of an uncertain future event or the counterparty's election to exercise an option). The following items are examples of conditional obligations:

- Physically settled written put options that, if exercised, could require the issuer to purchase equity shares and transfer assets.
- Physically settled forward contracts that require the issuer to purchase equity shares upon the occurrence or nonoccurrence of an event that is outside the issuer's control.
- Net-settled forward contracts to purchase equity shares that could require the issuer to transfer cash or a variable number of equity shares to settle the contracts' fair value if they are in a loss position.
- Net-settled written options that require the issuer to transfer assets or shares if the counterparty elects to exercise the options.

ASC 480-10 does not address the accounting for financial instruments that do not embody any obligation of the issuer. The following items are examples of such instruments:

- Outstanding equity shares that do not have any redemption or conversion provisions.
- Purchased call options that permit but do not require the issuer to purchase equity shares for cash (see ASC 480-10-55-35).
- Purchased put options that permit but do not require the issuer to sell equity shares for cash.

- They meet the definition of a financial instrument. Items that qualify as financial instruments include:
  - Ownership interests (e.g., common or preferred shares or interests in a partnership or limited liability company).
  - Contracts to deliver cash (e.g., net-cash-settled options or forward contracts).
  - Contracts to deliver shares (e.g., share-settled debt or net-share-settled options or forward contracts).
  - Contracts to exchange financial instruments (e.g., physically settled written options or forward contracts that involve the exchange of equity shares for cash or another financial asset).
- They meet the definition of a freestanding financial instrument (i.e., they are not features embedded in a freestanding financial instrument). ASC 480-10-20 defines a freestanding financial instrument as one that is entered into either "separately and apart from any of the entity's other financial instruments or equity transactions" or "in conjunction with some other transaction and is legally detachable and separately exercisable."
- Their legal form is that of a share, or they could result in the receipt or delivery of shares or are indexed to an obligation to repurchase shares.

ASC 480-10 requires an instrument that has all of the above characteristics to be classified outside of equity if it falls within one of the following classes of instruments:

- *Mandatorily redeemable financial instruments* — The issuer of a financial instrument that is in the form of a share must classify the share as a liability if it embodies an unconditional obligation requiring the issuer to redeem the share by transferring assets unless redemption would occur only upon the liquidation or termination of the reporting entity. Mandatorily redeemable financial instruments include those mandatorily redeemable shares and mandatorily redeemable noncontrolling interests that do not contain any substantive conversion features.
- *Obligations to repurchase the issuer's shares (or indexed to such obligations) by transferring assets* — A financial instrument other than an outstanding share is classified as an asset or a liability if it both (1) embodies an obligation to repurchase the issuer's equity shares (or is indexed to such an obligation) and (2) requires (or may require) the issuer to settle the obligation by transferring assets. Financial instruments that meet these criteria include those forward purchase contracts and written put options on the entity's own equity shares that are either physically settled or net cash settled.
- *Certain obligations to issue a variable number of shares* — An outstanding share that embodies an unconditional obligation, or a financial instrument other than an outstanding share that embodies an obligation, is classified as an asset or a liability if the issuer must or may settle the obligation by issuing a variable number of its equity shares and the obligation's monetary value is based solely or predominantly on one of the following: (1) a fixed monetary amount, (2) variations in something other than the fair value of the issuer's equity shares, or (3) variations inversely related to changes in the fair value of the issuer's equity shares. Instruments in this category include share-settled debt and those forward purchase contracts and written put options on the entity's own equity shares that are net share settled.

Financial instruments that are accounted for as assets or liabilities under ASC 480 are initially recognized at fair value, with one exception. A forward contract that requires the entity to repurchase a fixed number of its equity shares for cash is initially measured at the fair value of the shares at inception (i.e., not the fair value of the forward contract), with certain adjustments, and the offsetting entry is presented in equity (i.e., the transaction is treated as if the repurchase had already occurred with borrowed funds).

In subsequent periods, financial instruments classified as assets or liabilities under ASC 480-10 are remeasured at their then-current fair value, and changes in fair value are recorded in earnings, with two exceptions. ASC 480-10-35-3 states that physically settled forward contracts to repurchase "a fixed number of the issuer's equity shares [for] cash and mandatorily redeemable financial instruments [are] measured subsequently in either of the following ways," as applicable:

a. If both the amount to be paid and the settlement date are fixed, those instruments shall be measured subsequently at the present value of the amount to be paid at settlement, accruing interest cost using the rate implicit at inception.

b. If either the amount to be paid or the settlement date varies based on specified conditions, those instruments shall be measured subsequently at the amount of cash that would be paid under the conditions specified in the contract if settlement occurred at the reporting date, recognizing the resulting change in that amount from the previous reporting date as interest cost.

The fact that an instrument does not need to be classified as an asset or a liability under ASC 480-10 does not necessarily mean that it qualifies for equity classification. To determine whether an instrument qualifies for classification in equity in whole or in part, an entity must also consider other GAAP (e.g., ASC 470-20, ASC 815-10, ASC 815-15, and ASC 815-40). Further, under ASC 480-10-S99-3A, an entity that is subject to SEC guidance should consider whether an equity-classified instrument must be classified outside of permanent equity.

Once an issuer has determined that the appropriate balance sheet classification for the equity instrument is liability, temporary equity, or permanent equity, the issuer should further evaluate the instrument to identify any embedded features that may need to be bifurcated and accounted for separately as derivative instruments.

The sections below outline some of the more common types of securities that life sciences entities issue, together with the related accounting considerations.

10.2.2 Redeemable Equity Securities

The SEC staff believes that redeemable equity securities are significantly different from conventional equity capital because such securities possess characteristics similar to debt as a result of the redemption obligation attached to the securities. The guidance in ASC 480-10-S99-3A requires instruments to be classified outside of permanent equity in "temporary equity" if they are redeemable (1) at a fixed or determinable price on a fixed or determinable date, (2) at the option of the holder, or (3) upon the occurrence of an event that is not solely within the issuer's control. To determine the appropriate classification, SEC registrants must evaluate all facts and circumstances related to events that could trigger redemption of the securities.[2] Issuers should evaluate whether equity instruments that do not meet the definition of a liability under ASC 480-10 nevertheless must be presented outside of permanent equity because of any of these provisions.

Because only public entities are required to present certain equity instruments as temporary equity (sometimes referred to as mezzanine equity) instead of permanent equity, the SEC staff frequently comments on this topic during the IPO process.

10.2.2.1 Mandatorily Redeemable Equity Securities

ASC 480 requires mandatorily redeemable securities to be reported as liabilities. Other redeemable equity securities are classified outside of shareholders' equity in "temporary equity" under the SEC staff's guidance. More specifically, for a redeemable equity security to be classified as a liability under ASC 480, it must be certain that redemption will occur; redeemable equity securities whose redemption is not certain are classified as temporary equity under the SEC staff's guidance. Therefore, mandatorily redeemable preferred securities that have substantive conversion options at issuance would not be considered liabilities under ASC 480 even though such securities are called mandatorily redeemable convertible securities. This is because as long as the conversion option is substantive, it is not certain that redemption will occur. If the issuer does not have control over any event that could trigger redemption of the security, the security would be classified as temporary equity under the SEC staff's guidance.

The treatment of the return paid to the holder of redeemable securities differs depending on whether the securities are classified as liabilities or as temporary equity. For securities classified as liabilities under ASC 480, such a return is treated as an expense. For redeemable securities classified as temporary equity, such a return is treated as a dividend.

[2] See ASC 480-10-S99-3A-5.

Connecting the Dots

In general, an entity should first apply the guidance in ASC 480 when determining the appropriate presentation of redeemable securities on the balance sheet. If the securities are not classified as liabilities under ASC 480, the entity should examine them under SEC staff guidance to determine whether it is appropriate to classify them as temporary equity. In addition, registrants should be familiar with the SEC staff's views on the applicability of its guidance in certain situations. For example, if redemption is required only upon the liquidation of the reporting entity, an instrument is not considered redeemable. This situation and others are described in ASC 480-10-S99-3A.

10.2.2.2 Redeemable Securities Whose Redemption Is Outside the Issuer's Control

The analysis of whether a security's redemption is not solely within the issuer's control could be complicated depending on the triggering events associated with redemption. The SEC staff believes that the issuer should evaluate each triggering event separately, along with relevant facts and circumstances, to determine whether it is outside the issuer's control. If *any* triggering events are outside the issuer's control, the security should be classified outside of permanent equity regardless of the probability of such events.[3] ASC 480-10-S99-3A-6 through S99-3A-9 provide examples of events that are outside the issuer's control.

Connecting the Dots

Nonpublic life sciences entities, including start-ups and other entities financed by private equity or venture capital firms, often have one or more series of convertible preferred stock issued and outstanding. In evaluating the appropriate classification in the statement of financial condition of convertible preferred stock, a life sciences entity should first consider whether the convertible preferred stock represents a mandatorily redeemable financial instrument that is required to be classified as a liability under ASC 480-10-25-4. If a preferred stock instrument contains an embedded conversion option that is considered a substantive feature as of the issuance date,[4] the convertible preferred stock instrument would not qualify as a mandatorily redeemable financial instrument.[5]

When convertible preferred stock is not required to be classified as a liability, life sciences entities should consider the SEC staff's guidance in ASC 480-10-S99-3A to determine whether it is appropriate to classify the convertible preferred stock in permanent equity. Convertible preferred stock should be classified in temporary equity if the instrument contains (1) a stated redemption feature that allows or requires the holder to put the security to the issuer on a specified date (or dates) or (2) a stated redemption feature that allows the holder to put the security to the issuer upon the occurrence of a specified event that is not solely within the issuer's control. Therefore, when the holders of convertible preferred stock have control over the entity, the following convertible preferred stock instruments must also be classified in temporary equity:

- Convertible preferred stock that contains a stated redemption feature that allows the issuer to call the security on a specified date (or dates).

[3] See footnote 2.

[4] A conversion feature that results in settlement of the instrument through the issuance of a variable number of shares of common stock equal to a fixed monetary amount is equivalent to "share-settled" debt and would not represent a substantive conversion option. For additional guidance, see ASC 470-20-40-5 through 40-10.

[5] See ASC 480-10-55-11 and 55-12.

- Convertible preferred stock that contains a stated redemption feature that allows the holder to put the security to the issuer upon the occurrence of a specified event that can be controlled by the vote of the entity's stockholders or by actions of the entity's board of directors.

Even if a convertible preferred stock instrument does not contain a stated redemption feature (i.e., a stated call option or a stated put option), the instrument's liquidation provisions must still be considered, including whether those provisions are considered "ordinary liquidation" or "deemed liquidation" provisions. An ordinary liquidation provision does not trigger the requirement to classify the convertible preferred equity in temporary equity; a deemed liquidation provision will typically trigger the requirement to classify the convertible preferred equity in temporary equity. See Chapter 9 of Deloitte's *A Roadmap to Distinguishing Liabilities From Equity* for additional guidance.

10.2.2.3 Measurement of Instruments Classified in Temporary Equity

If an instrument classified in temporary equity is currently redeemable, it should be adjusted to its maximum redemption amount as of the balance sheet date. However, if an instrument classified in temporary equity is not currently redeemable and the registrant determines that its redeemability is not probable, subsequent adjustment of the carrying amount is not necessary until it is probable that the security will become redeemable.[6]

10.2.3 Preferred Stock That Is Nonredeemable or Is Redeemable Solely at the Option of the Issuer

When securities are not redeemable or are redeemable solely at the option of the issuer, those securities are generally classified in permanent equity on the balance sheet. All relevant facts and circumstances should be considered in the determination of whether the redemption is solely at the option of the issuer.[7] The SEC staff often emphasizes that issuers should examine the redemption provision of all securities classified in permanent equity to ensure their proper classification. For example, an instrument may not be redeemable for cash but may be convertible into another class of equity. Unless management can assert that it has the ability to settle the conversion with shares, it could be forced to redeem the instrument for cash, resulting in classification of that instrument outside of permanent equity. In addition, according to its terms, a security may be redeemable solely at the option of the issuer; however, if the holder of the security controls the issuer's board of directors, that security would be considered redeemable at the option of the holder and would be classified as temporary equity.[8]

If classification of securities as temporary equity is no longer appropriate because of a change in the redemption feature, the outstanding carrying amount of securities should be reclassified as permanent equity on the date of the event that causes the reclassification.

Even if the entire instrument should be classified in permanent equity under ASC 480-10-S99-3A, the issuer may be required to perform further analysis to determine whether the equity instrument contains embedded derivatives that must be bifurcated and accounted for separately as derivative instruments in accordance with ASC 815-15.

[6] See ASC 480-10-S99-3A-15.
[7] See ASC 480-10-S99-3A-11.
[8] See ASC 480-10-S99-3A-7.

10.2.4 Conversion Features of Preferred Stock and Debt

As discussed in Section 10.2.6.2, an issuer should perform an evaluation under ASC 815 to determine whether contracts, such as those involving convertible preferred stock or convertible debt, contain embedded equity derivatives that may need to be bifurcated and accounted for separately from the host contract under ASC 815's bifurcation requirements. If an embedded conversion feature does not need to be bifurcated from the hybrid instrument as an embedded derivative, but the convertible instrument contains beneficial conversion features (BCFs) or may be settled entirely or partially in cash, the instrument may need to be separated into a liability component and an equity component. After concluding that a conversion option does not need to be bifurcated under ASC 815, an issuer should consider whether the cash conversion guidance in ASC 470-20 applies. If the hybrid instrument is not within the scope of the cash conversion guidance, the issuer should consider the BCF guidance in ASC 470-20. Both the cash conversion guidance and the BCF guidance in ASC 470-20 are discussed below.

10.2.4.1 Cash Conversion Features

As discussed above, an issuer should evaluate whether a convertible instrument must be accounted for under the cash conversion guidance in ASC 470-20 if the conversion feature did not need to be bifurcated in accordance with ASC 815-15. The cash conversion guidance applies only to convertible debt that may be settled partially or fully in cash upon conversion. Typically, the convertible debt will allow the issuer to settle the par amount in cash and to deliver shares with a fair value equal to the intrinsic value of the conversion option.

Issuers of both convertible debt and convertible preferred stock should consider this guidance; however, since the guidance applies only to convertible debt, convertible preferred stock is considered only if the preferred stock is mandatorily redeemable and classified as a liability under ASC 480-10. Equity-classified convertible preferred stock (including preferred stock classified in temporary equity) is outside the scope of the cash conversion guidance in ASC 470-20. In general, mandatorily convertible preferred stock is also outside the scope of the cash conversion guidance in ASC 470-20 because it will be classified as a liability only if (1) the conversion option is not considered substantive at issuance or (2) the issuer, upon conversion, had to settle a portion of that conversion in cash (the issuance of cash for fractional shares can be ignored).

A convertible debt instrument would not be within the scope of the ASC 470-20 cash conversion guidance if cash settlement would occur only when all other holders of the underlying shares also receive cash. Further, convertible debt that provides for the settlement of fractional shares in cash upon conversion would not be within the scope of the cash conversion guidance.

The debt and equity components of instruments within the scope of the cash conversion guidance must be accounted for separately. To account for those components, the issuer first determines the fair value of a similar liability without the conversion option, which represents the liability (debt) portion of the instrument. The remainder of any proceeds allocated to the convertible instrument is allocated to the conversion (equity) portion. The method used to determine the value of a cash conversion feature (i.e., based on the fair value of the debt component) differs from the approach discussed below to determine the value of a BCF (i.e., based on the intrinsic value of the equity component).

10.2.4.2 Beneficial Conversion Features

ASC 470-20-20 defines a BCF as a "nondetachable conversion feature that is in the money at the commitment date." If the conversion price embedded in preferred stock or debt is lower than the fair value of the stock into which the preferred stock or debt is convertible as of the commitment date and the conversion feature does not need to be bifurcated as an embedded derivative, the conversion feature may be "beneficial." If the conversion feature is beneficial, the effect of the difference between the conversion price and the fair value of the stock should reduce the carrying amount of the convertible instrument and be recognized in equity.

Connecting the Dots

In determining whether a BCF exists, an entity should consider the "effective conversion price" that an investor effectively would pay for a share upon conversion. For instance, if convertible debt was issued at a discount or a portion of the proceeds was allocated to detachable warrants, an entity would calculate the effective conversion price of the debt by using the amount allocated to the debt for accounting purposes.

The SEC staff frequently seeks to identify embedded BCFs by analyzing the conversion price in convertible instruments issued within one year of an IPO filing. When the conversion price is lower than the IPO price, the SEC staff may require a prospective registrant to recognize an expense related to a BCF and may sometimes require it to use the IPO price as a base in measuring the BCF. If the prospective registrant believes that the conversion price represented the stock's fair value at the time the instrument was issued, it should be prepared to present sufficient evidence to support its assertion.

Connecting the Dots

Identifying a BCF can be complex because it is directly related to the appropriateness of the fair value assigned to the underlying stock when that stock is not actively traded.

Once an entity identifies a BCF, the entity would recognize that embedded feature separately at issuance by allocating a portion of the proceeds equal to the intrinsic value of the embedded feature to additional paid-in capital. If a BCF is contingent on the occurrence of a future event such as an IPO, an entity would measure the BCF in the same way but would not recognize it in earnings until the contingency is resolved.

10.2.5 Accelerated Share Repurchase Programs

Several life sciences companies have considered or executed accelerated share repurchase (ASR) programs in recent years. As described in ASC 505-30-25-5, an ASR program is "a combination of transactions that permits an entity to repurchase a targeted number of shares immediately with the final repurchase price of those shares determined by an average market price over a fixed period of time. An accelerated share repurchase program is intended to combine the immediate share retirement benefits of a tender offer with the market impact and pricing benefits of a disciplined daily open market stock repurchase program."

ASC 505-30-25 contains unit-of-account guidance for ASR programs. Under ASC 505-30-25-6, an entity accounts for an ASR as two separate units of account: a treasury stock repurchase and a separate forward contract on the entity's shares. An entity should analyze the treasury stock repurchase and forward contract separately to determine how to account for each unit of account. Because ASC 815-40 contains an exception for financial instruments that are within the scope of ASC 480-10, the entity should determine whether one or both units of account are within the scope of ASC 480-10 before considering whether ASC 815-40 applies.

The terms of ASRs vary. In a traditional ASR, an entity (1) repurchases a targeted number of its own shares at the current stock price immediately for cash and (2) simultaneously enters into a net-share-settled forward sale of the same number of shares indexed to the average stock market price over the contract period. Economically, the forward serves as a true-up mechanism for adjusting the price ultimately paid for the shares purchased. Its purpose is to reduce the number of outstanding shares immediately at a repurchase price that on a combined basis reflects the average stock market price over an extended period (e.g., the volume-weighted average price on each trading day during the contract period). On a combined basis, the initial share repurchase and the forward sale put the issuer in an economic position similar to that of having conducted a series of open market purchases of its own stock over a specified period.

Example 10-1

ASR Analysis

An entity makes an up-front cash payment and receives a specific number of shares from the counterparty (usually an investment bank). Upon settlement of the forward contract (typically within three to six months), the entity either (1) pays the counterparty an amount equal to any excess of the volume-weighted average daily market price (VWAP) of the entity's shares over the initial purchase price or (2) receives from the counterparty an amount equal to any excess of the initial purchase price over the VWAP. Often, the entity can choose to settle the forward contract with the counterparty in either cash or a variable number of shares. Under ASC 505-30, this transaction is analyzed as two units of account: a treasury stock repurchase and a net settled forward contract to sell the entity's stock over the contract period.

In practice, the settlement of the treasury stock repurchase often takes place one or a few days after the execution of the ASR (e.g., the initial share delivery date may be three business days after the transaction date), at which time the issuer pays cash and receives an initial number of shares. In such cases, the obligation to repurchase shares in exchange for cash is classified as a liability under ASC 480-10-25-8 (see Chapter 5 of Deloitte's *A Roadmap to Distinguishing Liabilities From Equity*) during the period between the ASR transaction date and the settlement date of the treasury stock repurchase (sometimes described as the "initial share delivery date" or the "prepayment date"). Note that in some ASR transactions, the payment of cash in the treasury stock repurchase occurs before the receipt of the initial shares, in which case ASC 480-10 may cease to apply once the obligation to pay cash has been settled.

In evaluating whether the forward component of an ASR is within the scope of ASC 480-10, the issuer should consider whether it embodies an obligation to transfer assets or a variable number of shares that meet the criteria in ASC 480-10-25-8 or ASC 480-10-25-14 (see Chapters 5 and 6 of Deloitte's *A Roadmap to Distinguishing Liabilities From Equity*). Usually, an issuer is not required to classify as a liability under ASC 480-10 the forward contract component in a traditional ASR because it does not embody an obligation to repurchase shares for assets and does not involve an obligation to deliver a variable number of shares with a monetary value that moves inversely with — or is based on something other than — the price of the issuer's stock. However, an issuer cannot assume that the forward contract component of an ASR is outside the scope of ASC 480-10 without analyzing its specific terms and features.

In some ASR transactions, a portion of the prepayment amount on the initial share delivery date represents a premium paid by the issuer to increase the forward sale price that the issuer will receive in the forward component of the transaction (relative to an at-market forward) rather than a payment for the shares to be received in the initial treasury stock repurchase. For example, the issuer may apply 20 percent of the prepayment amount to the forward component to reduce the likelihood that the forward component will ever dilute earnings per share. In that case, the issuer may be required to account for the forward component as an asset or a liability under ASC 480-10-25-8 in the period between the transaction date and the initial share delivery date if the forward component permits net share settlement. This is because the forward component embodies an obligation to pay cash (on the initial share delivery date) to repurchase shares (the issuer will receive shares on the forward settlement date if the stock price is less than the forward price).

If the forward component is outside the scope of ASC 480-10, the issuer considers the guidance in ASC 815-40 when it determines whether the forward should be accounted for as an asset or liability. The terms of an ASR often include rights for the counterparty to end the ASR early upon termination events defined by reference to ISDA's equity derivatives definitions (e.g., merger events, tender offers, nationalization, insolvency, delisting, change in law, failure to deliver, loss of stock borrowings, increased cost of stock borrowings, extraordinary dividends). Further, the contractual provisions often specify or permit the counterparty to make adjustments to the settlement terms upon the occurrence of such events (e.g., calculation agent adjustments, cancellation, and payment) and might require the entity to settle the contract net in cash. In evaluating an ASR's forward-contract component under ASC 815-40, therefore, the entity should be mindful of the need to assess such terms under the indexation guidance and other equity classification conditions in ASC 815-40.

Example 10-2

On December 30, an issuer enters into an ASR transaction that requires it to transfer a fixed amount of cash (a prepayment amount of $500 million) in exchange for a fixed number of its common shares (10 million initial shares) on the initial share delivery date (January 2). The issuer will either deliver or receive shares on the transaction's final settlement date (March 31). If the VWAP of the issuer's common shares exceeds $50, the issuer will deliver shares; if the VWAP is less than $50, the issuer will receive shares. The number of shares that will be received or delivered is calculated as the prepayment amount ($500 million) divided by the VWAP over the contract period less the initial shares (10 million) already delivered.

In these circumstances, the treasury stock repurchase must be accounted for as a liability under ASC 480-10-25-8. In accordance with ASC 480-10-30-3, the issuer recognizes the liability on the ASR transaction date, which was initially measured "at the fair value of the shares at inception, adjusted for any consideration or unstated rights or privileges." Simultaneously, in accordance with ASC 480-10-30-5, equity is "reduced by an amount equal to the fair value of the shares at inception." Because under ASC 480-10-35-3(a) both the amount to be paid — $500 million — and the settlement date — January 2 — are fixed, the liability is measured at the present value of the amount to be paid at settlement — $500 million — with interest cost accruing at the rate implicit at inception during the period from the transaction date to the initial share delivery date. (Further, if any part of the prepayment amount represents a premium payment for the forward component of the ASR transaction, that portion would be accounted for separately as a liability measured at fair value under ASC 480-10-35-1, ASC 480-10-35-4A, or ASC 480-10-35-5 between the transaction date and the initial share delivery date, as discussed above.)

On the initial share delivery date, the liability for the treasury stock repurchase is extinguished by delivery of the prepayment amount. After the initial share delivery date, the transaction is outside the scope of ASC 480-10 and is therefore evaluated under other GAAP (including ASC 815-10 and ASC 815-40).

10.2.6 Derivatives

Common financing arrangements issued by life sciences entities in the form of debt or equity capital may be considered to be or may contain equity derivatives (i.e., equity derivatives may be freestanding or embedded). Examples of common equity derivatives are stock warrants, stock options, and forward contracts to buy or sell an entity's shares. Equity derivatives may be classified as liabilities (or, in some cases, as assets) and measured at fair value on the balance sheet, with changes in fair value recognized in earnings. It is important to be aware of these instruments, how they are accounted for, and subsequent events that could affect such accounting. Sometimes, the measurement attribute for such instruments could be fair value as a result of an IPO or subsequent financing.

The first step in the analysis is to consider whether the equity derivative is a freestanding instrument or whether it is embedded in another instrument. If the instrument is freestanding, the guidance in ASC 815-40 will govern the classification and measurement of the instrument unless the instrument is a liability within the scope of ASC 480, as discussed above. It is important to note that the guidance in ASC 815-40 is applicable to freestanding contracts on an entity's own equity regardless of whether those contracts meet the definition of a derivative in ASC 815-10. Contracts on an entity's own equity may need to be classified as assets and liabilities (and remeasured at fair value every reporting period) even if they are not considered derivatives within the scope of ASC 815-10. Also, contracts that meet the conditions for classification in equity under ASC 815-40 are excluded from the scope of ASC 815-10 even if they meet the definition of a derivative.

If an equity derivative is embedded in a hybrid instrument, the guidance in ASC 815-40 will be applicable only to embedded features that meet the definition of a derivative and meet the other criteria for bifurcation. That is, if an embedded equity derivative is not clearly and closely related to the host contract, the hybrid instrument is not remeasured at fair value with changes in fair value recognized in earnings; and if the embedded derivative meets the definition of a derivative in ASC 815-10, the guidance in ASC 815-40 will be relevant in the determination of whether the equity derivative needs to be bifurcated because of the scope exception in ASC 815-10, as discussed above.

10.2.6.1 ASC 815-40 — Contracts on an Entity's Own Equity

ASC 815-40 provides guidance on whether an instrument or embedded feature is indexed to an entity's own stock and whether it can be settled in the entity's shares. The analysis under ASC 815-40 can be complex; in performing this analysis, an entity often must consult with its legal counsel regarding the various terms associated with the contract. The SEC staff has noted common questions related to applying the guidance in ASC 815-40, including the following:

- Cash settlement provisions.
- Requirement to settle in registered shares.
- Insufficient number of authorized but unissued shares.
- No limit on the number of shares to be delivered.
- Incorrect conclusion regarding whether the instrument is indexed to an entity's own stock.

In general, a contract on an entity's own equity can be classified in equity (and not remeasured while it is classified in equity) as long as it is considered to be indexed to the entity's own stock **and** the issuer has the ability to settle the contract by issuing its own shares under all scenarios. This determination requires an evaluation of all events that could change the settlement value (e.g., adjustments to strike price) and all events that would affect the form of settlement. For additional guidance on ASC 815-40, see Deloitte's *A Roadmap to Accounting for Contracts on an Entity's Own Equity*.

For example, as the result of a provision to adjust the conversion price (other than a standard antidilution provision that applies to all shareholders), an entity may consider an instrument not to be indexed to the issuer's own stock. This type of situation has often been problematic for entities that provide certain investors with price protection by adjusting the strike price if there is a subsequent round of equity or convertible instrument financing at a strike price that is lower than theirs. Under a provision that triggers such price protection (a "down-round provision"), the strike price would usually be adjusted to the strike price of the subsequent transaction. As a result, an instrument or embedded derivative would be accounted for as an asset or liability. However, in July 2017, the FASB issued ASU 2017-11, which makes limited changes to the guidance in ASC 815-40. (For a discussion of other new guidance on financial instruments, see Section 10.3.)

Before an issuer adopts ASU 2017-11, a contract (or embedded equity conversion feature) that contains a down-round provision does not qualify as equity because such an arrangement precludes a conclusion that the contract is indexed to the entity's own stock under ASC 815-40-15. Therefore, freestanding contracts on an entity's own equity that contain a down-round feature have been accounted for at fair value, with changes in fair value recognized in earnings. Similarly, embedded equity conversion features containing down-round provisions have been separated and accounted for as derivative instruments at fair value when the bifurcation criteria in ASC 815-15 have been met.

ASU 2017-11 applies to issuers of financial instruments with down-round features. It amends (1) the classification of many of such instruments as liabilities by revising the guidance in ASC 815 on the evaluation of whether instruments with down-round provisions may meet the conditions to be considered indexed to the issuer's own equity and (2) the guidance on recognition and measurement of the value transferred upon the triggering of a down-round feature for equity-classified instruments by revising ASC 260.

For PBEs, ASU 2017-11 is effective for annual reporting periods beginning after December 15, 2018, including interim periods within those annual reporting periods. For all other entities, the ASU is effective for annual reporting periods beginning after December 15, 2019, and interim periods within annual reporting periods beginning after December 15, 2020. Early adoption is permitted in any interim or annual period for which financial statements have not yet been issued or have not been made available for issuance.

For additional details, see Deloitte's July 21, 2017, *Heads Up*.

10.2.6.2 Considerations Related to Embedded Derivatives

In addition to the considerations related to freestanding instruments (e.g., warrants or stock options) under ASC 815, an entity should evaluate whether other contracts, such as those involving preferred stock or convertible debt, contain embedded equity derivatives that may need to be bifurcated and accounted for separately from the host contract under ASC 815's bifurcation requirements. A reporting entity identifies the terms of each embedded feature on the basis of the feature's economic payoff profile (underlying)[9] rather than on the basis of how the feature has been formally documented. In identifying the embedded features, the entity should consider all terms of the convertible instrument. Common examples of embedded features include conversion options and redemption provisions.

[9] Although there is no explicit guidance under U.S. GAAP on how to determine the unit of accounting for embedded features in a hybrid instrument, the approach described herein is commonly applied. Under the payoff-profile approach, each embedded derivative feature in a hybrid instrument is defined on the basis of the monetary or economic value that the feature conveys to the instrument's counterparty upon settlement. This approach is consistent with the definition of an embedded derivative in ASC 815-15-20, which focuses on the effect of an implicit or explicit term on the cash flows or values of other exchanges required under a contract.

An identified embedded feature generally[10] must be bifurcated and accounted for separately from the host contract if the following three conditions are met:

- The embedded feature is not clearly and closely related to the host contract.
- The host instrument (e.g., preferred stock or debt) is not remeasured at fair value, with changes in fair value recognized in earnings, under other applicable GAAP.
- A separate instrument with the same terms as the embedded feature meets the definition of a derivative instrument under ASC 815-10.[11]

10.2.6.2.1 Clearly and Closely Related to the Host Contract

10.2.6.2.1.1 Determining the Nature of the Host Contract

When determining whether the embedded feature being analyzed is clearly and closely related to the host contract, an entity must first decide whether the nature of the host contract is more debt-like or equity-like. ASU 2014-16, issued in November 2014, clarifies that the only acceptable method for determining the nature of the host contract in a hybrid instrument issued in the form of a share is a method commonly referred to as the "whole-instrument" approach. Under the whole-instrument approach, the nature of the host contract is the same for each embedded feature being analyzed. Determining the nature of the host contract under the whole-instrument approach involves the following steps:

- Identify all of the hybrid financial instrument's stated and implied substantive terms and features.
- Determine whether the identified terms and features are more debt-like or equity-like.
- Identify the relative weight of the identified terms and features "on the basis of the relevant facts and circumstances."[12]

Further, ASC 815-15-25-17A states, in part:

> In evaluating the stated and implied substantive terms and features, the existence or omission of any single term or feature does not necessarily determine the economic characteristics and risks of the host contract. Although an individual term or feature may weigh more heavily in the evaluation on the basis of the facts and circumstances, **an entity should use judgment based on an evaluation of all of the relevant terms and features**. For example, an entity shall not presume that the presence of a fixed-price, noncontingent redemption option held by the investor in a convertible preferred stock contract, in and of itself, determines whether the nature of the host contract is more akin to a debt instrument or more akin to an equity instrument. [Emphasis added]

If a reporting entity is still unclear about the nature of the host contract after performing this analysis, it should consider the anticipated outcome for the holder of the hybrid financial instrument in reaching its final conclusion. Given the complexity of determining the nature of a host contract of a hybrid instrument with both conversion and redemption features, entities are encouraged to consult with their accounting advisers.

The method described above for determining the nature of the host contract applies only to hybrid instruments issued in the form of a share. A legal-form debt instrument will typically be considered to be a debt host contract.

[10] Subject to the scope exceptions in ASC 815-10.
[11] See ASC 815-10-15-83.
[12] See ASC 815-15-25-17C.

10.2.6.2.1.2 Determining Whether the Feature Is Clearly and Closely Related to the Host Contract

Once the reporting entity has determined the nature of the host contract, it should, in accordance with ASC 815-15-25-1(a), evaluate each embedded feature separately to determine whether the economic characteristics and risks of the embedded feature are clearly and closely related to those of the host contract. If the embedded feature is clearly and closely related to the host contract, the embedded feature should not be bifurcated. If the embedded feature is not clearly and closely related to the host contract, the reporting entity must analyze the other two conditions described above to determine whether bifurcation of the embedded feature is required.

Commonly identified embedded features that an entity would evaluate to determine whether they are clearly and closely related to a debt or equity host contract include the following:

- *Redemption features* — A redemption feature enables the holder to receive cash to settle the equity instrument. A redemption feature may be held by the issuer or the holder and may be exercisable upon the occurrence of certain events or at any time. If an equity host contract has a redemption feature, the redemption is explicitly not considered clearly and closely related to that contract in accordance with ASC 815-15-25-20. Therefore, in such cases, an entity would need to perform additional analysis to determine whether it is required to bifurcate the redemption feature.

  Under ASC 815-15-25-42, if a debt host contract has a redemption feature, an entity must perform a four-step test to determine whether the redemption feature is clearly and closely related to the debt host.

- *Conversion features* — Conversion features enable an entity to convert an existing instrument into another form of the entity's equity (e.g., convertible preferred stock, convertible debt). ASC 815-15-25-16 indicates that a conversion feature in an equity host contract would be clearly and closely related to the equity host contract since it provides the holder with another residual interest in the same entity. Accordingly, a conversion feature in an equity host contract would not be bifurcated and accounted for separately as a derivative instrument.

  However, ASC 815-15-25-51 indicates that a conversion option in a debt host contract is not clearly and closely related to the contract. Therefore, the entity would have to perform further analysis to determine whether the other bifurcation criteria are met.

- *Changing interest/dividend rates* — Contracts may include provisions under which stated interest or dividend rates increase or decrease as a result of the occurrence or nonoccurrence of specific events. An embedded derivative that resets the interest rate of a debt host contract (i.e., a debt instrument or an equity instrument that was determined to represent a debt host) is generally clearly and closely related to the debt host if it is based on changes in interest rates,[13] the issuer's creditworthiness, or inflation. However, if, for example, an entity's bonds include a provision under which the interest rate must be reset to a different rate if an unrelated party's credit rating is downgraded at any time during the term of the bonds, the reset feature is not clearly and closely related to the debt host. An embedded derivative that changes an instrument's interest rate because of changes to the rate of inflation in the economic environment for the currency in which a debt instrument is denominated would be considered clearly and closely related to the debt host. Further, changes to an interest rate based on changes in an entity's operating performance (e.g., EBITDA) may be considered clearly and closely related to the debt host if the operating performance metric is related to the entity's creditworthiness.[14]

[13] See ASC 815-15-25-26.
[14] See ASC 815-15-25-46 and 25-47.

Such interest rate reset provisions are generally not considered clearly and closely related to an equity host, however.

10.2.6.2.2 Separate Instrument With Same Terms Meets the Definition of a Derivative

An embedded equity derivative (e.g., a conversion option) that meets the first two conditions outlined above for bifurcating embedded equity derivatives would require further evaluation for an entity to determine whether the embedded feature should be separately accounted for as a derivative under ASC 815-10. ASC 815-10-15-83 defines a derivative as a financial instrument or other contract that (1) has an underlying as well as a notional amount or payment provision, (2) requires little or no initial net investment, and (3) can be net settled.

Equity instruments will generally meet the first and second criteria in the definition of a derivative but may not meet the third. For instance, a contract in a nonpublic entity's own stock (e.g., a warrant or stock option) may not qualify as a derivative because the entity's equity shares are not publicly traded. In such cases, unless the contract provides for net share settlement or cash settlement, the contract generally would not meet the net settlement criterion because the equity shares would not be readily convertible to cash. However, upon an IPO, the entity would need to reevaluate the contract under ASC 815 to determine whether the contract is or contains an accounting derivative now that the entity's shares are publicly traded. If the post-IPO shares or an embedded conversion feature is readily convertible to cash, the net settlement criterion would be met, resulting in an accounting derivative that may need to be recognized unless it qualifies for a scope exception to derivative accounting (discussed further below).

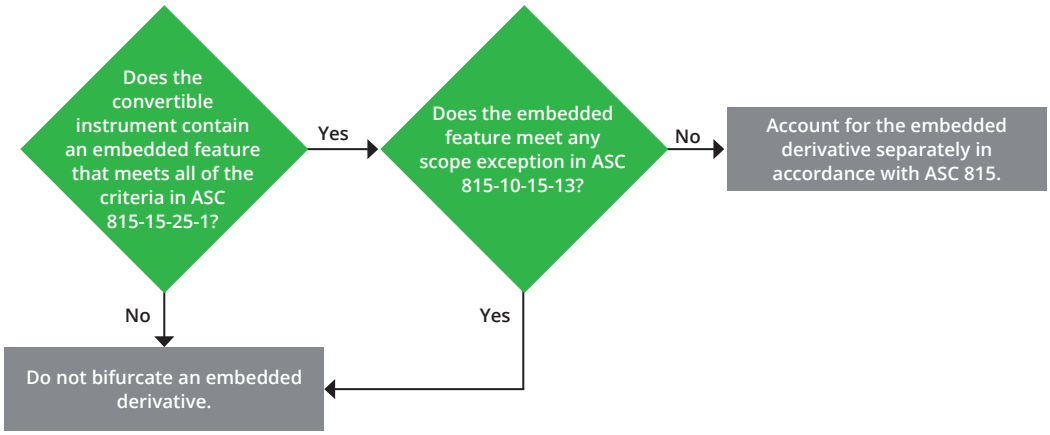
For example, a warrant to acquire common-stock shares that explicitly permits net settlement (e.g., cashless exercise) would meet the net settlement criterion. However, a warrant to acquire common-stock shares of a nonpublic entity for which gross exercise is required (i.e., the warrant holder pays the exercise price in cash to acquire common shares) would generally not meet the net settlement criterion since the contract would be settled in shares that are not readily convertible to cash. If that nonpublic entity went public, however, the warrant that previously did not meet the net settlement criterion might now satisfy the criterion since common-stock shares of a publicly traded entity are generally readily convertible to cash.

A contract that meets the definition of a derivative under the above criteria may not need to be accounted for as a derivative if it qualifies for any of the scope exceptions in ASC 815-10-15-13. One of these scope exceptions involves contracts on an entity's own equity. Generally, the value of an equity derivative is linked to the entity's own stock (i.e., the underlying of the derivative). If the derivative is indexed to the entity's own stock and would not require the entity to settle the derivative by paying cash or other assets, it would qualify for classification as equity and be outside of the scope of ASC 815.

Some equity derivatives may qualify for the scope exception in ASC 815-10-15-74 for certain contracts indexed to the company's own stock. If this scope exception applies, such equity derivatives would not have to be bifurcated.

However, an embedded feature that meets the definition of a derivative and does not qualify for an explicit scope exception would need to be bifurcated from the host instrument and accounted for separately as a derivative (if the other two conditions for bifurcation are also met). A bifurcated derivative (e.g., a conversion feature) would be measured initially and subsequently at fair value, with changes in fair value recognized in earnings.

The accounting for convertible debt instruments and convertible preferred stocks is complex, and the SEC staff frequently asks about the classification of such instruments in entities' registration statements. The flowchart below illustrates the multistep evaluation that entities are required to perform for any hybrid instrument with a conversion feature.



10.3 New Accounting Standards

10.3.1 Classification and Measurement (ASU 2016-01)

10.3.1.1 Background

ASU 2016-01 amends the guidance on the classification and measurement of financial instruments. The amendments contain changes related to the following:

- Accounting for equity investments (apart from those that are accounted for under the equity method or those that are consolidated).
- Recognition of changes in fair value attributable to changes in instrument-specific credit risk for financial liabilities for which the fair value option has been elected.
- Determining the valuation allowance for DTAs related to available-for-sale (AFS) debt securities.
- Disclosure requirements for financial assets and financial liabilities.

For PBEs, the new standard is effective for fiscal years beginning after December 15, 2017, including interim periods therein. For all other entities, the standard is effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early adoption of certain of the standard's provisions is permitted for all entities. Non-PBEs are permitted to adopt the standard in accordance with the effective date for PBEs. For more information about ASU 2016-01, see Deloitte's January 12, 2016, *Heads Up*.

10.3.1.2 Classification and Measurement of Equity Investments

The amendments in ASU 2016-01 will require entities to carry all investments in equity securities at fair value, with changes in fair value recorded through earnings, unless the equity investments are accounted for under the equity method or are consolidated. For equity investments that do not have a readily determinable fair value, the guidance will permit a measurement alternative under which the equity investment would be measured at cost less impairment, if any, plus or minus observable price changes in orderly transactions. This measurement alternative would not be available to reporting entities that are investment companies, broker-dealers in securities, or postretirement benefit plans.

An entity that has elected the measurement alternative for equity investments that do not have a readily determinable fair value is required to assess whether the equity investment is impaired by qualitatively considering the indicators described in ASC 321-10-35-3. If, on the basis of the qualitative assessment, the equity investment is impaired, an entity would be required to record an impairment equal to the amount by which the carrying value exceeds fair value. The entity should no longer evaluate whether such impairment is other than temporary.

Connecting the Dots

Before the adoption of ASU 2016-01, marketable equity securities other than equity method investments or those that result in consolidation of the investee are classified as either (1) held for trading, with changes in fair value recognized in earnings, or (2) AFS, with changes in fair value recognized in OCI. Further, nonmarketable equity securities for which the fair value cannot be readily determined generally would be measured at cost (less impairment) unless the fair value option is elected. Under ASU 2016-01, since equity securities can no longer be accounted for as AFS, entities holding such investments could see more volatility in earnings. Entities' application of the measurement alternative to investments without readily determinable fair values may reduce such earnings volatility, but this alternative is not available to broker-dealers.

10.3.1.3 Changes in Fair Value of a Liability Attributed to Changes in Instrument-Specific Credit Risk

For financial liabilities (excluding derivative instruments) for which the fair value option has been elected, the amendments in ASU 2016-01 will require an entity to separately recognize in OCI any changes in fair value associated with instrument-specific credit risk. The guidance indicates that the portion of the total change in fair value that exceeds the amount resulting from a change in a base market risk (such as a risk-free interest rate) may be attributable to instrument-specific credit risk, but it also acknowledges that there may be other methods that an entity can use to determine instrument-specific credit risk.

10.3.1.4 Valuation Allowance on a DTA Related to an AFS Debt Security

The new guidance eliminates the diversity in practice related to the evaluation of the need for a valuation allowance for DTAs related to debt securities that are classified as AFS. Before the adoption of ASU 2016-01, entities may perform this evaluation either separately from their other DTAs or in combination with them. The new guidance clarifies that an entity should "evaluate the need for a valuation allowance on a [DTA] related to [AFS] securities in combination with the entity's other [DTAs]."

10.3.1.5 Changes to Disclosure Requirements

For non-PBEs, the amendments in ASU 2016-01 eliminate the requirement to disclose the fair value of financial instruments measured at amortized cost. In addition, for such financial instruments, PBEs would not be required to disclose (1) the information related to the methods and significant assumptions used to estimate fair value or (2) a description of the changes in the methods and significant assumptions used to estimate fair value. The guidance also clarifies U.S. GAAP by eliminating the provisions in ASC 825 that had been interpreted to permit an "entry" price notion for estimating the fair value of loans for disclosure purposes. The amendments require a PBE to disclose the fair value in accordance with the exit price notion in ASC 820. In addition, all entities are required to disclose in the notes to the financial statement all financial assets and financial liabilities grouped by (1) measurement category (i.e., amortized cost or fair value — net income or OCI) and (2) form of financial asset (i.e., securities and loans/receivables).

10.3.1.6 Technical Corrections and Improvements to ASU 2016-01

In February 2018, the FASB issued ASU 2018-03 on technical corrections and improvements to ASU 2016-01 in response to feedback from stakeholders.

The amendments in ASU 2018-03 clarify certain aspects of ASU 2016-01 as follows:

- *Equity securities without readily determinable fair values* — ASU 2018-03 clarifies that an entity that measures an equity security by using the measurement alternative may change its measurement approach to a fair value method in accordance with the guidance in ASC 820 through an irrevocable election that would apply to that security and all identical or similar investments of the same issuer. Once the entity makes this election, it should measure all future purchases of identical or similar investments of the same issuer by using a fair value method in accordance with the guidance in ASC 820.

  In addition, ASU 2018-03 clarifies the guidance in ASC 321-10-55-9 (added by ASU 2016-01), which states that when applying the measurement alternative to securities without a readily determinable fair value, an entity should make adjustments from observable transactions to reflect the *current* fair value of the security. Specifically, ASU 2018-03 clarifies that the adjustments should be made to reflect the fair value of the security as of the date on which the observable transaction took place rather than as of the current reporting date.
- *Forward contracts and purchased options* — ASU 2018-03 clarifies that a change in observable price or impairment of underlying securities for forward contracts and purchased options on equity securities for which the measurement alternative is expected to be applied should result in the remeasurement of the *entire* fair value of the forward contracts and purchased options when observable transactions occur on the underlying equity securities.
- *Presentation requirements for certain fair value option liabilities* — ASU 2018-03 clarifies that when the fair value option is elected for a financial liability, the guidance in ASC 825-10-45-5 (added by ASU 2016-01) related to the disclosure of instrument-specific risk (see Section 10.3.1.3) should be applied, regardless of whether the fair value option is elected under ASC 815-15 or under ASC 825-10.
- *Fair value option liabilities denominated in a foreign currency* — ASU 2018-03 clarifies that when an entity elects to use the fair value option to measure a financial liability denominated in a currency other than the entity's functional currency, the entity should (1) first measure the change in fair value of the liability that results from changes in instrument-specific credit risk in the currency of denomination when that change is presented separately from the total change in fair value of the financial liability and (2) then remeasure into its functional currency both components of the change in fair value of the liability by using end-of-period spot rates.
- *Transition guidance for equity securities without a readily determinable fair value* — ASU 2016-01 states that the amendments related to equity securities without readily determinable fair values should be applied prospectively. ASU 2018-03 clarifies that the prospective approach in ASU 2016-01 should be applied only to equity securities without readily determinable fair values for which the measurement alternative has been elected.

For PBEs, the amendments in ASU 2018-03 are effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years beginning after June 15, 2018. PBEs with fiscal years beginning between December 15, 2017, and June 15, 2018, are not required to adopt ASU 2018-03 until the interim period beginning after June 15, 2018. PBEs with fiscal years beginning between June 15, 2018, and December 15, 2018, are not required to adopt ASU 2018-03 before adopting ASU 2016-01. For all other entities, the effective date of ASU 2018-03 is the same as the effective date of ASU 2016-01. All entities may early adopt ASU 2018-03 for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years, as long as they have adopted ASU 2016-01.

In addition, in November 2018, the FASB issued a proposed ASU of Codification improvements related to ASUs 2016-01, 2016-13, and 2017-12. The comment period ended on January 18, 2019.

10.3.2 Impairment (ASU 2016-13)

10.3.2.1 Background

In June 2016, the FASB issued ASU 2016-13, which amends guidance on the impairment of financial instruments. The ASU adds to U.S. GAAP an impairment model (known as the current expected credit loss (CECL) model) that is based on expected losses rather than incurred losses. Under the new guidance, an entity recognizes as its estimate of expected credit losses an allowance, which is presented as either (1) an offset to the amortized cost basis of the related asset (for on-balance-sheet exposures) or (2) a separate liability (for off-balance-sheet exposures). That is, the expected credit losses estimated over the lifetime of a financial instrument are recognized at inception (i.e., on day 1).

Key provisions of ASU 2016-13 are discussed below. For additional information, see Deloitte's June 17, 2016, *Heads Up*.

10.3.2.2 The CECL Model

10.3.2.2.1 Scope

The CECL model applies to most[15] debt instruments (other than those measured at fair value), trade receivables, net investments in leases, reinsurance receivables that result from insurance transactions, financial guarantee contracts,[16] and loan commitments. However, AFS debt securities are excluded from the model's scope and will continue to be assessed for impairment under the guidance in ASC 320 (the FASB moved the impairment model for AFS debt securities from ASC 320 to ASC 326-30 and has made limited amendments to the impairment model for AFS debt securities, as discussed below in Section 10.3.2.3).

10.3.2.2.2 Recognition of Expected Credit Losses

Unlike the incurred loss models in existing U.S. GAAP, the CECL model does not specify a threshold for the recognition of an impairment allowance. Rather, an entity will recognize its estimate of expected credit losses for financial assets as of the end of the reporting period. Credit impairment will be recognized as an allowance — or contra-asset — rather than as a direct write-down of the amortized cost basis of a financial asset. However, the carrying amount of a financial asset that is deemed uncollectible will be written off in a manner consistent with existing U.S. GAAP.

[15] The following debt instruments would not be accounted for under the CECL model:
- Loans made to participants by defined contribution employee benefit plans.
- Policy loan receivables of an insurance entity.
- Pledge receivables (promises to give) of an NFP.
- Loans and receivables between entities under common control.

[16] The CECL model does not apply to financial guarantee contracts that are accounted for as insurance or measured at fair value through net income.

10.3.2.2.3 Measurement of Expected Credit Losses

ASU 2016-13 describes the impairment allowance as a "valuation account that is deducted from the amortized cost basis of the financial asset(s) to present the net carrying value at the amount expected to be collected on the financial asset." An entity can use a number of measurement approaches to determine the impairment allowance. Some approaches project future principal and interest cash flows (i.e., a discounted cash flow method) while others project only future principal losses. Regardless of the measurement method used, an entity's estimate of expected credit losses should reflect those losses occurring over the contractual life of the financial asset.

When determining the contractual life of a financial asset, an entity is required to consider expected prepayments either as a separate input in the determination or as an amount embedded in the credit loss experience that it uses to estimate expected credit losses. The entity is not allowed to consider expected extensions of the contractual life unless it reasonably expects to execute a troubled debt restructuring with the borrower by the reporting date.

An entity must consider all available relevant information when estimating expected credit losses, including details about past events, current conditions, and reasonable and supportable forecasts and their implications for expected credit losses. That is, while the entity is able to use historical charge-off rates as a starting point for determining expected credit losses, it has to evaluate how conditions that existed during the historical charge-off period may differ from its current expectations and accordingly revise its estimate of expected credit losses. However, the entity is not required to forecast conditions over the contractual life of the asset. Rather, for the period beyond which the entity can make reasonable and supportable forecasts, the entity reverts to historical credit loss experience.

10.3.2.2.4 Unit of Account

The CECL model does not prescribe a unit of account (e.g., an individual asset or a group of financial assets) in the measurement of expected credit losses. However, an entity is required to evaluate financial assets within the scope of the model on a collective (i.e., pool) basis when assets share similar risk characteristics. If a financial asset's risk characteristics are not similar to the risk characteristics of any of the entity's other financial assets, the entity would evaluate the financial asset individually. If the financial asset is individually evaluated for expected credit losses, the entity would not be allowed to ignore available external information such as credit ratings and other credit loss statistics.

10.3.2.2.5 Write-Offs

Like current guidance, ASU 2016-13 requires an entity to write off the carrying amount of a financial asset when the asset is deemed uncollectible. However, unlike current requirements, the ASU's write-off guidance also applies to AFS debt securities.

10.3.2.2.6 Application of the CECL Model to Trade Receivables

The CECL model applies to trade receivables that result from revenue transactions within the scope of ASC 605 (or ASC 606, if adopted). The example below, which is reproduced from ASU 2016-13 and codified in ASC 326-20-55-38 through 55-40 (Example 5), illustrates how an entity would apply the guidance to trade receivables by using a provision matrix.[17]

> Entity E manufactures and sells products to a broad range of customers, primarily retail stores. Customers typically are provided with payment terms of 90 days with a 2 percent discount if payments are received within 60 days. Entity E has tracked historical loss information for its trade receivables and compiled the following historical credit loss percentages:
>
> a. 0.3 percent for receivables that are current
>
> b. 8 percent for receivables that are 1–30 days past due
>
> c. 26 percent for receivables that are 31–60 days past due
>
> d. 58 percent for receivables that are 61–90 days past due
>
> e. 82 percent for receivables that are more than 90 days past due.
>
> Entity E believes that this historical loss information is a reasonable base on which to determine expected credit losses for trade receivables held at the reporting date because the composition of the trade receivables at the reporting date is consistent with that used in developing the historical credit-loss percentages (that is, the similar risk characteristics of its customers and its lending practices have not changed significantly over time). However, 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. Specifically, Entity E has observed that unemployment has decreased as of the current reporting date, and Entity E expects there will be an additional decrease in unemployment over the next year. To adjust the historical loss rates to reflect the effects of those differences in current conditions and forecasted changes, 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. . . .

Past-Due Status	Amortized Cost Basis	Credit Loss Rate	Expected Credit Loss Estimate
Current	$ 5,984,698	0.27%	$ 16,159
1–30 days past due	8,272	7.2%	596
31–60 days past due	2,882	23.4%	674
61–90 days past due	842	52.2%	440
More than 90 days past due	1,100	73.8%	812
	$ 5,997,794		$ 18,681

[17] ASC paragraph numbers have been omitted.

Connecting the Dots

The example above from ASU 2016-13 highlights that an entity's application of the CECL model to trade receivables through the use of a provision matrix may not differ significantly from the entity's current methods for determining the allowance for doubtful accounts. However, the example illustrates that when an entity uses a provision matrix to estimate credit losses on trade receivables, it would be required to do the following when moving to an expected loss model:

- Under the CECL model, the entity would be required to consider whether expected credit losses should be recognized for trade receivables that are considered "current" (i.e., not past due). In the example above, a historical loss rate of 0.3 percent is applied to the trade receivables that are classified as current. This may be a change from current practice for many life sciences companies.
- When using historical loss rates in a provision matrix, the entity would be required to consider whether and, if so, how the historical loss rates differ from what is currently expected over the life of the trade receivables (on the basis of current conditions and reasonable and supportable forecasts about the future).

10.3.2.3 AFS Debt Securities

The CECL model does not apply to AFS debt securities. Instead, the FASB decided to make targeted improvements to the existing other-than-temporary impairment model in ASC 320 for certain AFS debt securities to eliminate the concept of "other than temporary" from that model.[18] Accordingly, ASU 2016-13 states that an entity:

- Must use an allowance approach (vs. permanently writing down the security's cost basis).
- Must limit the allowance to the amount at which the security's fair value is less than its amortized cost basis.
- May not consider the length of time fair value has been less than amortized cost.
- May not consider recoveries in fair value after the balance sheet date when assessing whether a credit loss exists.

10.3.2.4 Disclosures

Many of the disclosures required under ASU 2016-13 are similar to those already required under U.S. GAAP as a result of ASU 2010-20. Accordingly, entities must also disclose information about:

- Credit quality.[19]
- Allowances for expected credit losses.
- Policies for determining write-offs.
- Past-due status.
- Nonaccrual status.
- Purchased financial assets with credit deterioration ("PCD assets").
- Collateral-dependent financial assets.

[18] The amendments do not apply to an AFS debt security that an entity intends to sell or will more likely than not be required to sell before the recovery of its amortized cost basis. If an entity intends to sell or will more likely than not be required to sell a security before recovery of its amortized cost basis, the entity would write down the debt security's amortized cost to the debt security's fair value as required under existing U.S. GAAP.

[19] Short-term trade receivables resulting from revenue transactions within the scope of ASC 605 and ASC 606 are excluded from these disclosure requirements.

In addition, other disclosures are required as follows:

- PBEs that meet the U.S. GAAP definition of an SEC filer[20] must disclose credit quality indicators disaggregated by year of origination for a five-year period.
- PBEs that do not meet the U.S. GAAP definition of an SEC filer must disclose credit quality indicators disaggregated by year of origination. However, upon adoption of ASU 2016-13, they would be required to disclose such information for only the previous three years and would add another year of information each year after adoption until they have provided disclosures for the previous five years.
- Other entities are not required to disclose credit quality indicators disaggregated by year of origination.

10.3.2.5 Effective Date and Transition

10.3.2.5.1 Effective Date

For PBEs that meet the U.S. GAAP definition of an SEC filer, ASU 2016-13 is effective for fiscal years beginning after December 15, 2019, including interim periods therein.

For PBEs that do not meet the U.S. GAAP definition of an SEC filer, ASU 2016-13 is effective for fiscal years beginning after December 15, 2020, including interim periods therein.

For all other entities, ASU 2016-13 is effective for fiscal years beginning after December 15, 2021, including interim periods therein.

In addition, entities are permitted to early adopt the new guidance for fiscal years beginning after December 15, 2018, including interim periods therein.

10.3.2.5.2 Transition Approach

For most debt instruments, entities must record a cumulative-effect adjustment to the statement of financial position as of the beginning of the first reporting period in which the guidance is effective (modified retrospective approach). However, instrument-specific transition provisions are provided for other-than-temporarily impaired debt securities, PCD assets, and certain beneficial interests within the scope of ASC 325-40.

10.3.2.5.3 Transition Resource Group

In late 2015, the FASB established a credit losses TRG. Like the TRG established to discuss the new revenue recognition standard, the credit losses TRG does not issue guidance but provides feedback to the FASB on potential implementation issues. By analyzing and discussing such issues, the credit losses TRG helps the FASB determine whether it needs to take further action (e.g., by providing clarification or issuing additional guidance). For information about the topics discussed at the TRG's meetings on June 12, 2017, June 11, 2018, and November 1, 2018, see Deloitte's June 2017, June 2018, and November 2018 *TRG Snapshot* newsletters, respectively.

[20] Under U.S. GAAP, an SEC filer is defined as "[a]n 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 submission by another SEC filer are not included within this definition."

Further, in November 2018, the FASB issued a proposed ASU of Codification improvements related to ASUs 2016-01, ASU 2016-13, and ASU 2017-12. The comment period ended on January 18, 2019. The improvements related to ASU 2016-13 are mostly the result of TRG issues.

In addition, in February 2019, the FASB issued a proposed ASU that would allow entities to irrevocably elect, upon adoption of ASU 2016-13, the fair value option for financial instruments that were previously recorded at amortized cost (except for held-to-maturity debt securities) and that are within the scope of ASC 326-20, provided that the instruments are eligible for the fair value option under ASC 825-10. This election would be made on an instrument by instrument basis. The proposed ASU would prevent inconsistencies resulting from the measurement of certain assets at fair value while certain other assets continue to be measured at amortized cost. Comments on the proposed ASU are due by March 8, 2019. For further information on the proposed ASU, see Deloitte's February 11, 2019, *Heads Up*.

10.3.3 Hedging (ASU 2017-12)

10.3.3.1 Background

In August 2017, the FASB issued ASU 2017-12, which amends the hedge accounting recognition and presentation requirements in ASC 815. The Board's objectives in issuing the ASU were to (1) improve the transparency and understandability of information conveyed to financial statement users about an entity's risk management activities by better aligning the entity's financial reporting for hedging relationships with those risk management activities and (2) reduce the complexity, and simplify the application, of hedge accounting by preparers.

For PBEs, ASU 2017-12 is effective for fiscal years beginning after December 15, 2018, and interim periods therein. For all other entities, the ASU is effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020.

Entities are permitted to early adopt the new guidance in any interim or annual period after issuance of ASU 2017-12. An entity that early adopts the updated guidance in an interim period should record any transition adjustments as of the beginning of the fiscal year that includes that interim period. Further, entities should review existing hedge accounting documentation to determine whether revisions are needed on the basis of the new standard. For any revisions required for documentation related to active hedges, entities should maintain an audit trail to show that the changes were made to conform with the new standard given that no other alterations would be allowable under U.S. GAAP (i.e., this should not be seen as an opportunity for entities to simply go back and revise existing hedge documentation).

See Deloitte's August 30, 2017, *Heads Up* for additional information about ASU 2017-12.

10.3.3.2 Key Changes to the Hedge Accounting Model

ASU 2017-12 makes a number of improvements to the hedge accounting model, including those outlined below.

10.3.3.2.1 Elimination of the Concept of Separately Recognizing Periodic Hedge Ineffectiveness

ASU 2017-12 eliminates the concept of separately recognizing periodic hedge ineffectiveness for cash flow and net investment hedges (however, under the mechanics of fair value hedging, economic ineffectiveness will still be reflected in current earnings for those hedges). The Board believes that requiring an entity to record the impact of both the effective and ineffective components of a hedging relationship in the same financial reporting period and in the same income statement line item[21] will make that entity's risk management activities and their effect on the financial statements more transparent to financial statement users.

Under this rationale, even a portion of the change in a hedging instrument's fair value that is excluded from a hedging relationship's effectiveness assessment is considered part of the hedging relationship and should be recognized in the same income statement line item as the earnings effect of the hedged item (other than amounts excluded from the assessment of effectiveness of net investment hedges). However, in a departure from the proposed ASU that formed the basis for the guidance in ASU 2017-12, the Board determined that presentation should not be prescribed for "missed forecasts" in cash flow hedges. Thus, an entity that ultimately determines that it is probable that a hedged forecasted transaction will not occur will not be required to record the amounts reclassified out of AOCI for that hedging relationship into earnings in the same income statement line item that would have been affected by the forecasted transaction.

10.3.3.2.1.1 Components Excluded From the Hedge Effectiveness Assessment

ASU 2017-12 continues to allow an entity to exclude the time value of options, or portions thereof, and forward points from the assessment of hedge effectiveness. The ASU also permits an entity to exclude the portion of the change in the fair value of a currency swap attributable to a cross-currency basis spread from the assessment of hedge effectiveness.

For excluded components in fair value, cash flow, and net investment hedges, the base recognition model under ASU 2017-12 is an amortization approach. An entity still may elect to record changes in the fair value of the excluded component currently in earnings; however, such an election will need to be applied consistently to similar hedges. The entity should disclose the method it elects.

Under the amortization approach of ASU 2017-12, an entity recognizes the initial value of the component that was excluded from the assessment of hedge effectiveness as an adjustment to earnings over the life of the hedging instrument by using a "systematic and rational method." In each accounting period, the entity recognizes in OCI (or, for net investment hedges, the cumulative translation adjustment (CTA) portion of OCI) any difference between (1) the change in fair value of the excluded component and (2) the amount recognized in earnings under that systematic and rational method.

[21] Note that it is possible that changes in the fair value of the hedging instrument may be presented in more than one income statement line item if the changes in the value of the hedged item affect more than one income statement line item.

10.3.3.2.1.2 Changes in the Fair Value of the Hedging Instrument and the Hedged Item

The following table summarizes the recognition and presentation requirements for the hedging instrument and the related hedged item under the updated hedge accounting and presentation model in ASU 2017-12:

	Component of Hedging Instrument *Included* in the Assessment of Hedge Effectiveness		**Component of Hedging Instrument *Excluded* From the Assessment of Hedge Effectiveness**		**Hedged Item**
	Where Fair Value Changes Are Initially Recorded	**When Hedged Item Affects Earnings**	**Systematic and Rational Amortization Method**	**Mark-to-Market Approach**	
Fair value hedge					
Recognition	Income statement	N/A	Amortization of initial value — income statement Record in OCI any difference between the change in fair value of the excluded component and amounts recognized in earnings under the systematic and rational method	Income statement	The entire change in fair value of the hedged item attributable to the hedged risk is recorded currently in income/loss and as an adjustment to the carrying amount of the hedged item
Presentation	Same income statement line item as the earnings effect of the hedged item	N/A	Same income statement line item as the earnings effect of the hedged item	Same income statement line item as the earnings effect of the hedged item	

(Table continued)

	Component of Hedging Instrument *Included* in the Assessment of Hedge Effectiveness		Component of Hedging Instrument *Excluded* From the Assessment of Hedge Effectiveness		Hedged Item
	Where Fair Value Changes Are Initially Recorded	When Hedged Item Affects Earnings	Systematic and Rational Amortization Method	Mark-to-Market Approach	
Cash flow hedge					
Recognition	OCI	Income statement	Amortization of initial value — income statement Record in OCI any difference between the change in fair value of the excluded component and amounts recognized in earnings under the systematic and rational method	Income statement	When the hedged item affects earnings, amounts will be reclassified out of AOCI and presented in the same income statement line item in which the earnings effect of the hedged item is presented
Presentation	OCI/AOCI (balance sheet)	Same income statement line item as the earnings effect of the hedged item (income statement presentation not prescribed for missed forecasts)	Same income statement line item as the earnings effect of the hedged item	Same income statement line item as the earnings effect of the hedged item	

(Table continued)

	Component of Hedging Instrument *Included* in the Assessment of Hedge Effectiveness		Component of Hedging Instrument *Excluded* From the Assessment of Hedge Effectiveness		Hedged Item
	Where Fair Value Changes Are Initially Recorded	When Hedged Item Affects Earnings	Systematic and Rational Amortization Method	Mark-to-Market Approach	
Net investment hedge					
Recognition	OCI (CTA)	Income statement	Amortization of initial value — income statement Record in OCI (CTA) any difference between the change in fair value of the excluded component and amounts recognized in earnings under the systematic and rational method	Income statement	When the hedged net investment affects earnings (i.e., upon a sale or liquidation), amounts will be reclassified out of the CTA and be presented in the same income statement line item in which the earnings effect of the net investment is presented (e.g., gain or loss on sale of investment)
Presentation	OCI/AOCI (CTA)	Same income statement line item as the earnings effect of the hedged item (e.g., gain or loss on sale of investment)	Income statement presentation not prescribed	Income statement presentation not prescribed	

10.3.3.2.2 Hedge Effectiveness Assessments and Documentation Requirements — Quantitative Versus Qualitative Assessments of Hedge Effectiveness

ASU 2017-12 requires an entity to perform an initial prospective quantitative hedge effectiveness assessment (by using either a dollar-offset test or a statistical method such as regression) unless the hedging relationship qualifies for application of one of the expedients that permits an assumption of perfect hedge effectiveness (e.g., the shortcut method or critical-terms-match method). An entity may complete this initial prospective assessment after hedge designation, generally until the first quarterly hedge effectiveness assessment date, by using information available at hedge inception.

Further, if (1) an entity's initial prospective quantitative hedge effectiveness assessment of a hedging relationship demonstrates that there is a highly effective offset and (2) the entity can, at hedge inception, "reasonably support an expectation of high effectiveness on a qualitative basis in subsequent periods," the entity may elect to perform subsequent retrospective and prospective effectiveness assessments qualitatively. To do so, in the hedge documentation it prepares at hedge inception, the entity must (1) specify how it will perform the qualitative assessments and (2) document the alternative quantitative assessment method that it would use if it later concludes, on the basis of a change in the hedging relationship's facts and circumstances, that subsequent quantitative assessments will be necessary. The entity may make this election on a hedge-by-hedge basis and may revise existing documentation for active hedges that use one of these expedients to include the alternative quantitative assessment method.

After an entity makes its initial election to perform qualitative assessments, it must "verify and document whenever financial statements or earnings are reported and at least every three months that the facts and circumstances related to the hedging relationship" continue to support the entity's ability to make qualitative assessments. If the entity determines that there no longer is a sufficient basis to support continued qualitative assessments, it must subsequently assess effectiveness quantitatively by using the method that it specified in the initial hedge documentation. In future reporting periods, the entity could return to making qualitative assessments if it can support them on the basis of the same factors it had used in its original qualitative assessments.

10.3.3.2.3 Shortcut Method and Critical-Terms-Match Method

ASU 2017-12 retains both the shortcut method and critical-terms-match method and provides additional relief for entities applying those methods. Under the ASU, an entity that determines that a hedging relationship no longer meets the shortcut criteria can subsequently account for the hedging relationship by using a long-haul method (and avoid having to dedesignate the original hedging relationship) if the entity can show both of the following:

> a. [It] documented at hedge inception . . . which quantitative method it would use to assess hedge effectiveness and measure hedge results if the shortcut method was not or no longer is appropriate during the life of the hedging relationship.
>
> b. The hedging relationship was highly effective on a prospective and retrospective basis in achieving offsetting changes in fair value or cash flows attributable to the hedged risk for the periods in which the shortcut method criteria were not met.

If criterion (a) is not satisfied, the hedging relationship would be invalid in the period in which the shortcut-method criteria were not satisfied and all subsequent periods; otherwise (if criterion (a) is met), the hedging relationship would be invalid in all periods in which criterion (b) was not satisfied.

In addition, ASU 2017-12 updates certain shortcut-method criteria to allow partial-term fair value hedges of interest rate risk to qualify for the shortcut method.

ASU 2017-12 also expands an entity's ability to apply the critical-terms-match method to cash flow hedges of groups of forecasted transactions. If all other critical-terms-match criteria are satisfied, such hedges will qualify for the critical-terms-match method "if those forecasted transactions occur and the derivative matures within the same 31-day period or fiscal month." Although entities have historically used this 31-day buffer period when applying critical-terms-match criteria, the new standard formally codifies this window, providing relief for entities that had been performing periodic analysis to demonstrate that any resulting ineffectiveness in the hedging relationship was de minimis.

10.3.3.2.4 Hedges of Interest Rate Risk

ASU 2017-12 eliminates the benchmark interest rate concept for variable-rate financial instruments but retains it for fixed-rate financial instruments. For recognized variable-rate financial instruments and forecasted issuances or purchases of variable-rate financial instruments, the ASU defines interest rate risk as "the risk of changes in the hedged item's cash flows attributable to changes in the contractually specified interest rate in the agreement." Thus, for example, in a hedge of the interest rate risk associated with variable debt indexed to a specified prime rate index, an entity could hedge the variability in cash flows attributable to changes in the contractually specified prime rate index. Fair value hedges of interest rate risk would continue to hedge the changes in fair value associated with changes in a specified benchmark interest rate. The ASU also adds the SIFMA Municipal Swap Rate to the list of permissible U.S. benchmark interest rates.

10.3.3.2.5 Other Targeted Improvements to Fair Value Hedges of Interest Rate Risk

ASU 2017-12 makes a number of improvements that simplify the accounting for fair value hedges of interest rate risk and make that accounting better reflect an entity's risk management activities.

10.3.3.2.5.1 Measuring Changes in the Hedged Item's Fair Value by Using Benchmark Component Cash Flows

Under current guidance, an entity is required to use the total contractual coupon cash flows to determine the change in fair value of the hedged item attributable to changes in the benchmark interest rate. However, ASU 2017-12 allows an entity to calculate the change in fair value of the hedged item in a fair value hedge of interest rate risk by using either (1) the full contractual coupon cash flows or (2) the cash flows associated with the benchmark interest rate component determined at hedge inception.

An entity's ability to use only the benchmark component cash flows for measurement allows the entity to reduce the net earnings effect of its hedge accounting by eliminating recognition of any economic ineffectiveness related to credit spreads.

10.3.3.2.5.2 Measuring the Fair Value of a Prepayable Instrument

For prepayable instruments such as callable debt, ASU 2017-12 states that an entity "may consider only how changes in the benchmark interest rate affect the decision to settle the hedged item before its scheduled maturity" when it calculates the change in the fair value of the hedged item attributable to interest rate risk. That is, when adjusting the carrying amount of the hedged item, an entity would consider the same factors that it considered when assessing hedge effectiveness. Before the ASU, practice had evolved to require an entity to consider *all* factors that might lead an obligor to settle the hedged item before its scheduled maturity (e.g., changes in interest rates, credit spreads, or other factors) even if the entity had designated only interest rate risk as the risk being hedged. The ASU allows an entity to ignore factors other than changes in the benchmark interest rate that could affect the settlement decision when it assesses hedge effectiveness and makes it easier for the hedging relationship to meet the "highly effective" threshold.

For example, when an entity that has adopted ASU 2017-12 (1) assesses hedge effectiveness in a fair value hedge of interest rate risk of callable debt and (2) measures the change in the fair value of callable debt attributable to changes in the benchmark interest rate, it can consider only how changes in the benchmark interest rate (and not changes in credit risk or other factors) would affect the obligor's decision to call the debt.

10.3.3.2.5.3 Partial-Term Hedges of Interest Rate Risk

ASU 2017-12 also provides relief to entities that wish to enter into fair value hedges of interest rate risk for only a portion of the term of the hedged financial instrument. Under current guidance, successful hedging of such partial-term exposures is typically unachievable because it is difficult to find a hedging derivative that would be highly effective at offsetting changes in the fair value of the hedged exposure as a result of the difference in timing between the hedged item's principal repayment and the maturity date of the hedging derivative.

Under ASU 2017-12, an entity may measure the change in the fair value of the hedged item attributable to changes in the benchmark interest rate by "using an assumed term that begins when the first hedged cash flow begins to accrue and ends when the last hedged cash flow is due and payable." Also, the hedged item's assumed maturity will be the date on which the last hedged cash flow is due and payable; therefore, a principal payment will be assumed to occur at the end of the specified partial term.

10.3.3.2.6 Ability to Designate Components of Nonfinancial Assets as Hedged Items

Under current guidance, when an entity desires to cash flow hedge a risk exposure associated with a nonfinancial asset, it can designate as the hedged risk only the risk of changes in cash flows attributable to (1) all changes in the purchase or sales price or (2) changes in foreign exchange rates. Alternatively, for cash flow hedges of financial instruments, an entity can designate as the hedged risk either the risk of overall changes in cash flows or one or more discrete risks.

ASU 2017-12 enables an entity to designate the "risk of variability in cash flows attributable to changes in a contractually specified component" as the hedged risk in a hedge of a forecasted purchase or sale of a nonfinancial asset. The ASU defines a contractually specified component as an "index or price explicitly referenced in an agreement to purchase or sell a nonfinancial asset other than an index or price calculated or measured solely by reference to an entity's own operations." The Board believes that enabling an entity to component hedge purchases or sales of nonfinancial assets better reflects its risk management activities in its financial reporting and will allow the entity to more easily hedge cash flow variability associated with commodities received from multiple suppliers or delivered to multiple locations. The ASU also creates greater symmetry in the hedging models for financial and nonfinancial items by allowing an entity to hedge components of the total change in cash flows for both types of items.

Connecting the Dots

The Board declined to provide additional guidance in ASU 2017-12 on the nature and form of contracts that could contain a contractually specified component. However, ASC 815-20-55-26A states that the "definition of a contractually specified component is considered to be met if the component is explicitly referenced in agreements that support the price at which a nonfinancial asset will be purchased or sold."

An entity's determination of whether it may designate as the hedged risk the variability in cash flows attributable to changes in a contractually specified component for the purchase or sale of a nonfinancial asset depends on the nature of the contract, as follows:

- If the contract is a derivative in its entirety and the entity applies the normal purchases and normal sales scope exception, the entity may designate any contractually specified component in the contract as the hedged risk (failure to apply the normal purchases and normal sales scope exception precludes designation of any contractually specified component).
- If the contract is not a derivative in its entirety, the entity may designate any remaining contractually specified component in the host contract (i.e., after bifurcation of any embedded derivatives) as the hedged risk.

In addition, ASU 2017-12 permits an entity to designate a hedge of a contractually specified component (1) for a period that extends beyond the contractual term or (2) when a contract does not yet exist to sell or purchase the nonfinancial asset if the criteria specified (see bullet points in the paragraph above) will be met in a future contract and all the other cash flow hedging requirements are met. When the entity executes the contract, it will reassess the criteria specified above to determine whether the contractually specified component continues to qualify for designation as the hedged risk. If, at the time the contract is executed, there is a change in the contractually specified component (e.g., the hedge documentation specified a commodity grade different from that in the executed contract), the entity will not be required to automatically dedesignate the hedging relationship; however, the entity must demonstrate that the hedging relationship continues to be highly effective at achieving offsetting cash flows attributable to the revised hedged risk to justify continuation of hedge accounting.

Connecting the Dots

The amendments in ASU 2017-12 do not limit this guidance on changes in the designated hedged risk to hedges of nonfinancial items. Therefore, for example, an entity also would be permitted to continue applying hedge accounting to a cash flow hedge of a financial item if (1) the designated hedged risk changes during the life of the hedging relationship (e.g., if the interest rate index referenced in the final transaction differs from that specified in the hedge documentation for the forecasted transaction) and (2) the entity can conclude that the hedging instrument is still highly effective at achieving offsetting cash flows attributable to the revised hedged risk.

10.3.3.2.7 Disclosure Requirements

ASU 2017-12 updates certain illustrative disclosure examples in ASC 815. Also, to align the disclosure requirements with the updates to the hedge accounting model, the ASU removes the requirement for entities to disclose amounts of hedge ineffectiveness. Further, the ASU requires entities to provide tabular disclosures about:

- Both (1) the total amounts reported in the statement of financial performance for each income and expense line item that is affected by fair value or cash flow hedging and (2) the effects of hedging on those line items.
- The carrying amounts and cumulative basis adjustments of items designated and qualifying as hedged items in fair value hedges. As part of such disclosures, an entity also must provide details about hedging relationships designated under the last-of-layer method, including (1) the closed portfolio's (beneficial interest's) amortized cost basis, (2) the designated last-of-layer amounts, and (3) the related basis adjustment for the last of layer.

These disclosures are required for every annual and interim reporting period for which a statement of financial position and statement of financial performance are presented.

Connecting the Dots

Entities should exercise caution in removing specific references to ineffective or effective portions of gains and losses. Total gains and losses related to hedging activity are still required for disclosure and should be retained. For example, we believe that it would be acceptable for an entity to change "the effective portion of gains or losses" to simply "gains and losses" when issuing disclosures such as income statement geography for foreign exchange contracts designated as cash flow hedges.

10.3.3.3 Transition

Entities will adopt the guidance in ASU 2017-12 by applying a modified retrospective approach to existing hedging relationships[22] as of the adoption date. Under this approach, entities with cash flow or net investment hedges will make (1) a cumulative-effect adjustment to AOCI so that the adjusted amount represents the cumulative change in the hedging instruments' fair value since hedge inception (less any amounts that should have been recognized in earnings under the new accounting model) and (2) a corresponding adjustment to opening retained earnings as of the most recent period presented on the date of adoption.

In all interim periods and fiscal years ending after the date of adoption, entities should prospectively (1) present the entire change in the fair value of a hedging instrument in the same income statement line item(s) as the earnings effect of the hedged item when that hedged item affects earnings (other than amounts excluded from the assessment of net investment hedge effectiveness, for which ASU 2017-12 does not prescribe presentation) and (2) provide the amended disclosures required by the new guidance.

In addition, ASU 2017-12 allows entities to make certain one-time transition elections. See Deloitte's August 30, 2017, *Heads Up* for a detailed discussion of the one-time transition elections provided by ASU 2017-12 and the deadlines for making such elections.

Connecting the Dots

An entity that is considering early adoption of ASU 2017-12 should ensure that it has appropriate financial reporting internal controls in place so that it can comply with the ASU's accounting and disclosure requirements. The entity also should give appropriate advance consideration to determining which transition elections it wishes to make since those elections must be made within a specified time after adoption. Also, ASC 815's general requirement for an entity to assess effectiveness for similar hedges in a similar manner, including the identification of excluded components, will apply to hedging relationships entered into after adoption; therefore, it will be important for the entity to determine its desired future methods for assessing the effectiveness of its hedging relationships when it adopts the ASU.

In connection with recording transition adjustments, it is important for the entity to consider the potential effects of the following:

- Deferred taxes.
- The assessment of the current hedge accounting management tool/system to ensure compliance with the new standard.

[22] This refers to hedging relationships in which "the hedging instrument has not expired, been sold, terminated, or exercised" and that have not been dedesignated by the entity as of the date of adoption.

- Changes to the existing chart of accounts (e.g., the addition of new accounts to track amortization of excluded components or the elimination of previously used ineffectiveness accounts).
- Changes to accounting policies, operating procedures, and internal controls.

10.3.3.4 Ongoing Discussions

Industry groups, accounting firms, standard setters, and regulators are engaged in ongoing discussions of issues related to the implementation of ASU 2017-12, including (1) application of qualitative effectiveness assessments, (2) application of the last-of-layer method (e.g., accounting for basis adjustments and identification of financial instruments that are considered prepayable), (3) identification of contractually specified components of nonfinancial assets, and (4) accounting for a cash flow hedge of a forecasted transaction when the hedged risk changes. We will continue to monitor the progress of these discussions and provide updates as appropriate.

In addition, in November 2018, the FASB issued a proposed ASU of Codification improvements related to ASUs 2016-01, 2016-13, and 2017-12. The comment period ended on January 18, 2019.

10.3.4 Fair Value Measurement Disclosures (ASU 2018-13)

10.3.4.1 Background

In August 2018, the FASB issued ASU 2018-13, which changes the fair value measurement disclosure requirements of ASC 820. The amendments in this ASU are the result of a broader disclosure project called FASB Concepts Statement No. 8, *Conceptual Framework for Financial Reporting — Chapter 8: Notes to Financial Statements*, which the Board finalized in August 2018. The Board used the guidance in the Concepts Statement to improve the effectiveness of ASC 820's disclosure requirements.

The table below summarizes the amendments to the fair value measurement disclosure requirements of ASC 820 that will take effect upon adoption of ASU 2018-13.

	Applicable to:	
Summary of Changes to ASC 820	**Other-Than-Nonpublic Entities**	**Nonpublic Entities**
New Disclosure Requirements		
Changes in unrealized gains or losses included in other OCI for recurring Level 3 fair value measurements held at the end of the reporting period	Yes	No
Explicit requirement to disclose the range and weighted average used to develop significant unobservable inputs for Level 3 fair value measurements	Yes	No[23]

[23] Nonpublic entities are still subject to the quantitative requirements in ASC 820-10-50-2(bbb)(2) but are not subject to the requirements in ASC 820-10-50-2(bbb)(2)(i).

(Table continued)

Summary of Changes to ASC 820	Applicable to: Other-Than-Nonpublic Entities	Applicable to: Nonpublic Entities
Eliminated Disclosure Requirements		
Amount of and reasons for transfers between Level 1 and Level 2	Yes	No[24]
Valuation processes for Level 3 fair value measurements	Yes	Yes
Policy for timing of transfers between levels of the fair value hierarchy	Yes	Yes
Changes in unrealized gains and losses included in earnings for recurring Level 3 fair value measurements held at the end of the reporting period	No	Yes
Modified Disclosure Requirements		
Deletion of "at a minimum" from the phrase "an entity shall disclose at a minimum" to promote the appropriate exercise of discretion by entities	Yes	Yes
Ability to disclose transfers into and out of Level 3 and purchases and issues of Level 3 assets and liabilities in lieu of reconciling the opening balances to the closing balances of recurring Level 3 fair value measurements	No	Yes
Clarification that the measurement uncertainty disclosure is to communicate information about the uncertainty in measurement as of the reporting date	Yes	No[25]
For investments in certain entities that calculate net asset value, a requirement to disclose the timing of liquidation of an investee's assets and the date when restrictions from redemption might lapse only if the investee has communicated the timing to the entity or announced the timing publicly	Yes	Yes

10.3.4.2 Effective Date and Transition

ASU 2018-13 is effective for all entities for fiscal years beginning after December 15, 2019, including interim periods therein. Early adoption is permitted upon issuance of this ASU, including in any interim period for which financial statements have not yet been issued or made available for issuance. Entities making this election are permitted to early adopt the eliminated or modified disclosure requirements[26] and delay the adoption of all the new disclosure requirements[27] until their effective date.

The ASU requires application of the prospective method of transition (for only the most recent interim or annual period presented in the initial fiscal year of adoption) to the new disclosure requirements for (1) changes in unrealized gains and losses included in OCI and (2) the range and weighted average used to develop significant unobservable inputs for Level 3 fair value measurements. The ASU also requires prospective application to any modifications to disclosures made because of the change to

[24] Under current U.S. GAAP, nonpublic entities are exempt from this disclosure requirement. Accordingly, elimination or modification of this disclosure requirement by the ASU does not affect nonpublic entities.

[25] See footnote 24.

[26] See ASC 820-10-65-12(c), which states that "an entity is permitted to early adopt the removed or modified disclosures in paragraph 820-10-50-2(bb), (c)(3), (f), and (g), paragraph 820-10-50-2G, and paragraph 820-10-50-6A(b) and (e)."

[27] See ASC 820-10-65-12(c), which states that an entity may "adopt the additional disclosures in paragraph 820-10-50-2(bbb)(2)(i) and (d) upon their effective date."

the requirements for the narrative description of measurement uncertainty. The effects of all other amendments made by the ASU must be applied retrospectively to all periods presented.[28]

See Deloitte's August 31, 2018, *Heads Up* for additional information about ASU 2018-13.

10.4 On the Horizon — Proposed ASU on Classification of Debt in a Classified Balance Sheet

10.4.1 Background

In January 2017, the FASB issued a proposed ASU that would simplify the classification of debt as either current or noncurrent on the balance sheet. The guidance currently in ASC 470-10 consists of an assortment of fact-specific rules and exceptions, the application of which varies depending on the terms and conditions of the debt arrangement, management's expectations of when debt may be settled or refinanced, and certain post-balance-sheet events. The objective of the proposed ASU is to reduce the cost and complexity of applying this guidance while maintaining or improving the usefulness of the information provided to financial statement users.

For more information about the proposed ASU, see Deloitte's January 12, 2017, *Heads Up*.

10.4.2 Principles-Based Approach

The proposed ASU would replace the current, fact-specific guidance with a unified principle for determining whether the classification of a debt arrangement in a classified balance sheet is current or noncurrent. An entity would classify a debt arrangement as noncurrent if either of the following criteria is met as of the financial reporting date:

- The "liability is contractually due to be settled more than one year (or operating cycle, if longer) after the balance sheet date."
- The "entity has a contractual right to defer settlement of the liability for at least one year (or operating cycle, if longer) after the balance sheet date."

As an exception to this classification principle, debt that is due to be settled within one year as a result of a covenant violation as of the balance sheet date would be classified as noncurrent if the debtor receives a waiver that meets certain conditions after the balance sheet date (see Section 10.4.6).

10.4.3 Scope

The proposed ASU would clarify that the balance sheet classification guidance in ASC 470-10 applies not only to nonconvertible debt arrangements but also to convertible debt within the scope of ASC 470-20 and to mandatorily redeemable financial instruments that are classified as liabilities under ASC 480-10.

10.4.4 Short-Term Obligations Expected to Be Refinanced on a Long-Term Basis

Under current U.S. GAAP, an entity that has the intent and ability to refinance a short-term obligation on a long-term basis after the financial reporting date — as indicated by the post-balance-sheet-date issuance of a long-term obligation, equity securities, or a qualifying refinancing agreement — is required to present the obligation as a noncurrent liability as of the financial reporting date. Under the proposed

[28] See ASC 820-10-65-12(b), which states that "[a]n entity shall apply the pending content that links to this paragraph retrospectively to all periods presented, except for the changes in unrealized gains and losses required by paragraph 820-10-50-2(d), the range and weighted-average disclosure required by paragraph 820-10-50-2(bbb)(2)(i), and the narrative description of measurement uncertainty in accordance with paragraph 820-10-50-2(g) that are required to be applied prospectively for only the most recent interim or annual period presented in the initial fiscal year of adoption."

ASU, however, the entity would be required to classify the short-term obligation in current liabilities because the refinancing of debt after the financial reporting date would be viewed as a new transaction that should not be retroactively reflected on the balance sheet as of that date.

10.4.5 Subjective Acceleration Clauses and Debt Covenants

Under existing U.S. GAAP, the classification of long-term obligations depends in part on whether they are governed by subjective acceleration clauses (SACs) for which exercise is probable (e.g., because of recurring losses or liquidity problems). Under the proposed ASU, however, SACs and covenants within long-term obligations would affect the classification of long-term obligations only when triggered or violated, in which case disclosure of the SAC or covenant would be required.

Connecting the Dots

Under the proposed ASU, some liabilities that are now classified as noncurrent would be classified as current, and vice versa. For example, as a result of the proposed change to the treatment of the refinancing of short-term obligations, an entity would not be allowed to consider refinancing events after the financial reporting date but before the financial statements were issued. Thus, such debt obligations would be classified as current liabilities as of the financial reporting date. Entities should consider the timing of refinancing plans and the potential effect on the classification of short-term obligations.

10.4.6 Covenant Violations

Under current guidance, if the creditor can demand the repayment of a long-term obligation as of the financial reporting date because of the debtor's violation of a debt covenant, the corresponding debt obligation is classified as noncurrent if the debtor obtains a covenant waiver before the date the financial statements are issued and certain other conditions are met. While the proposed ASU would retain similar guidance, it would require an entity to classify such debt as current if, as a result of the waiver, the entity accounts for the debt as having been extinguished. Because debt extinguishment accounting treats the debt as a newly issued instrument, the original debt obligation should be classified in current liabilities as of the balance sheet date since the creditor could demand repayment as of that date.

The proposed ASU would also clarify the application of the probability assessment that is associated with the waiver exception. Entities would be required to assess whether a violation of any other covenant not covered by the waiver is probable within 12 months from the reporting date. If so, the related debt would need to be classified as current.

10.4.7 Presentation and Disclosure

Under the proposed ASU, debt that is classified as noncurrent in accordance with the exception for debt covenant waivers would be presented separately on the balance sheet. Further, as previously noted, the proposed ASU would require entities to disclose information about debt covenants and SACs upon violation or trigger.

10.4.8 Effective Date and Transition

At the FASB's September 13, 2017, meeting, the Board decided that for PBEs, the proposed guidance would be effective for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years. For all other entities, the proposed guidance would be effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021. Early adoption would be permitted. At the meeting, the Board also directed the staff to draft a final ASU for vote by written ballot.

At its January 23, 2019, meeting, as stated in the FASB's tentative Board decisions, the Board continued redeliberations of the proposed ASU. The Board "directed the staff to continue its research on a potential alternative that considers the contractual linkage between certain debt arrangements and unused long-term financing arrangements in place at the balance sheet date. That research would consider the underlying economics of and the markets for those arrangements and illustrative examples related to unused long-term financing arrangements."

Appendix A — Titles of Standards and Other Literature

The standards and other literature below were cited or linked to in this publication.

AICPA Literature

Accounting and Valuation Guide

Assets Acquired to Be Used in Research and Development Activities

Valuation of Privately-Held-Company Equity Securities Issued as Compensation

Audit and Accounting Guide

Revenue Recognition

Issues Paper

Identification and Discussion of Certain Financial Accounting and Reporting Issues Concerning LIFO Inventories

Other

AICPA Technical Practice Aid, Section 2260.03, "Other Assets; Legal Expenses Incurred to Defend Patent Infringement Suit"

FASB Literature

ASC Topics

ASC 205, *Presentation of Financial Statements*

ASC 210, *Balance Sheet*

ASC 220, *Income Statement — Reporting Comprehensive Income*

ASC 230, *Statement of Cash Flows*

ASC 235, *Notes to Financial Statements*

ASC 250, *Accounting Changes and Error Corrections*

ASC 260, *Earnings per Share*

ASC 280, *Segment Reporting*

ASC 310, *Receivables*

ASC 320, *Investments — Debt and Equity Securities*

ASC 321, *Investments — Equity Securities*

ASC 323, *Investments — Equity Method and Joint Ventures*

ASC 325, *Investments — Other*

ASC 326, *Financial Instruments — Credit Losses*

ASC 330, *Inventory*

ASC 350, *Intangibles — Goodwill and Other*

ASC 360, *Property, Plant, and Equipment*

ASC 405, *Liabilities*

ASC 410, *Asset Retirement and Environmental Obligations*

ASC 420, *Exit or Disposal Cost Obligations*

ASC 450, *Contingencies*

ASC 470, *Debt*

ASC 480, *Distinguishing Liabilities From Equity*

ASC 505, *Equity*

ASC 605, *Revenue Recognition*

ASC 606, *Revenue From Contracts With Customers*

ASC 610, *Other Income*

ASC 715, *Compensation — Retirement Benefits*

ASC 718, *Compensation — Stock Compensation*

ASC 720, *Other Expenses*

ASC 730, *Research and Development*

ASC 740, *Income Taxes*

ASC 805, *Business Combinations*

ASC 808, *Collaborative Arrangements*

ASC 810, *Consolidation*

ASC 815, *Derivatives and Hedging*

ASC 820, *Fair Value Measurement*

ASC 825, *Financial Instruments*

ASC 830, *Foreign Currency Matters*

ASC 840, *Leases*

ASC 842, *Leases*

ASC 845, *Nonmonetary Transactions*

ASC 850, *Related Party Disclosures*

ASC 855, *Subsequent Events*

ASC 915, *Development Stage Entities*

ASC 958, *Not-for-Profit Entities*

ASC 985, *Software*

ASUs

2010-20, *Receivables (Topic 310): Disclosures About the Credit Quality of Financing Receivables and the Allowance for Credit Losses*

2010-27, *Other Expenses (Topic 720): Fees Paid to the Federal Government by Pharmaceutical Manufacturers* — a consensus of the FASB Emerging Issues Task Force

2011-06, *Other Expenses (Topic 720): Fees Paid to the Federal Government by Health Insurers* — a consensus of the FASB Emerging Issues Task Force

2014-02, *Intangibles — Goodwill and Other (Topic 350): Accounting for Goodwill* — a consensus of the Private Company Council

2014-09, *Revenue From Contracts With Customers (Topic 606)*

2014-10, *Development Stage Entities (Topic 915): Elimination of Certain Financial Reporting Requirements, Including an Amendment to Variable Interest Entities Guidance in Topic 810,* Consolidation

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*

2014-16, *Derivatives and Hedging (Topic 815): Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share Is More Akin to Debt or to Equity* — a consensus of the FASB Emerging Issues Task Force

2015-14, *Revenue From Contracts With Customers (Topic 606): Deferral of the Effective Date*

2015-17, *Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes*

2016-01, *Financial Instruments — Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*

2016-02, *Leases (Topic 842)*

2016-04, *Liabilities — Extinguishment of Liabilities (Subtopic 405-20): Recognition of Breakage for Certain Prepaid Store-Valued Products* — a consensus of the FASB Emerging Issues Task Force

2016-08, *Revenue From Contracts With Customers (Topic 606): Principal Versus Agent Considerations (Reporting Revenue Gross Versus Net)*

2016-09, *Compensation — Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting*

2016-10, *Revenue From Contracts With Customers (Topic 606): Identifying Performance Obligations and Licensing*

2016-11, *Revenue Recognition (Topic 605) and Derivatives and Hedging (Topic 815): Rescission of SEC Guidance Because of Accounting Standards Updates 2014-09 and 2014-16 Pursuant to Staff Announcements at the March 3, 2016 EITF Meeting*

2016-12, *Revenue From Contracts With Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients*

2016-13, *Financial Instruments — Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*

2016-15, *Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments* — a consensus of the FASB Emerging Issues Task Force

2016-16, *Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory*

2016-17, *Consolidation (Topic 810): Interests Held Through Related Parties That Are Under Common Control*

2016-18, *Statement of Cash Flows (Topic 230): Restricted Cash* — a consensus of the FASB Emerging Issues Task Force

2016-20, *Technical Corrections and Improvements to Topic 606,* Revenue From Contracts With Customers

2017-01, *Business Combinations (Topic 805): Clarifying the Definition of a Business*

2017-04, *Intangibles — Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*

2017-05, *Other Income — Gains and Losses From the Derecognition of Nonfinancial Assets (Subtopic 610-20): Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets*

2017-07, *Compensation — Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost*

2017-11, *Earnings per Share (Topic 260); Distinguishing Liabilities From Equity (Topic 480); Derivatives and Hedging (Topic 815): (Part I) Accounting for Certain Financial Instruments With Down Round Features, (Part II) Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests With a Scope Exception*

2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*

2017-13, *Revenue Recognition (Topic 605), Revenue From Contracts With Customers (Topic 606), Leases (Topic 840), and Leases (Topic 842): Amendments to SEC Paragraphs Pursuant to the Staff Announcement at the July 20, 2017 EITF Meeting and Rescission of Prior SEC Staff Announcements and Observer Comments* (SEC Update)

2017-14, *Income Statement — Reporting Comprehensive Income (Topic 220), Revenue Recognition (Topic 605), and Revenue From Contracts With Customers (Topic 606)* (SEC Update)

2018-01, *Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842*

2018-02, *Income Statement — Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects From Accumulated Other Comprehensive Income*

2018-03, *Technical Corrections and Improvements to Financial Instruments — Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*

2018-07, *Compensation — Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting*

2018-08, *Not-For-Profit Entities (Topic 958): Clarifying the Scope and the Accounting Guidance for Contributions Received and Contributions Made*

2018-10, *Codification Improvements to Topic 842,* Leases

2018-11, *Leases (Topic 842): Targeted Improvements*

2018-13, *Fair Value Measurement (Topic 820): Disclosure Framework — Changes to the Disclosure Requirements for Fair Value Measurement*

2018-14, *Compensation — Retirement Benefits — Defined Benefit Plans — General (Subtopic 715-20): Disclosure Framework — Changes to the Disclosure Requirements for Defined Benefit Plans*

2018-17, *Consolidation (Topic 810): Targeted Improvements to Related Party Guidance for Variable Interest Entities*

2018-18, *Collaborative Arrangements (Topic 808): Clarifying the Interaction Between Topic 808 and Topic 606*

Concepts Statements

No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*

No. 6, *Elements of Financial Statements*

No. 8, *Conceptual Framework for Financial Reporting — Chapter 1,* The Objective of General Purpose Financial Reporting*, and Chapter 3,* Qualitative Characteristics of Useful Financial Information

Proposed ASUs

No. 2015-310, *Notes to Financial Statements (Topic 235): Assessing Whether Disclosures Are Material*

No. 2015-340, *Government Assistance (Topic 832): Disclosures by Business Entities About Government Assistance*

No. 2016-270, *Income Taxes (Topic 740) Disclosure Framework — Changes to the Disclosure Requirements for Income Taxes*

No. 2017-200, *Debt (Topic 470): Simplifying the Classification of Debt in a Classified Balance Sheet (Current Versus Noncurrent)*

No. 2017-210, *Inventory (Topic 330): Disclosure Framework — Changes to the Disclosure Requirements for Inventory*

No. 2017-280, *Consolidation (Topic 812): Reorganization*

No. 2018-300, *Codification Improvements — Financial Instruments*

No. 2019-100, *Targeted Transition Relief for Topic 326, Financial Instruments — Credit Losses*

Other FASB Proposal

Proposed Concepts Statement 2014-200, *Conceptual Framework for Financial Reporting: Chapter 8: Notes to Financial Statements*

International Standards

IFRS 3, *Business Combinations*

IFRS 11, *Joint Arrangements*

IFRS 15, *Revenue From Contracts With Customers*

IFRS 16, *Leases*

IAS 10, *Events After the Reporting Period*

IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance*

IRC

Section 78, "Gross Up for Deemed Paid Foreign Tax Credit"

Section 163(j), "Interest; Limitation on Business Interest"

Section 199, "Income Attributable to Domestic Production Activities"

Section 383, "Special Limitations on Certain Excess Credits, etc."

Section 409A "Inclusion in Gross Income of Deferred Compensation Under Nonqualified Deferred Compensation Plans"

Section 422, "Incentive Stock Options"

Section 423, "Employee Stock Purchase Plans"

Section 965, "Treatment of Deferred Foreign Income Upon Transition to Participation Exemption System of Taxation"

Section 4191, "Medical Devices"

PCAOB Literature

Release No. 2017-001, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards*

SEC Literature

FRM

Topic 1, "Registrant's Financial Information"

Topic 2, "Other Financial Statements Required"

Topic 3, "Pro Forma Financial Information"

Topic 7, "Related Party Matters"

Topic 9, "Management's Discussion and Analysis of Financial Position and Results of Operations (MD&A)"

Topic 10, "Emerging Growth Companies"

Interpretive Release

33-10403, *Updates to Commission Guidance Regarding Accounting for Sales of Vaccines and Bioterror Countermeasures to the Federal Government for Placement Into the Pediatric Vaccine Stockpile or the Strategic National Stockpile*

Regulation S-K

Item 103, "Business; Legal Proceedings"

Regulation S-X

Rule 1-02(w), "Definitions of Terms Used in Regulation S-X (17 CFR part 210); Significant Subsidiary"

Rule 3-05, "Financial Statements of Businesses Acquired or to Be Acquired"

Rule 3-09, "Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons"

Rule 3-14, "Special Instructions for Real Estate Operations to Be Acquired"

Rule 4-08(g), "General Notes to Financial Statements: Summarized Financial Information of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons"

Rule 4-08(h), "General Notes to Financial Statements: Income Tax Expense"

Article 11, "Pro Forma Financial Information"

Rule 11-01 "Presentation Requirements"

SAB Topics

SAB Topic 1.M, "Financial Statements; Materiality"

SAB Topic 5.Y, "Miscellaneous Accounting; Accounting and Disclosures Relating to Loss Contingencies"

SAB Topic 11.A, "Miscellaneous Disclosure; Operating-Differential Subsidies"

SAB Topic 13, "Revenue Recognition"

SAB Topic 14.B, "Share-Based Payment; Transition From Nonpublic to Public Entity Status"

SAB Topic 14.D.1, "Certain Assumptions Used in Valuation Methods; Expected Volatility"

SAB Topic 14.D.2, "Certain Assumptions Used in Valuation Methods; Expected Term"

SAB 116, "Staff Accounting Bulletin No. 116"

Superseded Literature

EITF Issues

Issue 00-21, "Revenue Arrangements With Multiple Deliverables"

Issue 01-8, "Determining Whether an Arrangement Contains a Lease"

Issue 01-9, "Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)"

Issue 08-6, "Equity Method Investment Accounting Considerations"

Issue 09-2, "Research and Development Assets Acquired in an Asset Acquisition"

Issue 09-4, "Seller Accounting for Contingent Consideration"

FASB Interpretations

No. 48, *Accounting for Uncertainty in Income Taxes* — an interpretation of FASB Statement No. 109

FASB Statements

No. 5, *Accounting for Contingencies*

No. 123(R), *Share-Based Payment*

No. 141(R), *Business Combinations*

No. 160, *Noncontrolling Interests in Consolidated Financial Statements* — an amendment of ARB No. 51

Appendix B — Abbreviations

Abbreviation	Description
ABO	accumulated benefit obligation
AFS	available for sale
AICPA	American Institute of Certified Public Accountants
AMT	alternative minimum tax
AOCI	accumulated other comprehensive income
API	active pharmaceutical ingredient
APIC	additional paid-in capital
ASC	FASB Accounting Standards Codification
ASR	accelerated share repurchase
ASU	FASB Accounting Standards Update
BCF	beneficial conversion feature
BEAT	base erosion anti-abuse tax
BEMTA	base erosion minimum tax amount
BOLI	bank-owned life insurance
BPD	branded prescription drug
CAM	critical audit matter
CAQ	Center for Audit Quality
CDO	chief digital officer
CECL	current expected credit loss
CFC	controlled foreign corporation
CMO	contract manufacturing organization
CODM	chief operating decision maker
COLI	corporate-owned life insurance
CRO	contract research organization
CTA	cumulative translation adjustment

Abbreviation	Description
DTA	deferred tax asset
DTL	deferred tax liability
E&P	earnings and profits
EBITDA	earnings before interest, taxes, depreciation, and amortization
EDGAR	SEC electronic data gathering, analysis, and retrieval system
EGC	emerging growth company
EITF	Emerging Issues Task Force
ESPP	employee stock purchase plan
EU	European Union
FAQ	frequently asked question
FASB	Financial Accounting Standards Board
FAST Act	Fixing America's Surface Transportation Act
FDA	Food and Drug Administration
FDII	foreign derived intangible income
FIFO	first in, first out
FOB	free on board
FRM	SEC Division of Corporation Finance Financial Reporting Manual
GAAP	generally accepted accounting principles
GILTI	global intangible low-taxed income
GPO	group purchasing organization
IAS	International Accounting Standard
IASB	International Accounting Standards Board

Abbreviation	Description
IFRS	International Financial Reporting Standard
IIR	investigator-initiated research
IP	intellectual property
IPO	initial public offering
IPR&D	in-process research and development
IRC	Internal Revenue Code
IRS	Internal Revenue Service
ISO	incentive stock option
IT	information technology
JOBS Act	Jumpstart Our Business Startups Act
LIFO	last in, first out
LLC	limited liability company
LP	limited partnership
M&A	merger and acquisition
MD&A	Management's Discussion & Analysis
MDET	medical device excise tax
MSL	medical science liaison
NFP	not-for-profit entity
NOL	net operating loss
NQSO	non-qualified stock option
NSO	nonstatutory option
OCI	other comprehensive income
OECD	Organisation for Economic Co-operation and Development
OEM	original equipment manufacturer
PBE	public business entity
PBO	projected benefit obligation

Abbreviation	Description
PCAOB	Public Company Accounting Oversight Board
PCC	Private Company Council
PCD asset	purchased financial asset with credit deterioration
PP&E	property, plant, and equipment
PRV	priority review voucher
PTRS	probability of technical and regulatory success
Q&A	question and answer
R&D	research and development
R&E	research and experimentation
REMS	risk evaluation and mitigation strategy
ROI	return on investment
ROU	right of use
SAB	Staff Accounting Bulletin
SAC	subjective acceleration clause
SEC	Securities and Exchange Commission
SFC	specified foreign corporation
SIFMA	Securities Industry and Financial Markets Association
S&P 500	Standard & Poor's 500 Index
TD	Treasury Decision
TPA	AICPA Technical Practice Aid
TRG	transition resource group
UTB	unrecognized tax benefit
VIE	variable interest entity
VWAP	volume-weighted average daily market price