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Life Sciences

Accounting and Financial Reporting Update — Interpretive Guidance on New and Relevant Accounting Guidance

March 2017

Statement of Cash Flows

Introduction

The accounting principles related to the statement of cash flows have been in place for many years. However, errors in the statement of cash flows remain one of the leading causes of restatements, and companies continue to receive comments from the SEC[1] staff on cash flow presentation matters. In light of this, the FASB has issued new guidance intended to address diversity in practice. In addition, Deloitte's *A Roadmap to the Preparation of the Statement of Cash Flows* provides further insights into topics not addressed below.

Recently Issued Accounting Standards Updates

Classification Issues

In August 2016, the FASB issued ASU 2016-15,[2] which amends ASC 230 to add or clarify guidance on the classification of certain cash receipts and payments in the statement of cash flows. This ASU was the result of consensuses reached by the EITF to reduce the diversity in practice that has developed. Key provisions of the amendments are summarized below.

Cash Flow Issues	Amendments
Debt prepayment or debt extinguishment costs	Cash payments for debt prepayment or extinguishment costs (including third-party costs, premiums paid, and other fees paid to lenders) must "be classified as cash outflows for financing activities."
Settlement of zero-coupon bonds	The cash outflows for the settlement of a zero-coupon bond must be bifurcated into operating and financing activities. The portion of the cash payment related to accreted interest should be classified in operating activities, while the portion of the cash payment related to the original proceeds (i.e., the principal) should be classified in financing activities.
Contingent consideration payments made after a business combination	Contingent consideration payments that were not made soon after a business combination (on the basis of the consummation date) must be separated and classified in operating and financing activities. Cash payments up to the amount of the contingent consideration liability recognized as of the acquisition date, including any measurement-period adjustments, should be classified in financing activities, while any excess cash payments should be classified in operating activities. For example, assume that Entity A acquired Entity B on December 31, 2016, for cash consideration of $100 million plus an earn-out provision with a maximum payout of $50 million payable on January 31, 2019. Entity A classified the contingent consideration as a liability and determined that the acquisition-date fair value was $20 million, for total consideration of $120 million. On the basis of the performance of B's legacy operations, A determined that the fair value of the contingent consideration was $30 million on December 31, 2017, and $35 million on December 31, 2018.

[1] For a list of abbreviations used in this publication, see Appendix B.
[2] For the full titles of standards and other literature referred to in this publication, see Appendix A.

(Table continued)

Cash Flow Issues	Amendments
	Entity A should present information in its statement of cash flows as follows: • *December 31, 2016* — Entity A should disclose a $100 million investing outflow related to the acquisition and a noncash investing activity of $20 million related to the contingent consideration portion of the acquisition. • *December 31, 2017* — Entity A should disclose a $10 million reconciling item between net income and cash flows from operating activities related to the adjustment of the contingent consideration obligation. • *December 31, 2018* — Entity A should disclose a $5 million reconciling item between net income and cash flows from operating activities related to the adjustment of the contingent consideration obligation. • *January 31, 2019* — Of the $35 million A paid to the former owners of B, $20 million represents the portion recognized in purchase accounting and therefore should be classified as a financing activity. The remaining $15 million (i.e., the change in the liability after the acquisition date) should be reflected as a cash outflow from operating activities.
Proceeds from the settlement of insurance claims	Cash proceeds from the settlement of insurance claims should be classified on the basis of the nature of the loss. For insurance proceeds received in a lump-sum settlement, an entity should determine the classification on the basis of the nature of each loss included in the settlement.
Proceeds from the settlement of corporate-owned life insurance (COLI) policies and bank-owned life insurance (BOLI) policies	Cash proceeds from the settlement of COLI and BOLI polices must be classified in investing activities. However, an entity is permitted, but not required, to align the classification of premium payments on COLI and BOLI policies with the classification of COLI and BOLI proceeds (i.e., payments for premiums may be classified as investing, operating, or a combination thereof).
Distributions received from equity method investees	An entity is required to make an accounting policy election to classify distributions received from equity method investees under either of the following methods: • *Cumulative-earnings approach* — Under this approach, distributions are presumed to be returns on investment and classified as operating cash inflows. However, if the cumulative distributions received, less distributions received in prior periods that were determined to be returns of investment, exceed the entity's cumulative equity in earnings, such excess is a return of capital and should be classified as cash inflows from investing activities. • *Nature of the distribution approach* — Under this approach, each distribution is evaluated on the basis of the source of the payment and classified as either operating cash inflows or investing cash inflows. If an entity whose chosen policy is the nature of the distribution approach cannot apply the approach because it does not have enough information to determine the appropriate classification (i.e., the source of the distribution), the entity must apply the cumulative-earnings approach and report a change in accounting principle on a retrospective basis. The entity is required to disclose that a change in accounting principle has occurred as a result of the lack of available information as well as the information required under ASC 250-10-50-2, as applicable. The amendments do not address equity method investments measured under the fair value option.
Beneficial interests in securitization transactions	A transferor's beneficial interests received as proceeds from the securitization of an entity's financial assets must be disclosed as a noncash activity. Subsequent cash receipts of beneficial interests from the securitization of an entity's trade receivables must be classified as cash inflows from investing activities.

In addition to the specific transaction guidance discussed above, the new guidance provides a three-step approach for classifying cash receipts and payments that have aspects of more than one class of cash flows:

1. An entity should first apply specific guidance in U.S. GAAP, if applicable.
2. If there is no specific guidance related to the cash receipt or payment, an entity should bifurcate the cash payment or receipt into "each separately identifiable source or use [of cash] on the basis of the nature of the underlying cash flows." Each separately identifiable source or use of cash will be classified as operating, investing, or financing activities in accordance with the guidance in ASC 230.
3. If the cash payment or receipt cannot be bifurcated, the entire payment or receipt should be classified as operating, investing, or financing activities on the basis of the activity that is likely to be the predominant source or use of cash.

Thinking It Through

Since the new guidance is intended to eliminate diversity in practice, it could result in significant changes for some entities, particularly with respect to the issues discussed below.

Settlement of Zero-Coupon Bonds

The lack of guidance on the classification of payments to settle zero-coupon bonds in the statement of cash flows has led to diversity in the classification of the cash payment made by a bond issuer at the settlement of a zero-coupon bond. Some entities bifurcate the settlement payment between the principal (the amount initially received by the entity) and accreted interest. In those situations, the portion of the repayment related to principal is classified in financing activities, and the portion related to accreted interest is classified in operating activities. However, other entities do not bifurcate the settlement payment between principal and accreted interest and present the entire repayment in financing activities.

Under the new guidance, entities are required to bifurcate the repayment of zero-coupon bonds into principal and accreted interest, with the principal portion classified in financing activities and the accreted interest portion classified in operating activities. As a result, entities that currently classify the entire repayment of zero-coupon bonds in financing activities will need to identify the portion of such payments that are related to accreted interest and apply the provisions of the ASU accordingly.

Further, the consensus that the EITF reached with respect to zero-coupon bonds also applies to other debt instruments with coupon rates that are insignificant in relation to the effective interest rate of the borrowing. An entity will need to use judgment when assessing the significance of the coupon rate since the ASU does not provide guidance on how to make such a determination.

Distributions Received From Equity Method Investees

While ASC 230 distinguishes between returns of investment (which should be classified as inflows from investing activities) and returns on investment (which should be classified as inflows from operating activities), it does not prescribe a method for differentiating between the two. With respect to distributions from equity method investees, entities make this determination by applying a cumulative-earnings approach or a nature of the distribution approach. The ASU formalizes each of these methods and allows an entity to choose either one as an accounting policy election.

However, the ASU requires entities that choose the nature of the distribution approach to report a change in accounting principle if the information required under this approach is unavailable with respect to a particular investee. Therefore, while the ASU will not eliminate diversity in practice, entities that are currently applying the nature of the distribution approach should be mindful of the additional information and disclosure requirements under the ASU in electing a method as their accounting policy.

Beneficial Interests in Securitization Transactions

There is no specific guidance in ASC 230 on how to classify cash receipts associated with beneficial interests in securitization transactions. As a result, entities have classified the subsequent cash receipts from payments on beneficial interests obtained by the transferor in a securitization of the transferor's trade receivables as either operating activities or investing activities in the statement of cash flows. Although there is diversity in practice, we believe that entities have predominantly presented cash receipts from payments on a transferor's beneficial interests in securitized trade receivables as a cash inflow from operating activities. Accordingly, the requirement to present such cash receipts as a cash inflow from investing activities could change practice significantly.

Separately Identifiable Cash Flows and Application of the Predominance Principle

ASC 230 acknowledges that certain cash inflows and outflows may have characteristics of more than one cash flow class (e.g., financing, investing, or operating) and states that the "appropriate classification shall depend on the activity that is likely to be the predominant source of cash flows for the item." Although ASC 230 gives examples illustrating the application of the predominance principle,[3] entities often have difficulty applying the guidance.

As a result, when cash flows have aspects of more than one cash flow class, the ASU requires that entities first determine the classification of those cash receipts and payments by applying the specific guidance in ASC 230 and other applicable ASC topics. Further, the ASU notes that "[i]n the absence of specific guidance, a reporting entity shall determine each separately identifiable source or each separately identifiable use within the cash receipts and cash payments on the basis of the nature of the underlying cash flows." The ASU goes on to observe that "[i]n situations in which cash receipts and payments have aspects of more than one class of cash flows and cannot be separated by source or use . . . the appropriate classification shall depend on the activity that is likely to be the predominant source or use of cash flows for the item." However, because the ASU does not define the term "separately identifiable" in this context, we believe that challenges may be presented related to identifying separately identifiable cash receipts and payments as well as applying the term "predominant."

For more information about ASU 2016-15, see Deloitte's August 30, 2016, *Heads Up*.

[3] See ASC 230-10-45-22 and 45-23.

Restricted Cash

In November 2016, the FASB issued ASU 2016-18, which amends ASC 230 to provide guidance on the classification and presentation of restricted cash in the statement of cash flows. This ASU was the result of a consensus reached by the EITF and is intended to reduce diversity in practice that has developed related to the cash flow classification of restricted cash. Key requirements of the ASU are as follows:

- An entity should include in its cash and cash-equivalent balances in the statement of cash flows those amounts that are deemed to be restricted cash and restricted cash equivalents. The ASU does not define the terms "restricted cash" and "restricted cash equivalents" but states that an entity should continue to provide appropriate disclosures about its accounting policies pertaining to restricted cash in accordance with other GAAP. The ASU also states that any change in accounting policy will need to be assessed under ASC 250.
- A reconciliation between the statement of financial position and the statement of cash flows must be disclosed when the statement of financial position includes more than one line item for cash, cash equivalents, restricted cash, and restricted cash equivalents.
- Changes in restricted cash and restricted cash equivalents that result from transfers between cash, cash equivalents, and restricted cash and restricted cash equivalents should not be presented as cash flow activities in the statement of cash flows.
- An entity with a material balance of amounts generally described as restricted cash and restricted cash equivalents must disclose information about the nature of the restrictions.

For more information about ASU 2016-18, see Deloitte's November 17, 2016, *Heads Up*.

Effective Date and Transition

The effective date and transition guidance for both ASU 2016-15 and ASU 2016-18 are consistent. For public business entities, the guidance is effective for fiscal years beginning after December 15, 2017, including interim periods therein. For all other entities, it is effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early adoption will be permitted for all entities. Entities must apply the guidance retrospectively to all periods presented.

Income Taxes

Introduction

Entities in the life sciences industry often engage in several types of tax transactions to reduce their effective tax rate and facilitate certain corporate strategies, such as M&A transactions. For example, entities domiciled outside the United States frequently leverage their tax structure outside the United States to execute tax transactions such as intra-entity debt or intellectual property transfers and thereby obtain interest deductions in the United States and shift future income to lower-tax jurisdictions.

In addition, accounting for income taxes has recently become a focus of the FASB as the Board executes its simplification initiative and disclosure framework project. The disclosure framework project is intended to "improve the effectiveness of disclosures in the notes to financial statements by clearly communicating the information that is most important to users of each entity's financial statements."[4]

[4] Quoted from the related Project Update page of the FASB's Web site.

The sections below discuss FASB standard setting for accounting issues related to income taxes. For more information and interpretative guidance on the accounting for income taxes, see Deloitte's *A Roadmap to Accounting for Income Taxes*.

Recently Issued Accounting Standards Updates

Tax Effects of Intra-Entity Transfers of Assets Other Than Inventory

Background

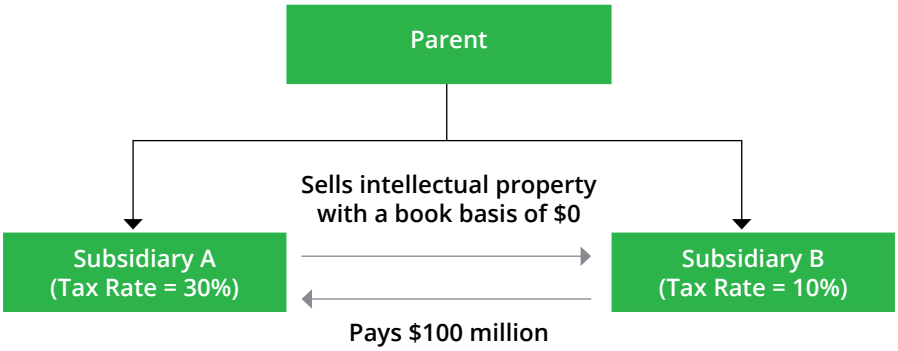
In October 2016, the FASB issued ASU 2016-16, which removes the prohibition in ASC 740 against the immediate recognition of the current and deferred income tax effects of intra-entity transfers of assets other than inventory. The ASU, which is part of the Board's simplification initiative, is intended to reduce the complexity of U.S. GAAP and diversity in practice related to the tax consequences of certain types of intra-entity asset transfers, particularly those involving intellectual property.

For additional information about the ASU, see Deloitte's October 25, 2016, *Heads Up*.

Key Provisions of the ASU

Under the ASU, the selling (transferring) entity is required to recognize any current tax expense or benefit upon transfer of the asset. Similarly, the purchasing (receiving) entity is required to recognize a deferred tax asset (DTA) or deferred tax liability (DTL), as well as the related deferred tax benefit or expense, upon receipt of the asset. An entity measures the resulting DTA or DTL by (1) computing the difference between the tax basis of the asset in the buyer's jurisdiction and its financial reporting carrying value in the consolidated financial statements and (2) multiplying such difference by the enacted tax rate in the buyer's jurisdiction.

The example below compares the income tax accounting for intra-entity transfers of assets other than inventory under current GAAP with that under the ASU.



Under current U.S. GAAP, Subsidiary A recognizes on its tax return a gain of $100 million on the sale of intellectual property to Subsidiary B, which is equal to the proceeds received ($100 million) less the

financial reporting carrying value of the intellectual property (zero). However, in accordance with ASC 740-10-25-3(e), A is prohibited from recognizing the current tax expense associated with that $100 million gain. Therefore, upon the sale, A would record the following journal entry for the tax effects:

Journal Entry

Prepaid taxes	30,000,000	
Current taxes payable		30,000,000

Further, B receives a tax basis in the intellectual property of $100 million, which is equal to the amount that it paid to A. This tax basis is greater than the carrying value of the intellectual property in the consolidated financial statements (zero), which would generally result in a DTA. However, in accordance with ASC 740-10-25-3(e), B is prohibited from recognizing the DTA (benefit) associated with its tax-over-book basis difference. Therefore, B would not record any tax entries associated with this transaction.

Under the ASU, since the exception to recognizing current and deferred taxes on intra-entity transfers of assets other than inventory is removed, A is required to recognize the current tax expense associated with the taxable gain on the sale of the intellectual property by recording the following journal entry:

Journal Entry

Current tax expense	30,000,000	
Current taxes payable		30,000,000

In addition, B is required to recognize the deferred tax effects associated with its purchase of the intellectual property by recording the following journal entry:

Journal Entry

DTA	10,000,000	
Deferred tax benefit		10,000,000

Interim Reporting Considerations

The ASU does not explicitly state whether the tax effects of intra-entity transfers of assets other than inventory should be recognized as discrete items or included in the estimated annual effective tax rate for interim reporting purposes. The ASU's Basis for Conclusions states, in part:

> Because of the variety of intra-entity asset transfers, the Board did not want to preclude an entity from making its own assessment about how to treat an intra-entity asset transfer for purposes of the estimate. The Board also agreed with stakeholders who indicated that if the Board had decided that all intra-entity asset transfers should be treated similarly for purposes of the estimate, it would have created an exception to the model in Topic 740. The Board's view is that it would not be unusual for entities following the guidance to conclude that many intra-entity transfers of assets other than inventory would be treated as discrete items for purposes of the computation. However, the Board understands from stakeholders' input that because the nature of, frequency of, and ability to estimate these transfers vary among entities, there are circumstances in which an entity could conclude that the transaction should be included in the computation of the estimated annual effective tax rate. The Board understands that an entity will need to apply judgment on the basis of the facts and circumstances to conclude whether the tax consequences of an intra-entity asset transfer other than inventory should be included in the computation of the estimated annual effective tax rate or treated as a discrete item in the interim period in which the transfer occurs.

Thinking It Through

Entities should carefully consider all of the provisions and exceptions in ASC 740-270 to determine whether the tax effects of intra-entity asset transfers are appropriately treated for interim reporting.

Effective Date and Transition

For public business entities, the ASU is effective for annual periods beginning after December 15, 2017, and interim periods therein. For all other entities, the ASU is effective for annual periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019. Early adoption is permitted.

Entities should apply the ASU's amendments on a modified retrospective basis, recognizing the effects in retained earnings as of the beginning of the year of adoption.

Balance Sheet Classification of Deferred Taxes

Background

In November 2015, the FASB issued ASU 2015-17, which requires entities to present DTAs and DTLs as noncurrent in a classified balance sheet. The ASU simplifies the current guidance, which requires entities to separately present DTAs and DTLs as current and noncurrent in a classified balance sheet.

For additional information about the ASU, see Deloitte's November 30, 2015, *Heads Up*.

Key Provisions of the ASU

Under current guidance (ASC 740-10-45-4), entities are required to "separate deferred tax liabilities and assets into a current amount and a noncurrent amount. Deferred tax liabilities and assets shall be classified as current or noncurrent based on the classification of the related asset or liability for financial reporting." Stakeholder feedback indicated that the separate presentation of deferred taxes as current or noncurrent provided little useful information to financial statement users and resulted in additional costs to preparers. Therefore, the FASB issued the ASU to simplify the presentation of deferred taxes in a classified balance sheet. Netting of DTAs and DTLs by tax jurisdiction will still be required under the new guidance.

Noncurrent balance sheet presentation of all deferred taxes eliminates the requirement to allocate a valuation allowance on a pro rata basis between gross current and noncurrent DTAs, which constituents had also identified as an issue contributing to complexity in accounting for income taxes.

Effective Date and Transition

The ASU requires the following:

- For public business entities, the ASU is effective for annual periods beginning after December 15, 2016, and interim periods therein.
- For entities other than public business entities, the ASU is effective for annual reporting periods beginning after December 15, 2017, and interim reporting periods within annual reporting periods beginning after December 15, 2018.

The Board decided to allow all entities to early adopt the ASU. Therefore, the ASU can be adopted by all entities for any interim or annual financial statements that have not been issued. In addition, entities are permitted to apply the amendments either prospectively or retrospectively.

In the period the ASU is adopted, an entity will need to disclose "the nature of and reason for the change in accounting principle." If the new guidance is applied prospectively, the entity should disclose that prior balance sheets were not retrospectively adjusted. However, if the new presentation is applied retrospectively, the entity will need to disclose the quantitative effects of the change on the prior balance sheets presented.

On the Horizon — Proposed ASU on Income Tax Disclosure Requirements

Background

In July 2016, the FASB issued a proposed ASU that would modify or eliminate certain disclosure requirements related to income taxes as well as establish new requirements. The proposal is part of the FASB's disclosure framework project, which, as noted on the related Project Update page of the FASB's Web site, is intended to "improve the effectiveness of disclosures in notes to financial statements by clearly communicating the information that is most important to users of each entity's financial statements."

For additional information about the proposed ASU, see Deloitte's July 29, 2016, *Heads Up*.

Key Provisions of the Proposed ASU

Scope

Although many of the amendments would apply to all entities that are subject to income taxes, certain amendments would apply only to public business entities.

Indefinitely Reinvested Foreign Earnings

The proposed ASU would require all entities to explain any change to an indefinite reinvestment assertion made during the year, including the circumstances that caused such change in assertion. All entities would also be required to disclose the amount of earnings for which there was a change in assertion made during the year. In addition, all entities would be required to disclose the aggregate of cash, cash equivalents, and marketable securities held by their foreign subsidiaries.

Such information is intended to give financial statement users information that will help them predict the likelihood of future repatriations and the associated income tax consequences related to foreign indefinitely reinvested earnings.

Unrecognized Tax Benefits

The proposed ASU would modify the disclosure requirements for a public business entity related to unrecognized tax benefits. It would add a requirement for entities to disclose, in the tabular reconciliation of the total amount of unrecognized tax benefits required by ASC 740-10-50-15A(a), settlements disaggregated by those that have been (or will be) settled in cash and those that have been (or will be) settled by using existing DTAs (e.g., settlement by using existing net operating loss or tax credit carryforwards).

A public business entity would also be required to provide a breakdown (i.e., a mapping) of the amount of total unrecognized tax benefits shown in the tabular reconciliation by the respective balance-sheet lines on which such unrecognized tax benefits are recorded. If an unrecognized tax benefit is not included in a balance-sheet line, such amount would be disclosed separately. In addition, a public business entity would be required to disclose the total amount of unrecognized tax benefits that are offset against existing DTAs for net operating loss and tax credit carryforwards.

Under the guidance currently in ASC 740-10-50-15(d), all entities must disclose details of tax positions for which it is reasonably possible that the total amount of unrecognized tax benefits will significantly increase or decrease in the next 12 months. The proposed ASU would eliminate this disclosure requirement.

ASC 740-10-55-217 (as amended) would provide an example of the applicability of these disclosure requirements.

Operating Loss and Tax Credit Carryforwards

Currently, entities are required to disclose the amount and expiration dates of operating losses and tax credit carryforwards for tax purposes. Historically, there has been diversity in practice related to this disclosure requirement. The proposed ASU would reduce this diversity by requiring a public business entity to disclose the total amount of:

- Federal, state, and foreign gross net operating loss and tax credit carryforwards (i.e., not tax effected) by period of expiration for each of the first five years after the reporting date and a total for any remaining years.
- Federal, state, and foreign DTAs related to net operating loss and tax credit carryforwards (i.e., tax effected) before any valuation allowance.

As discussed previously, a public business entity would also be required to disclose the total amount of unrecognized tax benefits that are offset against existing DTAs for net operating loss and tax credit carryforwards.

In addition, the proposed ASU would modify the disclosure requirement related to net operating loss and tax credit carryforwards for entities other than public business entities. An entity other than a public business entity would be required to disclose the total gross amounts of federal, state, and foreign net operating loss and tax credit carryforwards (i.e., not tax effected) along with their expiration dates.

ASC 740-10-55-218 through 55-222 (as amended) would provide an example of the applicability of these disclosure requirements.

Rate Reconciliation

ASC 740-10-50-12 currently requires a public business entity to disclose a reconciliation of the reported amount of income tax expense (or benefit) from continuing operations to the amount of income tax expense (or benefit) that would result from multiplying the pretax income (or loss) from continuing operations by the domestic federal statutory tax rate.

The proposed ASU would amend the requirement for a public business entity to disclose the income tax rate reconciliation in a manner consistent with SEC Regulation S-X, Rule 4-08(h). As amended, ASC 740-10-50-12 would continue to require a public business entity to disclose a reconciliation of the reported amount of income tax expense (or benefit) from continuing operations to the amount of income tax expense (or benefit) that would result from multiplying the pretax income (or loss) from continuing operations by the domestic federal statutory tax rate. However, the amendment would modify the requirement to disaggregate and separately present components in the rate reconciliation that are greater than or equal to 5 percent of the tax at the statutory rate in a manner consistent with the requirement in Rule 4-08(h).

Government Assistance

As a result of deliberations on its November 2015 proposed ASU on government assistance, the FASB decided to require an entity to disclose certain information related to assistance received from a governmental unit that reduces the entity's income taxes. Accordingly, the July 2016 proposed ASU on income tax disclosure requirements would require all entities that receive income tax–related government assistance to disclose a "description of a legally enforceable agreement with a government, including the duration of the agreement and the commitments made with the government under that agreement and the amount of benefit that reduces, or may reduce, its income tax burden." This disclosure requirement would apply only when the government determined whether, under such agreement, the entity would receive assistance and, if so, how much it would receive even if it met the applicable eligibility requirements.

In the absence of a specific agreement between the entity and the government, the entity would not be required to disclose this information if the entity obtained the government assistance because it met eligibility requirements that apply to all taxpayers.

Other Income Tax Disclosure Requirements

The proposed ASU would require all entities to disclose the following:

- The amount of pretax income (or loss) from continuing operations disaggregated by foreign and domestic amounts.
- The amount of income tax expense (or benefit) from continuing operations disaggregated by foreign and domestic amounts.
- The amount of income taxes paid disaggregated by foreign and domestic amounts. A further disaggregation would be required for any country that is significant to the total amount of income taxes paid.
- An enacted tax law change if it is probable that such change would have an effect on the entity in the future.

In addition, the proposed ASU would require public business entities to explain any valuation allowance recognized or released during the year along with the corresponding amount.

Thinking It Through

The proposed ASU on income tax disclosure requirements is also aligned with the FASB's proposed ASU on assessing the materiality of disclosures, which would allow an entity to consider materiality when assessing income tax disclosure requirements. For additional information about the proposed ASU on assessing the materiality of disclosures, see Deloitte's September 28, 2015, *Heads Up*.

Effective Date and Transition

The proposed ASU would be applied prospectively. The FASB will determine an effective date for the final guidance after it has considered feedback from stakeholders.

Employee Share-Based Payment Accounting Improvements

Background

In March 2016, the FASB issued ASU 2016-09, which simplifies several aspects of the accounting for employee share-based payment transactions for both public and nonpublic entities, including the accounting for income taxes, forfeitures, and statutory tax withholding requirements, as well as classification in the statement of cash flows. The new guidance, which is part of the Board's simplification initiative, also contains practical expedients for nonpublic entities.

Key Provisions of the ASU

Accounting for Income Taxes

Under current guidance, when a share-based payment award is granted to an employee, the fair value of the award is generally recognized over the vesting period, and a corresponding DTA is recognized to the extent that the award is tax-deductible. The tax deduction is generally based on the intrinsic value at the time of exercise (for an option) or on the fair value upon vesting of the award (for restricted stock), and it can be either greater (excess tax benefit) or less (tax deficiency) than the compensation cost recognized in the financial statements. All excess tax benefits are recognized in additional paid-in capital (APIC), and tax deficiencies are recognized either in the income tax provision or in APIC to the extent that there is a sufficient "APIC pool" related to previously recognized excess tax benefits.

Under the ASU, an entity recognizes all excess tax benefits and tax deficiencies as income tax expense or benefit in the income statement. This change eliminates the notion of the APIC pool and significantly reduces the complexity and cost of accounting for excess tax benefits and tax deficiencies. In addition, excess tax benefits and tax deficiencies are considered discrete items in the reporting period in which they occur and are not included in the estimate of an entity's annual effective tax rate.

The ASU's guidance on recording excess tax benefits and tax deficiencies in the income statement also has a corresponding effect on the computation of diluted EPS when an entity applies the treasury stock method. An entity that applies such method under current guidance estimates the excess tax benefits and tax deficiencies to be recognized in APIC in determining the assumed proceeds available to repurchase shares. However, under the ASU, excess tax benefits and tax deficiencies are excluded from the calculation of assumed proceeds since such amounts are recognized in the income statement. In addition, the new guidance affects the accounting for tax benefits of dividends on share-based payment awards, which will now be reflected as income tax expense or benefit in the income statement rather than as an increase to APIC.

Further, the ASU eliminates the requirement to defer recognition of an excess tax benefit until the benefit is realized through a reduction to taxes payable.

In addition to addressing the recognition of excess tax benefits and tax deficiencies, the ASU provides guidance on the related cash flow presentation. Under existing guidance, excess tax benefits are viewed as a financing transaction and are presented as financing activities in the statement of cash flows. However, there is no cash receipt but only a reduction in taxes payable. Therefore, a reclassification is made in the statement of cash flows to reflect a hypothetical inflow in the financing section and a hypothetical outflow from the operating section.

Under the ASU, excess tax benefits no longer represent financing activities since they are recognized in the income statement; therefore, excess tax benefits are not separate cash flows and should be classified as operating activities in the same manner as other cash flows related to income taxes. Accordingly, the ASU eliminates the requirement to reclassify excess tax benefits from operating activities to financing activities.

Accounting for Forfeitures

The ASU allows an entity to elect as an accounting policy either to continue to estimate the total number of awards for which the requisite service period will not be rendered (as currently required) or to account for forfeitures when they occur. This entity-wide accounting policy election applies only to service conditions; for performance conditions, the entity continues to assess the probability that such conditions will be achieved. An entity must also disclose its policy election for forfeitures.

Thinking It Through

An entity that adopts a policy to account for forfeitures as they occur must still estimate forfeitures when an award is (1) modified (the estimate applies to the original award in the measurement of the effects of the modification) and (2) exchanged in a business combination (the estimate applies to the amount attributed to precombination service). However, the accounting policy for forfeitures will apply to the subsequent accounting for awards that are modified or exchanged in a business combination.

Statutory Tax Withholding Requirements

The ASU modifies the current exception to liability classification of an award when an employer uses a net-settlement feature to withhold shares to meet the employer's minimum statutory tax withholding requirement. Currently, the exception applies only when no more than the number of shares necessary for the minimum statutory tax withholding requirement to be met is repurchased or withheld. The new guidance stipulates that the net settlement of an award for statutory tax withholding purposes would not result, by itself, in liability classification of the award provided that the amount withheld for taxes does not exceed the maximum statutory tax rate in the employees' relevant tax jurisdictions.

Further, to eliminate diversity in practice, the ASU requires that cash payments to tax authorities in connection with shares withheld to meet statutory tax withholding requirements be presented as a financing activity in the statement of cash flows because such payments represent an entity's cash outflow to reacquire the entity's shares.

Thinking It Through

Under current guidance, an entity is required to track the minimum statutory tax withholding requirement applicable to each specific award grantee in each applicable jurisdiction if shares are repurchased or withheld. Under the new guidance, the maximum rate is determined on a jurisdiction-by-jurisdiction basis even if that rate exceeds the highest rate applicable to a specific award grantee. However, the classification exception would not apply to entities that do not have a statutory tax withholding obligation; for such entities, any net settlement for tax withholding would result in a liability-classified award.

In addition, an entity may change the terms of its awards related to net settlement for withholding taxes from the minimum statutory tax rate to a higher rate up to the maximum statutory tax rate. While this change may be made to existing awards, the entity would not be required to account for such a change as a modification. However, this accounting treatment

applies only in these narrow circumstances (i.e., solely to change the net-settlement provisions from the minimum statutory tax rate to a higher rate up to the maximum statutory tax rate for statutory tax withholding purposes).

Practical Expedients for Nonpublic Entities

Expected-Term Practical Expedient

The ASU allows nonpublic entities to use the simplified method to estimate the expected term for awards (including liability-classified awards measured at fair value) with service or performance conditions that meet certain requirements. Such entities would apply this practical expedient as follows:

- For awards with only a service condition, nonpublic entities can estimate the expected term as the midpoint between the requisite service period and the contractual term of the award.
- For awards with a performance condition, the estimate of the expected term would depend on whether it is probable that the performance condition will be achieved:
  - If it is probable that the performance condition will be achieved, nonpublic entities can estimate the expected term as the midpoint between the requisite service period and the contractual term.
  - If it is not probable that the performance condition will be achieved, nonpublic entities can estimate the expected term as (1) the contractual term if the award does not contain an explicit service period or (2) the midpoint between the requisite service period and the contractual term if the award does contain an explicit service period.

Intrinsic Value Practical Expedient

The ASU allows nonpublic entities to make a one-time election to switch from fair value measurement to intrinsic value measurement, without demonstrating preferability, for share-based payment awards classified as liabilities.

Nonpublic entities are not allowed to make this election on an ongoing basis after the effective date of the new guidance.

Transition and Related Disclosures

The following table outlines the transition methods for an entity's adoption of ASU 2016-09:

Type	Transition Method
Recognition of excess tax benefits and tax deficiencies (accounting for income taxes)	Prospective
Unrecognized excess tax benefits (accounting for income taxes)	Modified retrospective
Classification of excess tax benefits in the statement of cash flows	Retrospective or prospective
Accounting for forfeitures	Modified retrospective
Classification and statutory tax withholding requirements	Modified retrospective
Classification of employee taxes paid in the statement of cash flows when an employer withholds shares for tax withholding purposes	Retrospective
Nonpublic entity practical expedient for expected term	Prospective
Nonpublic entity practical expedient for intrinsic value	Modified retrospective

Thinking It Through

An entity's prior-year APIC pool is not affected because prior-year excess tax benefits and tax deficiencies have already been recognized in the financial statements, and the recognition of excess tax benefits and tax deficiencies in the income statement is prospective only in the fiscal year of adoption. As a result, there is no reclassification between APIC and retained earnings in the fiscal years before adoption. The modified retrospective transition guidance for taxes applies only to previously unrecognized excess tax benefits outstanding upon adoption of ASU 2016-09 with a cumulative-effect adjustment to retained earnings.

In the period of adoption, entities are required to disclose (1) the nature of and reason for the changes in accounting principle and (2) any cumulative effects of the changes on retained earnings or other components of equity as of the date of adoption.

In addition, because the change in presentation in the statement of cash flows related to excess tax benefits can be applied either prospectively or retrospectively, entities are required to disclose (1) "that prior periods have not been adjusted" if the change is applied prospectively or (2) the "effect of the change on prior periods retrospectively adjusted" if the change is applied retrospectively. For the change in presentation in the statement of cash flows related to statutory tax withholding requirements, entities are required to disclose the "effect of the change on prior periods retrospectively adjusted."

Effective Date

For public business entities, the ASU is effective for annual reporting periods beginning after December 15, 2016, including interim periods therein. For all other entities, the ASU is effective for annual reporting periods beginning after December 15, 2017, and interim periods within annual reporting periods beginning after December 15, 2018.

Early adoption will be permitted in any interim or annual period for which financial statements have not yet been issued or have not been made available for issuance. If early adoption is elected, all amendments in the ASU that apply must be adopted in the same period. In addition, if early adoption is elected in an interim period, any adjustments should be reflected as of the beginning of the annual period that includes that interim period.

Example

Entity A, an SEC registrant, adopts ASU 2016-09 in its third fiscal quarter. Entity A had $50 of excess tax benefits in each quarter in its current fiscal year to date and is not affected by adopting any of the other provisions of ASU 2016-09. In its previously issued financial statements in Form 10-Q, A recognized a total of $100 ($50 in each quarter) of excess tax benefits in APIC. In its third fiscal quarter, the period in which the ASU is adopted, A recognizes $50 of excess tax benefits in its income statement. That is, the quarter-to-date income tax provision will include only the third fiscal quarter excess tax benefits ($50). In addition, the year-to-date income tax provision will include excess tax benefits of $150 to reflect the reversal of the excess tax benefits recognized in APIC for the first two fiscal quarters ($100) and the recognition of those benefits in the income statement in those prior quarters (the $100 in excess tax benefits related to the first and second fiscal quarters are not recognized in the third quarter but are reflected on a recasted basis in the applicable prior quarters). In the quarterly information footnote of its subsequent Form 10-K filing, A will present a schedule reflecting the first and second fiscal quarters' excess tax benefits ($50 each quarter) in the income statement even though these amounts were reported in APIC in previously issued financial statements in Form 10-Q. Finally, A's financial statements in Form 10-Q issued in the year after A's adoption of the ASU will reflect the prior-year quarterly excess tax benefits (i.e., first and second fiscal quarters of the prior year) on a recasted basis in the income statement rather than in APIC.

Financial Instruments

Recently Issued Accounting Standards Updates

Classification and Measurement

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 public business entities, 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. Nonpublic business entities are permitted to adopt the standard in accordance with the effective date for public business entities. For more information about ASU 2016-01, see Deloitte's January 12, 2016, *Heads Up*.

Classification and Measurement of Equity Investments

The amendments 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 practicability exception under which the equity investment would be measured at cost less impairment, if any, plus or minus observable price changes in orderly transactions. This practicability exception 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 practicability exception 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.

Thinking It Through

Under current U.S. GAAP, 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 other comprehensive income (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 the new guidance, 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 practicability exception to investments without readily determinable fair values may reduce such earnings volatility, but this exception is not available to broker-dealers.

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 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 also acknowledges that there may be other methods an entity may use to determine instrument-specific credit risk.

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. Under current U.S. GAAP, 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]."

Changes to Disclosure Requirements

For nonpublic business entities, the amendments eliminate the requirement to disclose the fair value of financial instruments measured at amortized cost. In addition, for such financial instruments, public business entities 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 public business entity 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).

Impairment

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 an allowance its estimate of expected credit losses, which the FASB believes will result in more timely recognition of such losses. The ASU is also intended to reduce the complexity of U.S. GAAP by decreasing the number of credit impairment models that entities use to account for debt instruments.

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

The CECL Model

Scope

The CECL model applies to most[5] 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,[6] 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).

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.

Measurement of Expected Credit Losses

The ASU 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.

[5] 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 a not-for-profit entity.
- Loans and receivables between entities under common control.

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

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.

Write-Offs

Like current guidance, the ASU 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.

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 ASC 326-20-55-38 through 55-40 (Example 5), illustrates how an entity would apply the proposed guidance to trade receivables by using a provision matrix.[7]

> 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.

[7] ASC paragraph numbers have been omitted.

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

Thinking It Through

The ASU's example 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.
- 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).

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.[8] Accordingly, the ASU 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.

[8] 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.

Disclosures

Many of the disclosures required under the ASU 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.[9]
- 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.

In addition, other disclosures are required as follows:

- Public business entities that meet the U.S. GAAP definition of an SEC filer[10] must disclose credit quality indicators disaggregated by year of origination for a five-year period.
- Public business entities 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 the ASU, 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.

Effective Date and Transition

Effective Date

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

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

For all other entities, the ASU is effective for fiscal years beginning after December 15, 2020, and interim periods within those fiscal years beginning after December 15, 2021.

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

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

[10] Under U.S. GAAP, an SEC filer is defined as follows:

> "An entity that is required to file or furnish its financial statements with either of the following:
>
> a. The Securities and Exchange Commission (SEC)
> b. With respect to an entity subject to Section 12(i) of the Securities Exchange Act of 1934, as amended, the appropriate agency under that Section.
>
> Financial statements for other entities that are not otherwise SEC filers whose financial statements are included in submission by another SEC filer are not included within this definition."

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.

On the Horizon — Simplifying the Balance Sheet Classification of Debt

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.

Stakeholders are encouraged to review and provide comment on the FASB's proposal to simplify and improve the guidance on determining whether debt should be classified as a current or noncurrent liability in a classified balance sheet by May 5, 2017.

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

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 the Covenant Violations section below).

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.

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

Under current U.S. GAAP, entities that have 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 — are required to present the obligation as a noncurrent liability as of the financial reporting date. The proposed ASU, however, would require such short-term obligations to be classified within 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 in the balance sheet as of that date.

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.

Thinking It Through

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.

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 classify such debt as current if the waiver results in the debt's being accounted for as having been extinguished. Because debt extinguishment accounting treats the debt as a newly issued instrument, the original debt obligation, as of the balance sheet date, should be classified within current liabilities since the debtor 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.

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 in 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.

Effective Date and Transition

The Board will determine an effective date for the final guidance after it considers feedback on the proposed ASU. Once finalized, the proposed approach will be applicable on a prospective basis to debt that exists as of the effective date. Early adoption will be permitted.

Leases

New Leases Standard (Codified in ASC 842)

In February 2016, the FASB issued ASU 2016-02, its new standard on accounting for leases. The primary objective of the leases project was to address the off-balance-sheet financing concerns related to lessees' operating leases. Accordingly, the standard's lessee model requires lessees to adopt a right-of-use (ROU) asset approach that brings substantially all leases, with the exception of short-term leases (i.e., those with a lease term of less than 12 months), onto the balance sheet. Under this approach, a lessee would record an ROU asset representing its right to use the underlying asset during the lease term and a corresponding lease liability (in a manner similar to the current approach for capital leases).

As part of the leases project, the Board also addressed questions such as (1) whether an arrangement is a service or a lease, (2) what amounts should be initially recorded on the lessee's balance sheet for the arrangement, (3) how to reflect the effects of leases in the statement of comprehensive income, and (4) how to apply the resulting accounting in a cost-effective manner. The standard also aligns certain underlying principles of the new lessor model with those in ASC 606, the FASB's new revenue recognition standard (e.g., those related to the evaluation of how collectibility should be considered and the determination of when profit can be recognized).

The sections below summarize the key provisions of the new leases standard that are expected to have the greatest impact on life sciences entities.

Definition of a Lease

The new leases standard states that a contract is, or contains, a lease if the contract gives a customer "the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration." Control is considered to exist if the customer has both of the following:

- The "right to obtain substantially all of the economic benefits from use of [an identified] asset."
- The "right to direct the use of that asset."

An entity is required at inception to identify whether a contract is, or contains, a lease. The entity will reassess whether the contract is or contains a lease only in the event of a modification to the terms and conditions of the contract.

The table below summarizes each key concept related to the definition of a lease.

Concept	Requirement	Observation
Use of an identified asset	An asset is typically identified if it is explicitly specified in a contract or implicitly specified at the time the asset is made available for use by the customer. However, if the supplier has substantive rights to substitute the asset throughout the period of use, the asset is not considered "identified."	This requirement is similar to the guidance in ASC 840-10-15 (formerly EITF Issue 01-8). An entity does not need to be able to identify the particular asset (e.g., by serial number) but must instead determine whether an identified asset is needed to fulfil the contract. An entity will need to use significant judgment in distinguishing between a lease and a capacity contract. The standard clarifies that a capacity portion of an asset is an identified asset if it is physically distinct (e.g., a floor of a building). On the other hand, a capacity portion of a larger asset that is not physically distinct (e.g., a percentage of a pipeline) is not an identified asset unless the portion represents substantially all of the asset's capacity.
Substantive substitution rights	A supplier's right to substitute an asset is substantive only if both of the following conditions apply: (1) the supplier has the practical ability to substitute alternative assets throughout the period of use and (2) the supplier would benefit economically from the exercise of its right to substitute the asset.	The FASB established this requirement because it reasoned that if a supplier has a substantive right to substitute the asset throughout the period of use, then the supplier — not the customer — controls the use of the asset.
Right to obtain economic benefits from use of the identified asset	To control the use of an identified asset, a customer must have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use.	The economic benefits from use of an asset include the primary output and by-products of the asset as well as other economic benefits from using the asset that could be realized from a commercial transaction with a third party.
Right to direct the use of the identified asset	A customer has the right to direct the use of an identified asset throughout the period of use if either (1) the customer has the right to direct how and for what purpose the asset is used throughout the period of use or (2) the relevant decisions about how and for what purpose the asset is used are predetermined and (a) the customer has the right to operate (or direct others to operate) the asset throughout the period of use and the supplier does not have the right to change the operating instructions or (b) the customer designed the asset in a way that predetermines how and for what purpose the asset will be used.	The relevant rights to be considered are those that affect the economic benefits derived from the use of the asset. Some examples of customers' rights that meet the definition are (1) rights to change the type of output produced by the asset, (2) rights to change when the output is produced, and (3) rights to change where the output is produced. On the other hand, rights that are limited to maintaining or operating the asset do not grant a right to direct how and for what purpose the asset is used.

In many cases, the assessment of whether a contract is or contains a lease will be straightforward. However, the evaluation will be more complicated when an arrangement involves both a service component and a leasing component or when both the customer and the supplier make decisions about the use of the underlying asset.

Thinking It Through

Historically, entities may have accounted for operating leases under ASC 840 in a manner similar to how they accounted for service contracts. However, under ASC 842, since most leases will be recognized on the balance sheet, the financial statement implications of erroneously not identifying a lease in, for example, a service contract are far more significant.

Further, under ASC 840, "placed equipment" by a medical device entity may not have represented an identified asset if the medical device entity could demonstrate that it had substitution rights, which could result in a conclusion that the placed equipment did not represent a lease. Under ASC 842, however, for the medical device entity to conclude that it has a substantive substitution right, it would have to demonstrate not only that it has the practical ability to substitute the placed equipment but also that it would benefit economically from the exercise of its right to substitute the asset. As a result, it is possible that more arrangements that allow for placed equipment will represent an identified asset that an entity would need to further assess to determine whether the asset represents a lease.

Example 1 — Contract Manufacturing Arrangement

Entity A, a pharmaceutical company, enters into an arrangement with a contract manufacturer, Entity B, to purchase a particular type, quality, and quantity of active pharmaceutical ingredient (API) needed to manufacture drug compound X. Entity B has only one factory that can meet the requirements of the contract with A, and B is prohibited from supplying A through another factory or third-party suppliers. Entity A has not contracted substantially all of the factory's capacity.

The required quantities of API are established in the contract at inception. Entity B makes all of the decisions about the factory's operations, including when to run the factory to satisfy the required quantities and which customer orders to fulfill.

The contract does not contain a lease. The factory is an identified asset because it is implicit that B can fulfill the contract only through the use of the specific factory. However, A does not have the "right to obtain substantially all of the economic benefits from use of [an identified] asset" since the capacity A has contracted for does not represent substantially all of the factory's capacity. In addition, A does not hold the "right to direct the use of that asset." While A may specify quantities of product, B has the right to direct the factory's use because it can determine when to run the factory and which customer contracts to fulfill. As a result, A does not meet the ASU's criterion of directing "how and for what purpose" the factory is being used, and the arrangement is not a lease.

Example 2 — Placement of Medical Device With Sale of Consumables

Entity C is a medical device manufacturer that supplies diagnostic kits to customers. The kits can be used only on instruments manufactured by C. Entity C provides its customers with the right to use its instruments at no separate cost to the customer in exchange for a multiyear agreement to purchase annual minimum quantities of diagnostic kits. The term of the agreement generally corresponds with the expected useful life of the instruments. Entity C retains title to the instruments and is permitted to substitute them under the terms of the contract, although historically these instruments have been substituted only when they malfunction given that C does not benefit economically from the exercise of its right to substitute the asset.

The multiyear agreement to purchase diagnostic kits contains an embedded lease for the instrument system. The instrument system is an identified asset because it is implicit that C can fulfill the contract only through the customers' use of the specific instruments. Although C has the right to substitute the instruments, the substitution right is not substantive because of the lack of economic benefit from doing so. In addition, customers have the right to control the instruments' use because they have the right to obtain substantially all of the economic benefits from the use of the instruments during the multiyear term of the contract, which corresponds to the useful life of the instruments. Further, customers can make decisions about how and when the instruments are used when the customers perform diagnostic testing procedures.

Lessee Accounting

The development of the new leases standard began as a convergence project of the FASB and IASB. Although the boards conducted joint deliberations, there are several notable differences between the boards' respective leases standards. One of the more significant differences is related to the classification of a lease. While the boards agreed that a lessee should record an ROU asset and a corresponding lease liability when the lease commences, they supported different approaches for the lessee's subsequent accounting. The FASB chose a dual-model approach under which a lessee classifies a lease by using criteria similar to the lease classification criteria currently in IAS 17. Under ASC 842, a lease would be classified as a finance lease (for a lessee) or a sales-type lease (for a lessor) if any of the following criteria are met at the commencement of the lease:

- "The lease transfers ownership of the underlying asset to the lessee by the end of the lease term."
- "The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise."
- "The lease term is for the major part of the remaining economic life of the underlying asset."
- "The present value of the sum of the lease payments and any residual value guaranteed by the lessee . . . equals or exceeds substantially all of the fair value of the underlying asset."
- "The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term."

For leases that are considered finance leases (many current capital leases are expected to qualify as finance leases), the lessee would account for the lease in a manner similar to a financed purchase arrangement. That is, the lessee would recognize interest expense and amortization of the ROU asset, which typically would result in a greater expense during the early years of the lease. For leases that are considered operating leases (many current operating leases are expected to continue to qualify as operating leases), the lessee would recognize a straight-line total lease expense. For both types of leases, the lessee would recognize an ROU asset for its interest in the underlying asset and a corresponding lease liability.

Thinking It Through

While many aspects of the lease classification criteria under ASC 842 are consistent with existing guidance, bright-line tests (i.e., whether the lease term is for 75 percent or more of the economic life of the asset or whether the present value of the lease payments (including any guaranteed residual value) is at least 90 percent of the fair value of the leased asset) are noticeably absent. However, ASC 842-10-55-2 states that these tests are "one reasonable approach to assessing the criteria."

Lessor Accounting

After proposing multiple different amendments to lessor accounting, the FASB ultimately decided to make only minor modifications to the current lessor model. The most significant changes align the profit recognition requirements under the lessor model with those under the FASB's new revenue standard and amend the lease classification criteria to be consistent with those for a lessee. Accordingly, the leases standard requires a lessor to use the classification criteria discussed above to classify a lease, at its commencement, as a sales-type lease, a direct financing lease, or an operating lease.

Effective Date and Transition

ASU 2016-02 is effective for public business entities for fiscal years beginning after December 15, 2018 (i.e., calendar periods beginning on January 1, 2019), including interim periods therein. For all other entities, the standard is effective for annual periods beginning after December 15, 2019 (i.e., calendar periods beginning on January 1, 2020), and interim periods thereafter. Early adoption is permitted. Entities are required to use a modified retrospective transition method of adoption, and the FASB has proposed several forms of transition relief that should significantly ease the burden of adoption.

For discussion of additional implementation considerations, see Deloitte's March 1, 2016, *Heads Up*.

Thinking It Through

Covenant Considerations

Given the requirement to bring most leases onto the balance sheet, many companies, including those in the life sciences industry, will reflect additional liabilities on their balance sheets after adopting the ASU. An entity's determination of whether the increased leverage will negatively affect any key metrics or potentially cause debt covenant violations is a critical aspect of its planning for the new standard's implementation. This determination may depend, in part, on how various debt agreements define and limit indebtedness as well as on whether the debt agreements use "frozen GAAP" covenants (i.e., covenants that are based on GAAP at the time the debt was issued). The ASU requires presentation of operating lease liabilities outside traditional debt, which may provide relief. Regardless, we believe that it will be critical for all life sciences entities to determine the ASU's potential effects on debt covenants and begin discussions with lenders early if they believe that violations are likely to occur as a result of adopting the ASU.

Operational Considerations

To implement the lessee accounting requirements, life sciences entities will have to collect and maintain data from all individual leases they are party to, including information related to real estate leases and equipment leases (e.g., manufacturing equipment, laboratory equipment). This data-gathering exercise may result in entity-wide operational challenges, particularly for entities with a global footprint. The new requirements could affect external as well as internal reporting information, including financial budgets and forecasts.

Government Assistance

On the Horizon — Proposed ASU on Disclosures by Business Entities About Government Assistance

In November 2015, the FASB issued a proposed ASU on disclosures about government assistance received by entities. As explained in the proposed ASU, the proposal's objective is "to increase transparency about government assistance arrangements including (1) the types of arrangements, (2) the accounting for government assistance, and (3) their effect on an entity's financial statements."

Comments were due by February 10, 2016, and the Board received approximately 40 comment letters.

Background and Key Provisions of the Proposed ASU

There is no explicit guidance under current U.S. GAAP on the recognition, measurement, or disclosure of government assistance. As a result, there is diversity in practice related to how business entities account for, and disclose information about, government assistance arrangements.

The proposed ASU would apply to all entities, other than not-for-profit entities within the scope of ASC 958, that enter into a "legally enforceable agreement with a government to receive value." However, the proposed ASU states that it "would not apply to transactions in which the government is either (1) legally required to provide a nondiscretionary level of assistance to an entity simply because the entity meets applicable eligibility requirements that are broadly available without specific agreement between the entity and the government or (2) solely a customer" of the entity.

Under the proposal, entities would be required to disclose in their annual financial statements information about the nature of the assistance, related accounting policies, and the effect on the financial statements, including:

- A "general description of the significant categories (for example, grants, loans, or tax incentives) and the form in which the assistance has been received (for example, as a reduction of an expense, a refund of taxes paid, free resources, or a cash grant)."
- "The accounting policy used to account for government assistance (for example, whether assistance is recognized immediately into income or recognized over the life of a related asset)."
- The financial statement line items "affected by government assistance (for example, whether the assistance has been deducted from the carrying value of an asset or presented as a performance obligation liability) and the amounts applicable to each line item."
- "Unless impracticable, the amount of government assistance received but not recognized directly in the financial statements."

The proposed ASU would also require entities to disclose the significant terms and conditions of the agreement, including its duration or period, the tax rate or interest rate provided in the agreement, the commitments made by each party, the provisions (if any) for recapturing government assistance, and any other contingencies.

Redeliberations and Next Steps

After the comment period closed, the FASB began redeliberations on the basis of stakeholder feedback. The Board staff plans to focus on scope, disclosure requirements for amounts not recognized directly in the financial statements, restrictions, transition and effective date, private-company considerations, and overall costs and benefits of the disclosures.

At the FASB's June 8, 2016, meeting, the Board reached several tentative decisions. The Board staff indicated that several stakeholders provided feedback in which they asked the Board to consider including recognition, measurement, and presentation guidance within the scope of the project rather than limiting it to disclosures; however, the Board reaffirmed that the project would address disclosures only. In addition, the Board reaffirmed that legally enforceable agreements with a government to receive cash, nonmonetary assets, or benefits that reduce or eliminate an entity's expenditures would be included within the project's scope. The Board directed the staff to further analyze the types of nonmonetary assets that should be included within the project's scope. The Board also tentatively decided to exclude government assistance provided to an entity in the form of benefits that are available for purposes of determining taxable income or that are determined or limited on the basis of income tax liability, in accordance with ASC 740. The Board also decided not to require the proposed disclosure about the amount of government assistance received but not recognized directly in the financial statements. Lastly, the Board decided to clarify the proposed requirements to allow an entity to omit disclosures if it is legally prohibited from providing such disclosures; however, an entity would be required to disclose a general description of the information omitted as well as a reference to the specific source of legal prohibition.

The Board will continue its redeliberations at a future meeting.

Thinking It Through

Entities in the life sciences industry have historically benefited domestically and internationally from a wide variety of government assistance programs. Although the tentative decisions the FASB reached at its June 2016 meeting limited the scope of the required disclosures, the proposed ASU, when finalized, may still require significant effort to track a vast array of arrangements and provide the appropriate level of disclosure. Life sciences entities should continue to monitor the progress of this standard and consider whether systems or other changes will be needed to gather the required information.

Going Concern

New Accounting Standards Update

In August 2014, the FASB issued ASU 2014-15, which provides guidance on how to determine when and how to disclose going-concern uncertainties in the financial statements. The new standard requires management to perform interim and annual assessments of an entity's ability to continue as a going concern within one year of the date the financial statements are issued. An entity must provide certain disclosures if "conditions or events raise substantial doubt about [the] entity's ability to continue as a going concern." The ASU applies to all entities and is effective for annual periods ending after December 15, 2016, and interim periods thereafter, with early adoption permitted.

Under U.S. GAAP, an entity's financial reports reflect its assumption that it will continue as a going concern until liquidation is imminent. However, before liquidation is deemed imminent, an entity may have uncertainties about its ability to continue as a going concern. Because there are no specific requirements under current U.S. GAAP related to disclosing such uncertainties, auditors have used applicable auditing standards to assess the nature, timing, and extent of an entity's disclosures, which has resulted in diversity in practice. The ASU is intended to alleviate that diversity.

The ASU extends the responsibility for performing the going-concern assessment to management and contains guidance on (1) how to perform a going-concern assessment and (2) when going-concern disclosures would be required under U.S. GAAP. The FASB believes that requiring management to perform the assessment will enhance the timeliness, clarity, and consistency of related disclosures and improve convergence with IFRSs (which emphasize management's responsibility for performing the going-concern assessment). However, the time horizon for the assessment (look-forward period) and the disclosure thresholds under U.S. GAAP and IFRSs will continue to differ.

For additional information about the ASU, see Deloitte's August 28, 2014, *Heads Up*.

Disclosure Threshold

Under the ASU, an entity would be required to disclose information about its potential inability to continue as a going concern when "substantial doubt" about its ability to continue as a going concern exists. In applying this disclosure threshold, entities would be required to evaluate "relevant conditions and events that are known and reasonably knowable at the date that the financial statements are issued."

Time Horizon

In each reporting period (including interim periods), an entity would be required to assess its ability to meet its obligations as they become due for one year **after the date the financial statements are issued or available to be issued**.[11] This is in contrast to the current auditing literature, which requires auditors to evaluate whether there is "substantial doubt about [an] entity's ability to continue as a going concern for a reasonable period of time, **not to exceed one year** beyond the date of the financial statements being audited [i.e., the balance sheet date]" (emphasis added).[12]

Thinking It Through

Implications of the change in the look-forward period for entities applying the standard include the need to change forecasting to reflect the period as modified, which may be a period that is not typically assessed, and a potential need to obtain debt covenant waivers for an additional period. The change in the look-forward period is expected to have a greater impact on private entities, which typically issue financial statements later than public entities and may not prepare rolling forecasts. Users of private entities' financial statements will often benefit from having a significantly longer look-forward period over which the going-concern presumption is assessed.

[11] An entity that is neither an SEC filer nor a conduit bond obligor for debt securities that are traded in a public market would use the date the financial statements are available to be issued (in a manner consistent with the ASU's definition of "issued").

[12] Paragraph .02 of PCAOB AS 2415, *Consideration of an Entity's Ability to Continue as a Going Concern*.

Disclosure Content

The disclosure requirements in the ASU closely align with those under current auditing literature. If an entity triggers the substantial-doubt threshold, its footnote disclosures must contain the following information, as applicable:

Substantial Doubt Is Raised but Is Alleviated by Management's Plans	Substantial Doubt Is Raised and Is Not Alleviated
• Principal conditions or events. • Management's evaluation. • Management's plans.	• Principal conditions or events. • Management's evaluation. • Management's plans. • Statement that there is "substantial doubt about the entity's ability to continue as a going concern."

Inventory

New Accounting Standards Update — Simplifying the Measurement of Inventory

Background and Key Provisions

In July 2015, the FASB issued ASU 2015-11, which requires entities to measure most inventory "at the lower of cost and net realizable value." The ASU is part of the FASB's simplification initiative and is intended to streamline the current requirements, under which entities measure inventory at the lower of cost or market (with market defined as replacement cost as long as replacement cost is not above net realizable value or below net realizable value less a normal profit margin). The new guidance states that inventory should be "measured at the lower of cost and net realizable value," thereby eliminating the need to determine replacement cost and evaluate whether it is above or below the relevant net realizable value measure. The ASU defines net realizable value as the "estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation." The ASU does not apply to inventory measured under either the last-in, first-out (LIFO) method or the retail inventory method.

For more information about the ASU, see Deloitte's July 24, 2015, *Heads Up*.

Effective Date and Transition

ASU 2015-11 is effective prospectively for public business entities for annual periods beginning after December 15, 2016, and interim periods therein. For all other entities, the ASU is effective prospectively for annual periods beginning after December 15, 2016, and interim periods within annual periods beginning after December 15, 2017. Early application is permitted. Upon transition, entities must disclose the nature of and reason for the accounting change.

Thinking It Through

In addition to reducing the complexity of applying the current requirements, the ASU also more closely aligns U.S. GAAP with IFRSs (which require inventory to be measured at the lower of cost or net realizable value). The closer alignment may simplify reporting requirements for multinational life sciences entities.

On the Horizon — Proposed ASU on Inventory Disclosures

Background

In January 2017, the FASB issued a proposed ASU that would modify or eliminate certain disclosure requirements related to inventory as well as establish new requirements. Comments on the proposed ASU are due by March 13, 2017.

The proposal is part of the FASB's disclosure framework project, which, as explained on the FASB's related Project Update page, is intended to help reporting entities improve the effectiveness of financial statement disclosures "by clearly communicating the information that is most important to users of each entity's financial statements."

In March 2014, the FASB issued a proposed concepts statement on its conceptual framework for financial reporting. The Board later decided to test the guidance in that proposal by considering the effectiveness of financial statement disclosures related to inventory, income taxes, fair value measurements, and defined benefit pensions and other postretirement plans. The proposed ASU is the result of the application of the guidance in the proposed concepts statement to inventory.

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

Thinking It Through

Also as part of its disclosure framework project, the FASB proposed guidance in July 2016, January 2016, and December 2015 that would amend disclosure requirements related to income taxes, defined benefit pensions and other postretirement plans, and fair value measurement. See Deloitte's July 29, 2016; January 28, 2016; and December 8, 2015, *Heads Up* newsletters for more information.

Objective of Inventory Disclosures

The proposed ASU notes that the objective of the inventory disclosures in ASC 330 is to give financial statement users information that would help them assess how future cash flows may be affected by:

- Different types of inventory.
- The use of differing methods to measure inventory balances.
- Transactions, events, and circumstances that are outside the entity's normal course of business.

Scope, Transition, and Effective Date

The proposed ASU would affect only inventory disclosures under ASC 330 for all entities (i.e., the proposal would not affect disclosures related to cost of goods sold). The guidance would be applied prospectively, and the Board will determine an effective date and whether to permit early adoption after it considers feedback from stakeholders on the proposal.

Thinking It Through

On January 12, 2017, the Board announced that it plans to hold a public roundtable meeting on March 17, 2017, with interested stakeholders to discuss the proposed amendments as well as the overall disclosure framework project and related proposals.

Key Provisions of the Proposed ASU

Materiality

The proposed ASU notes that entities would not be required to provide inventory disclosures if such disclosures are immaterial. For guidance on making that determination, the proposed ASU refers entities to ASC 235-10-50-7 through 50-9, which would be added by the FASB's proposed ASU on assessing whether disclosures are material. For additional information about the proposed ASU on materiality, see Deloitte's September 28, 2015, *Heads Up*.

Disclosure of Changes in Inventory

The Board considered several approaches for disclosing changes in inventory, including (1) a detailed rollforward of the inventory balance in tabular format; (2) disclosure of significant changes in the balance that are not attributable to the purchase, manufacture, and sale of inventory in the normal course of business; and (3) a hybrid approach that would combine both methods depending on the significance of an entity's inventory. Because the Board believes that the rollforward and hybrid approaches would most likely be too costly and difficult for entities to implement, the proposed ASU would require all entities to disclose significant changes in inventory resulting from transactions or events other than the purchase, manufacture, or sale of inventory in the normal course of business.

Examples of such changes include:

- "Atypical losses from the subsequent measurement of inventory or shrinkage, spoilage, or damage and a description of the facts and circumstances leading to those losses."
- "Balance sheet reclassifications."
- "Inventory obtained through a business combination" or "disposed of through a divestiture."
- "Unrealized gains and losses for inventories recorded above cost or at selling prices."

The proposed ASU also includes an example of the disclosure that would be required by ASC 330-10-55-14.

Composition of Inventory

In addition to total inventory, the proposed ASU would require all entities to disclose the inventory's major components. That is, entities would disclose the composition of inventory such as raw materials, work in process, finished goods, and supplies. Under the proposed ASU's amendments, an entity would also be required to (1) provide "a qualitative description of the types of costs it capitalizes into inventory" and (2) the bases it uses to measure its inventory as well as the amount recorded under each basis.

Further, an entity that reports inventory on a LIFO basis would be excluded from the requirement if it were to conclude that it is impracticable to allocate the LIFO reserve to inventory components. That is, an entity would be permitted to disclose inventory components under another cost basis — such as first in, first out (FIFO) — and reconcile such components to the ending aggregate LIFO inventory balance with the aggregate LIFO reserve.

Inventory Reported Under the LIFO Cost Flow Assumption

Besides adding the practicability exception discussed above, the proposed ASU would codify LIFO-related disclosures that SEC registrants are currently required to provide. In addition, paragraph BC49 of the proposal notes that other entities include similar disclosures in their financial statements on the basis of recommendations in a 1984 AICPA Issues Paper.[13] Consequently, the Board proposes to add ASC 330-10-50-13, which would require all entities that apply the LIFO method to disclose (1) the excess of replacement cost or current cost over the reported inventory amount and (2) the effect on net income of the liquidation of a portion of an entity's LIFO inventory.

Thinking It Through

In the proposed ASU's Basis for Conclusions, the FASB observed that the cost to implement the guidance should be minimal because many entities reporting inventory under LIFO are likely to be providing the proposed disclosures already.

Other Inventory Disclosures

For entities that use standard costs to measure inventory, the proposed ASU would update ASC 330-10-30-12 to eliminate the requirement to describe the relationship between standard costs and costs computed under another recognizable inventory measurement basis. This disclosure was seen as redundant because as long as standard costs are updated at reasonable intervals, the revised standard costs should approximate another acceptable inventory measurement basis, such as FIFO or average costs.

Segment Disclosures for Public Business Entities

For public business entities, the proposed ASU would amend ASC 280-10-50-25 to add inventory disclosures by reportable segment and a related example in ASC 280-10-55-53 and 55-54. Specifically, if inventory balances are included in (1) the determination of segment assets that the chief operating decision maker (CODM) reviews or (2) information that the CODM regularly reviews (even if such balances are not included in the determination of segment assets), public business entities would be required to disclose the following by reportable segment:

- Total inventory.
- A disaggregation of inventory by major component (such as raw materials, work in process, finished goods, and supplies).

In addition, inventory or a major component of inventory that has not been allocated to a reportable segment would be classified as unallocated.

A public business entity would also be required to provide similar disclosures in its interim financial statements if the criteria in ASC 280-10-50-25 are met (i.e., inventory balances are included in the determination of segment assets, or the CODM reviews information that includes inventory balances).

Thinking It Through

Only the information reviewed by the CODM is required to be disclosed on an interim basis. As illustrated in Example 4 (see ASC 280-10-55-54), if the CODM reviews inventory by segment in total but does not regularly review information about inventory for each component by segment, an entity would be required to disclose only total inventory by segment in its interim financial statements.

[13] AICPA Issues Paper, *Identification and Discussion of Certain Financial Accounting and Reporting Issues Concerning LIFO Inventories.*

Common-Control Transactions

As life sciences entities seek to balance their portfolio and potentially prepare for public offerings, they may engage in a variety of common-control transactions. A common-control transaction is a transfer of net assets or an exchange of equity interests between entities under the control of the same parent. Such a transaction is similar to a business combination for the entity that receives the net assets or equity interests; however, the transaction does not meet the definition of a business combination because there is no change in control over the net assets by the parent. Therefore, the accounting and reporting for a transaction between entities under common control is outside the scope of the business combinations guidance in ASC 805-10, ASC 805-20, and ASC 805-30 and is addressed in the "Transactions Between Entities Under Common Control" subsections of ASC 805-50. Since there is no change in control over the net assets from the parent's perspective, there is no change in basis in the net assets. ASC 805-50 requires that the receiving entity recognize the net assets received at their historical carrying amounts, as reflected in the parent's financial statements.

For more information and interpretive guidance on common-control transactions, see Deloitte's *A Roadmap to Common-Control Transactions*.

Discontinued-Operations Reporting

While many life sciences entities have sought ways to expand their pipeline of products in development or to acquire additional commercial products, others have explored how to generate additional returns on assets that are no longer a strategic focus. When an entity sells a business or product line, questions often arise about whether the divested group of assets should be accounted for as a discontinued operation.

In April 2014, the FASB issued ASU 2014-08, which amends the definition of a discontinued operation in ASC 205-20 and requires entities to provide additional disclosures about disposal transactions that do not meet the discontinued-operations criteria. The revised guidance changes how entities identify and disclose information about disposal transactions under U.S. GAAP. The ASU elevates the threshold for a disposal transaction to qualify as a discontinued operation (since too many disposal transactions were qualifying as discontinued operations under existing guidance).

The ASU became effective prospectively for all disposals (except disposals classified as held for sale before the adoption date) of components initially classified as held for sale in periods beginning on or after December 15, 2014.

For more information and interpretations on applying the new guidance, see Deloitte's *A Roadmap to Reporting Discontinued Operations*.

Carve-Outs

Carve-out financial statements are commonly prepared for divestments of businesses in transactions involving life sciences entities. A carve-out occurs when a parent company segregates a portion of its operations and prepares a distinct set of financial information in preparation for a sale, spin-off, or divestiture of the "carve-out entity." The carve-out entity may consist of all or part of an individual subsidiary, multiple subsidiaries, or even an individual segment or multiple segments. In some cases, one or more portions of a previously consolidated parent company's subsidiaries may create the newly defined carve-out operations.

"Carve-out financial statements" is a generic term used to describe separate financial statements that are derived from the financial statements of a larger parent company. The form of those financial statements may vary, however, depending on the situation. For example, if the acquisition is small, a strategic buyer of a carve-out entity may be satisfied with an unaudited balance sheet and income statement for the most recent fiscal year. Another public buyer, however, may require a full set of SEC-compliant audited financial statements, including footnotes, for the three most recent fiscal years, while yet a third buyer might ask that the periods be audited but be completely unconcerned with SEC reporting considerations. Accordingly, assessing the potential audience is critical to understanding the basis of presentation and the number of periods needed. Such an assessment can be particularly difficult when the carve-out financial statements are being prepared before the buyer or potential buyers are identified.

For more information and interpretive guidance on preparing carve-out financial statements, see Deloitte's *A Roadmap to Accounting and Financial Reporting for Carve-Out Transactions*.

Appendix A — Glossary 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*

FASB Accounting Standards Updates

ASU 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*

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

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

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

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

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

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

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

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

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

ASU 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*

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

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

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

ASU 2016-07, *Investments — Equity Method and Joint Ventures (Topic 323): Simplifying the Transition to the Equity Method of Accounting*

ASU 2016-03, *Intangibles — Goodwill and Other (Topic 350), Business Combinations (Topic 805), Consolidation (Topic 810), Derivatives and Hedging (Topic 815): Effective Date and Transition Guidance* — a consensus of the Private Company Council

ASU 2016-02, *Leases (Topic 842)*

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

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

ASU 2015-16, *Business Combinations (Topic 805): Simplifying the Accounting for Measurement-Period Adjustments*

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

ASU 2015-11, *Inventory (Topic 330): Simplifying the Measurement of Inventory*

ASU 2015-02, *Consolidation (Topic 810): Amendments to the Consolidation Analysis*

ASU 2014-18, *Business Combinations (Topic 805): Accounting for Identifiable Intangible Assets in a Business Combination* — a consensus of the Private Company Council

ASU 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

ASU 2014-15, *Presentation of Financial Statements — Going Concern (Subtopic 205-40): Disclosure of Uncertainties About an Entity's Ability to Continue as a Going Concern*

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ASC 235, *Notes to Financial Statements*

ASC 250, *Accounting Changes and Error Corrections*

ASC 250-10, *Accounting Changes and Error Corrections: Overall*

ASC 280-10, *Segment Reporting: Overall*

ASC 320, *Investments — Debt and Equity Securities*

ASC 321-10, *Investments — Equity Securities: Overall*

ASC 323-10, *Investments — Equity Method and Joint Ventures: Overall*

ASC 325-10, *Investments — Other: Overall*

ASC 325-40, *Investments — Other: Beneficial Interests in Securitized Financial Assets*

ASC 326-20, *Financial Instruments — Credit Losses: Measured at Amortized Cost*

ASC 326-30, *Financial Instruments — Credit Losses: Available-for-Sale Debt Securities*

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ASC 330-10, *Inventory: Overall*

ASC 350, *Intangibles — Goodwill and Other*

ASC 350-30, *Intangibles — Goodwill and Other: General Intangibles Other Than Goodwill*

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ASC 605-28, *Revenue Recognition: Milestone Method*

ASC 605-45, *Revenue Recognition: Principal Agent Considerations*

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ASC 730-10, *Research and Development: Overall*

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ASC 740-10, *Income Taxes: Overall*

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ASC 808-10, *Collaborative Arrangements: Overall*

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IFRS 11, *Joint Arrangements*

IFRS 3, *Business Combinations*

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

IAS 17, *Leases*

Appendix B — Abbreviations

Abbreviation	Description
AFS	available for sale
AICPA	American Institute of Certified Public Accountants
ANDA	abbreviated new drug application
API	active pharmaceutical ingredient
APIC	additional paid-in capital
ASC	FASB Accounting Standards Codification
ASU	FASB Accounting Standards Update
BOLI	bank-owned life insurance
C&DI	SEC Compliance and Disclosure Interpretation
CECL	current expected credit loss
CODM	chief operating decision maker
COLI	corporate-owned life insurance
CRO	contract research organization
DCP	disclosure control procedure
DTA	deferred tax asset
DTL	deferred tax liability
EBITDA	earnings before interest, taxes, depreciation, and amortization
EITF	Emerging Issues Task Force
EPS	earnings per share
EU	European Union
FAQ	frequently asked question
FASB	Financial Accounting Standards Board
FDA	Food and Drug Administration
FIFO	first in, first out

Abbreviation	Description
FIN	FASB Interpretation Number (superseded)
FOB	free on board
GAAP	generally accepted accounting principles
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standard
IIR	investigator-initiated research
IPR&D	in-process research and development
LIFO	last in, first out
LLC	limited liability company
LP	limited partnership
M&A	merger and acquisition
MD&A	Management's Discussion and Analysis
MDET	medical device excise tax
MSL	medical science liaison
NDA	new drug application
OCI	other comprehensive income
OEM	original equipment manufacturer
PCAOB	Public Company Accounting Oversight Board
PCD asset	purchased financial asset with credit deterioration
PMA	premarket approval
PTRS	probability of technical and regulatory success
Q&A	question and answer

Abbreviation	Description
R&D	research and development
REMS	risk evaluation and mitigation strategy
ROU	right of use
SAB	SEC Staff Accounting Bulletin
SAC	subjective acceleration clause
SEC	Securities and Exchange Commission
TRG	transition resource group
VIE	variable interest entity
WAC	wholesaler acquisition cost

Contacts

If you have any questions about this publication, please contact the following Deloitte industry specialists:

Chris Cooper
U.S. Audit Leader — Life Sciences and Health Care
Deloitte & Touche LLP
+1 973 602 6623
ccooper@deloitte.com

Jeff Ellis
Life Sciences Industry Professional Practice Director
Deloitte & Touche LLP
+1 412 338 7204
jeellis@deloitte.com

Dennis Howell
Professional Practice Group and Life Sciences
Deputy Industry Professional Practice Director
Deloitte & Touche LLP
+1 203 761 3478
dhowell@deloitte.com