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# Investment Management

## Accounting and Financial Reporting Update

December 1, 2017

# Contents

# Foreword

December 1, 2017

To our clients and colleagues in the investment management sector:

We are pleased to issue the 2017 edition of Deloitte's *Investment Management — Accounting and Financial Reporting Update*. The topics discussed in this publication were selected because they may be of particular interest to investment management entities.

Some of the notable standard-setting developments in 2017 were (1) the issuance of targeted improvements to hedge accounting and (2) continued work by the various standard setters on issues related to implementation of the new revenue recognition and leasing standards.

In this publication, the Updates to Guidance section highlights changes to accounting and reporting standards that investment management entities need to start preparing for now. The 2017 edition also includes the following appendixes: (1) Appendix A, which lists selected ASUs that became effective for calendar year 2017; (2) Appendix B, which summarizes the current status of, and next steps for, selected active standard-setting projects of the FASB; (3) Appendix C, which lists the titles of standards and other literature referred to in this publication; and (4) Appendix D, which defines the abbreviations we used.

The 2017 accounting and financial reporting updates for the banking and securities, insurance, and real estate sectors are available (or will be available soon) on US GAAP Plus and the Deloitte Accounting Research Tool.

As always, we encourage you to contact your local Deloitte office for additional information and assistance.

Sincerely,

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# Introduction

The year 2017 has seen continued economic improvement, as shown by increasing consumer confidence, strong market performance, and the Federal Reserve's elevation of the federal funds rate. However, continued volatility in Europe and the volatility of global markets as a result of the new U.S. administration are creating uncertainty.

## Business Outlook

Technology in the investment management industry is driving disruption, as is the belief that there are tremendous opportunities, and associated risks, within the industry. Opportunities in technology may bring down the cost of active portfolio management for firms that embrace it, and blockchain is a potentially game-changing technology and a possible threat to established players. But while opportunities exist, barriers such as the cost of implementation, ever-changing technology, and competition remain.

The industry faces increased regulatory compliance requirements as a result of Investment Company Report Modernization and Liquidity Risk Management Program Rules. Consequently, investment managers should expect greater compliance costs as well as pressure to produce higher returns for lower management fees. To retain existing investors and attract new prospects, investment managers will need to differentiate themselves.

## Regulatory Reform

### Investment Company Report Modernization

On October 13, 2016, the SEC finalized its Investment Company Report Modernization rules, making sweeping changes to registered investment company reporting. The new and amended rules are intended to keep up with changes in the industry and technology as well as to provide more timely transparency to the SEC and investors. The new rules will create forms such as N-PORT and N-CEN, replace existing forms such as N-Q and N-SAR, and considerably reduce the filing requirements for other forms. In addition to the new forms, the amendments to Regulation S-X, which became effective in 2017, enhance and standardize derivatives disclosures in financial statements to allow for more comparability among funds. Forms N-PORT and N-CEN, which will become effective in 2018, will significantly affect the industry and should be reviewed by investment companies and investment advisers.

### Investment Company Liquidity Risk Management

The liquidity risk management rules are intended to reduce the risk that registered open-end management investment companies, including open-end exchange-traded funds (ETFs), will not be able to meet shareholder redemptions or mitigate potential ownership dilution of the residual shareholders. Under the new rules, which will become effective in 2018, mutual funds and ETFs will be required to establish programs under which the assessment, management, and periodic review of a fund's liquidity risk would be performed and the oversight of boards would be enhanced.

## Core Principles for Regulating the U.S. Financial System

In October 2017, the U.S. Department of the Treasury issued *A Financial System That Creates Economic Opportunities — Asset Management and Insurance Industries*, a report on a presidential executive order. The report outlines recommendations for Congress and financial service regulators, supporting an approach based on principles rather than prescriptive rules. The report's recommendations include:

- Postponing the December 2018 implementation of the SEC's Liquidity Risk Management Rule 22e-4 bucketing requirement.
- Having the SEC consider requiring funds to have a derivatives risk management program.
- A proposal that the SEC examine derivatives data based on the new filing requirements.
- Creating a "plain-vanilla" ETF rule to allow easier entrance into the market.
- Reducing the burden of the Volcker Rule.[1]

[1] Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

# Updates to Guidance

# Revenue Recognition

## Background

In May 2014, the FASB and IASB issued their final standard on revenue recognition. The standard, issued as ASU 2014-09 by the FASB and as IFRS 15 by the IASB, outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance (e.g., certain sections of ASC 946-605).

In response to stakeholder concerns related to the application of the requirements in ASU 2014-09, the FASB in 2016 issued the following five ASUs, which amend the new revenue recognition guidance and rescind certain SEC guidance on revenue:

- ASU 2016-08, *Principal Versus Agent Considerations (Reporting Revenue Gross Versus Net)*.
- ASU 2016-10, *Identifying Performance Obligations and Licensing*.
- ASU 2016-11, *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 2016-12, *Narrow-Scope Improvements and Practical Expedients*.
- ASU 2016-20, *Technical Corrections and Improvements to Topic 606,* Revenue From Contracts With Customers.

For additional information about ASU 2014-09 and the subsequent amendments that are codified in ASC 606, see Deloitte's *A Roadmap to Applying the New Revenue Recognition Standard*.

Regarding the application of the new revenue standard by public entities, the SEC staff has been reminding registrants about best practices to follow in the periods leading up to the adoption of the new standard. The staff's comments reiterate themes it has addressed over the past year that have focused on disclosures related to implementation activities. In September 2016, the SEC staff made an announcement regarding SAB Topic 11.M, in which it stated that when a registrant is unable to reasonably estimate the impact of adopting ASU 2014-09, ASU 2016-02 (the new leasing standard), or ASU 2016-13 (the new credit losses standard), the registrant should consider providing additional qualitative disclosures about the significance of the impact on its financial statements. The SEC staff would expect such disclosures to include a description of:

- The effect of any accounting policies that the registrant expects to select upon adopting the ASU(s).
- How such policies may differ from the registrant's current accounting policies.
- The status of the registrant's implementation process and the nature of any significant implementation matters that have not yet been addressed.

The SEC staff has also explained that it would expect a company's disclosures about the impact of adopting new standards to increase as the adoption dates approach. The staff's September 2016 announcement is reflected in ASU 2017-03.

## Connecting the Dots

Aspects of the new revenue recognition guidance that could potentially present implementation challenges for investment managers include the following:

- *Performance-based fees* — ASU 2014-09 provides specific requirements for contracts that include variable consideration (including performance fee arrangements whose consideration fluctuates depending on changes in the underlying assets managed by an investment manager). Specifically, it indicates that the estimated variable consideration is included in the transaction price only to the extent that it is probable that subsequent changes in the estimate would not result in a significant reversal of cumulative revenue recognized to date. This concept is commonly referred to as the "constraint." Since an investment manager's performance-based fees may be affected by the future performance of the underlying assets it manages, it may be difficult to estimate how much of the performance-based fees payable to the entity if recognized is probable of not being reversed until the fees are fixed (no longer contingent on future market performance) or close to being fixed. This could be after the entity has received the performance-based fees.

  Accordingly, for entities that currently apply Method 2 under EITF D-96 (codified in ASC 605-20-S99-1), the timing of revenue recognition for performance-based fees may be delayed by the ASU's constraint on the amount of revenue that may be recognized as of a reporting date. In addition, the ASU could potentially accelerate the recognition of revenue for these fees for entities that currently apply Method 1 under EITF D-96. The ASU provides an example[1] to illustrate how an entity would apply the new revenue recognition requirements to a management arrangement that includes performance-based fees.

- *Costs of managing investment companies* — The determination of whether the investment company or the individual investor in the investment company is the customer is likely to affect the recognition of costs associated with sales commissions and placement fees. That is, if the individual investor is deemed to be the customer, the company would assess whether to capitalize and amortize commissions and placement fees under ASC 340-40-25-1 as costs to obtain a contract. However, if the investment company is deemed to be the customer, such costs would most likely be costs to fulfill a contract,[2] which may not qualify for capitalization since ASC 340-40-25-8(d) explicitly prohibits the capitalization of costs when an entity cannot distinguish whether the costs are related to unsatisfied performance obligations or to satisfied (or partially satisfied) performance obligations.

- *Incentive-based capital allocations* — ASU 2014-09 indicates that financial instruments within the scope of Codification topics other than ASC 606 are outside the scope of the ASU. However, the ASU does not address whether contracts involving incentive-based capital allocations, such as those in the form of carried interests, are (1) revenue contracts for investment management services that are similar to contracts involving other incentive fees and, therefore, are within the scope of the ASU or (2) financial instruments that should be accounted for as equity method investments in accordance with ASC 323-30-S99-1. Accounting for these arrangements will depend on the specific facts and circumstances, and entities are encouraged to consult with their accounting advisers if they believe that these arrangements are outside the scope of the ASU. For further discussion of whether an investment manager could apply ASC 323 to its carried interest arrangements and an overview of relevant discussions at the April 2016 TRG meeting,

[1] ASC 606-10-55-221 through 55-225, *Example 25 — Management Fees Subject to the Constraint*.

[2] ASC 340-40-25-5 addresses costs to fulfill a contract with a customer. Note that this guidance is applicable only if the costs are not addressed by other authoritative literature. For example, costs to launch a new investment vehicle are addressed in ASC 720-15-25-1 and are therefore outside the scope of ASC 340-40.

see Q&A 3-9A and TRG Update — Management Fees of Asset Managers in Deloitte's *A Roadmap to Applying the New Revenue Recognition Standard*.

- *Gross versus net presentation* — Often, an investment manager or its affiliates involve third parties to provide services they have agreed to perform (e.g., distribution services). The investment manager must determine whether it is the principal in the transaction (i.e., whether it has an obligation to provide the specified goods or services itself) or is an agent (i.e., arranges for the other party to provide those goods or services). ASU 2014-09 provides indicators and other implementation guidance to help an entity determine whether it is acting as a principal (with revenue recognized on a gross basis) or as an agent (with revenue recognized on a net basis). While the ASU's indicators for determining whether an entity is acting as a principal or as an agent in an arrangement are similar to the current requirements, its guidance on making this determination differs slightly from that in current U.S. GAAP. The ASU requires an entity to apply an overall principle on the basis of the "control" notion, and it replaces the examples in the current guidance with more limited examples. Investment managers will need to evaluate their arrangements under the new principal-versus-agent guidance to determine whether they need to revise their presentation and should not presume that their conclusions under previous U.S. GAAP will remain unchanged. For example, investment managers may pay close attention to the gross-versus-net guidance when evaluating any unitary fee arrangements, subadvisory relationships, or situations in which an investment fund agrees to reimburse the investment manager for reasonable out-of-pocket expenses incurred as part of performing investment management services. Investment managers may find the nonauthoritative paper of the AICPA Asset Management Revenue Recognition Task Force (in draft form as of the date of this publication) to be helpful when they perform this evaluation.
- *Management fee waivers and customer expense reimbursements* — Under U.S. GAAP, investment managers historically have recorded fee waivers and expense reimbursements as either (1) a reduction of revenue or (2) an expense when the waivers or reimbursements are not refunds or rebates of the amount charged to the fund. Under ASU 2014-09, investment managers may need to apply the contract modification guidance[3] to determine the appropriate accounting for management fee waivers and expense caps. Fee waivers and expense caps will most likely be presented as a reduction of the transaction price since (1) they represent consideration payable to a customer and (2) an investment manager typically does not receive a distinct good or service from a customer in exchange for a fee waiver or expense cap.
- *Distribution fees received* — Under current U.S. GAAP, up-front distribution fees are generally recognized as revenue when received. However, under the new revenue guidance, investment managers would need to determine whether up-front distribution fees are related to the transfer of a separate promised service (a "distinct" performance obligation). If the up-front fees are related to the transfer of a service or services that are separable from other promises in the contact, the entity should recognize an allocated portion of the total consideration as revenue when it transfers the related service or services to the customer. However, if the activities associated with the fees are not related to a separate performance obligation, the entity should recognize the fees as revenue, include them in the transaction price, and allocate them to the performance obligations in the contract. In addition, sales and distribution contracts may entitle the distributor to consideration that is variable (e.g., consideration that is based on the quantity of shares purchased by a shareholder, assets under management, and time in which a shareholder

[3] ASC 606-10-25-10 through 25-13.

is invested in a fund). In accordance with ASU 2014-09, a distributor should include variable consideration in the transaction price only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved. Distributors will need to evaluate whether variable consideration is constrained and therefore excluded from the transaction price.

- *Third-party distribution fees paid* — The new revenue standard retains the cost guidance in ASC 946-605-25-8 that requires an entity that receives CDSC fees and 12b-1 fees (or fees similar to, or substantially the same as, CDSC fees and 12b-1 fees) to (1) defer and amortize incremental direct costs associated with distributing a mutual fund's shares and (2) expense indirect distribution costs when such costs are incurred. However, ASU 2014-09 supersedes the guidance in ASC 946-605-25-8 on when to recognize as revenue the fees received from investors to compensate the entity for these costs (i.e., the current requirement is that these fees should be recognized as revenue when received). Accordingly, such fees would be subject to the overall revenue recognition model under ASC 606.
- *Transfer of rights to certain future distribution fees* — The new revenue guidance supersedes the industry-specific guidance in ASC 946-605, which requires immediate revenue recognition for the sale of rights to cash flows from future distribution fees if certain criteria are met. Since these arrangements may include provisions that protect the purchasers of such rights if certain events occur (e.g., termination of the 12b-1 plan by the fund's independent board of directors), entities will need to carefully assess whether to account for the arrangements as borrowings in accordance with ASC 470 or evaluate them as sales under the new revenue standard.

These and other issues are the subject of several papers drafted by the AICPA's revenue recognition task forces. Implementation issues identified and addressed by the AICPA's Asset Management Revenue Recognition Task Force are listed on the AICPA's Web site. For more information, see Chapter 4 of the AICPA Audit and Accounting Guide *Revenue Recognition*.

## Effective Date and Transition

In August 2015, as a result of stakeholder concerns, the FASB issued ASU 2015-14, which delays the effective date of ASU 2014-09. Accordingly, ASU 2014-09 is effective for public business entities (PBEs) for annual reporting periods (including interim reporting periods within those periods) beginning after December 15, 2017. Early adoption is permitted as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within those annual periods.

For nonpublic entities, the standard is effective for annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019. Nonpublic entities can also elect to early adopt the standard as of the following:

- Annual reporting periods beginning after December 15, 2016, including interim periods.
- Annual reporting periods beginning after December 15, 2016, and interim periods within annual reporting periods beginning one year after the annual reporting period of initial application of the new standard.

# Financial Instruments

## 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 deferred tax assets (DTAs) related to available-for-sale (AFS) debt securities.
- Disclosure requirements for financial assets and financial liabilities.

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

### 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 measurement alternative under which the equity investments would be measured at cost less impairment, if any, plus or minus observable price changes in orderly transactions. This measurement alternative would not be available to reporting entities that are investment companies, broker-dealers, or postretirement benefit plans.

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

**Connecting the Dots**

The requirement to classify and measure equity securities at fair value with changes recorded through earnings could significantly affect investors in bond and other debt funds. Although these funds invest in bonds or other debt securities, on the basis of existing guidance in ASC 320-10-50-4, investors in the bond funds are required to classify their investments as equity securities. Currently, such investments are often classified as AFS with changes in fair value recognized through OCI. Under the new guidance, however, investors will need to account for their investments in these bond funds at fair value with changes recorded through earnings (rather than recording the changes in fair value through OCI, which would only be permitted if the investor held the bond or debt securities in the fund directly).

## 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 associated with 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 non-PBEs, the amendments eliminate the requirement to disclose the fair value of financial instruments measured at amortized cost. In addition, for such financial instruments, PBEs are not required to disclose (1) the information related to the methods and significant assumptions used to estimate fair value or (2) a description of the changes in the methods and significant assumptions used to estimate fair value. The guidance also clarifies U.S. GAAP by eliminating the provisions in ASC 825 that had been interpreted to permit an "entry" price notion for estimating the fair value of loans for disclosure purposes. The amendments require a PBE to disclose the fair value in accordance with the exit price notion in ASC 820. In addition, all entities are required to separately present in the statement of financial position or separately disclose in the notes to the financial statements 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).

## Proposed Amendments

On September 27, 2017, the FASB issued a proposed ASU on technical corrections and improvements to ASU 2016-01 in response to feedback from stakeholders. Comments on the proposed ASU were due by November 13, 2017.

The proposed amendments would clarify certain aspects of ASU 2016-01 as follows:

- *Equity securities without readily determinable fair values* — The proposed ASU would clarify that an entity that elects to use the measurement alternative to measure equity securities may reverse that election and choose instead to measure those securities at fair value through an election that would apply to those securities and other securities of the same type.

  In addition, the proposed ASU would clarify the guidance in ASC 321-10-55-9 (added by ASU 2016-01), which states that when applying the measurement alternative to securities without a readily determinable fair value, an entity should make adjustments from observable transactions to reflect the *current* fair value of the security. Specifically, the proposed ASU would clarify that the adjustments should be made to reflect the fair value of the security as of the date on which the observable transaction took place rather than as of the current reporting date.

- *Forward contracts and purchased options* — The proposed ASU would clarify that a change in observable price or impairment of underlying securities for forward contracts and purchased

options on equity securities should result in the remeasurement of the entire fair value of the forward contracts and purchased options.

- *Presentation requirements for certain liabilities measured under the fair value option* — The proposed ASU would clarify that the guidance in ASC 825-10-45-5 (added by ASU 2016-01) related to the disclosure of instrument-specific risk (see the Changes in Fair Value of a Liability Attributed to Changes in Instrument-Specific Credit Risk section above) should be applied if the fair value option was elected under either ASC 815-15 or ASC 825-10.
- *Election of fair value option to measure liabilities denominated in a foreign currency* — The proposed ASU would clarify that when an entity elects to use the fair value option to measure a financial liability denominated in a currency other than the entity's functional currency, the entity should (1) first measure the change in fair value of the liability that results from changes in instrument-specific credit risk in the currency of denomination when that change is presented separately from the total change in fair value of the financial liability and (2) then remeasure into its functional currency both components of the change in fair value of the liability by using end-of-period spot rates.
- *Transition guidance for equity securities without readily determinable fair values* — ASU 2016-01 states that the amendments related to equity securities without readily determinable fair values should be applied prospectively. The proposed ASU would clarify that the prospective approach in ASU 2016-01 should be applied only to equity securities without readily determinable fair values for which the measurement alternative has been elected.

## Receivables — Nonrefundable Fees and Other Costs

### Background and Key Provisions of ASU 2017-08

In March 2017, the FASB issued ASU 2017-08, which amends the amortization period for certain purchased callable debt securities held at a premium, shortening such period to the earliest call date.

Under the current guidance in ASC 310-20, entities generally amortize the premium on a callable debt security as an adjustment of yield over the contractual life (to maturity date) of the instrument. Accordingly, entities do not consider early payment of principal, and any unamortized premium is recorded as a loss in earnings upon the debtor's exercise of a call on a purchased callable debt security held at a premium.

The amendments will require entities to amortize the premium on certain purchased callable debt securities to the earliest call date regardless of how the premium is generated (e.g., deferred acquisition costs and cumulative fair value hedge adjustments that increase the amortized cost basis of a callable security above par value). Therefore, entities will no longer recognize a loss in earnings upon the debtor's exercise of a call on a purchased callable debt security held at a premium.

ASU 2017-08 could affect investment management entities, including investment companies that invest in securities such as municipal bonds since these securities are commonly issued at a premium and have call features that are consistent with the scope of the ASU. Further, entities may want to consider the ASU's potential effect on their tax reporting.

### Connecting the Dots

Under the ASU, if an entity amortizes a premium to a call price greater than the par value of the debt security (e.g., because the debt security is callable at a premium to par on the earliest call date) and the debt security is not called on the earliest call date, the entity should reset the yield by using the payment terms of the debt security. If the security contains additional future call dates, the entity should consider whether the amortized cost basis exceeds the amount repayable by the issuer on the next call date. If the entity determines that the amortized cost basis does exceed the amount repayable, it should amortize the excess to the next call date.

## Scope

Purchased callable debt securities within the scope of ASU 2017-08 are those that contain explicit, noncontingent call features that are exercisable at fixed prices and on preset dates. Because the ASU does not affect an entity's ability to elect to estimate prepayments under ASC 310-20-35-26, the amended guidance will not affect an entity that (1) applies ASC 310-20-35-26 to purchased callable debt securities and (2) estimates prepayments under the interest method.

Further, the ASU does not apply to any of the following:

- Loans and other financing receivables that do not meet the definition of a debt security.
- Purchased debt securities held at a discount; the discount continues to be amortized as an adjustment of yield over the contractual life (to maturity) of the instrument.
- Purchased debt securities held at a premium and for which the call date or call price is not known in advance, including debt securities with a prepayment feature whose prepayment date is not preset (i.e., immediately prepayable instruments). As a result, the following purchased debt securities held at a premium are not within the ASU's scope:
    - Debt securities callable at fair value.
    - Debt securities callable at an amount that includes a make-whole provision that is based on the present value of future interest payments.
    - Asset-backed debt securities, including mortgage-backed securities, in which early repayment is based on the prepayment of the assets underlying the securitization as opposed to the issuer's decision to prepay the debt security itself.
- Purchased debt securities held at a premium that are contingently callable.

## Effective Date and Transition

For PBEs, the new standard is effective for fiscal years beginning after December 15, 2018, including interim periods therein. For all other entities, the standard is effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Earlier application is permitted for all entities, including adoption in an interim period. If an entity early adopts the ASU in an interim period, any adjustments must be reflected as of the beginning of the fiscal year that includes that interim period.

To apply the ASU, entities must use a modified retrospective approach and recognize the cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption. Entities are also required to provide disclosures about a change in accounting principle in the period of adoption.

# Impairment

## Background

In June 2016, the FASB issued ASU 2016-13,[4] which amends the Board's guidance on the impairment of financial instruments by adding 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 its estimate of expected credit losses as an allowance, which is presented as either (1) an offset to the amortized cost basis of the related asset (for on-balance-sheet exposures) or (2) a separate liability (for off-balance-sheet exposures). That is, the expected credit losses estimated over the lifetime of a financial instrument are recognized at inception (i.e., on day 1).

## Transition Resource Group

In late 2015, the FASB established a credit losses transition resource group (TRG). Like the TRG established to discuss the new revenue recognition standard, the credit losses TRG does not issue guidance but provides feedback to the FASB on potential implementation issues. By analyzing and discussing such issues, the credit losses TRG helps the FASB determine whether it needs to take further action (e.g., by providing clarification or issuing additional guidance).

The credit losses TRG discussed the following topics related to ASU 2016-13 at its meeting on June 12, 2017:

- Determining the effective interest rate under the CECL model.
- Scope of purchased financial assets with credit deterioration guidance for beneficial interests accounted for under ASC 325-40.
- Applying the transition guidance to pools of purchased credit-impaired assets under ASC 310-30.
- Accounting for troubled debt restructurings under the CECL model.
- Estimating the life of a credit card receivable under the CECL model.

For more information about the topics discussed at the TRG's meeting on June 12, 2017, see TRG Memos 6 and 6B and Deloitte's June 2017 *TRG Snapshot*.

### *Next Steps*

The FASB indicated at its October 4, 2017, meeting that no additional inquiries have been submitted to the TRG for consideration.

## Other Developments

### *Interagency FAQs*

On June 17, 2016, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Office of the Comptroller of the Currency (OCC) (collectively, the "agencies") issued a joint statement summarizing key elements of ASU 2016-13 and providing initial supervisory views on measurement methods, use of vendors, portfolio segmentation, data needs, qualitative adjustments, and allowance processes. Since that time, the agencies have developed FAQs to assist institutions and examiners. The agencies plan to issue additional and updated FAQs periodically. The existing FAQs (last updated in September 2017) can be found on the OCC's Web site.

[4] See Deloitte's June 17, 2016, *Heads Up* for additional information about ASU 2016-13.

### *Ongoing Discussions*

Industry groups, accounting firms, standard setters, and regulators are engaged in ongoing discussions of issues related to the implementation of the ASU, including (1) accounting for financial instruments when zero expected credit losses would be acceptable, (2) determining appropriate historical loss information for the loss reversion period (i.e., after the "reasonable and supportable" period), (3) accounting for recoveries from freestanding insurance contracts, and (4) consideration of subsequent events in the estimation of credit losses. We will continue to monitor the progress of these discussions and provide updates as appropriate.

## Hedging

### Background

On August 28, 2017, the FASB issued ASU 2017-12, which amends the hedge accounting recognition and presentation requirements in ASC 815. The Board's objectives in issuing the ASU were to (1) improve the transparency and understandability of information conveyed to financial statement users about an entity's risk management activities by better aligning the entity's financial reporting for hedging relationships with those risk management activities and (2) reduce the complexity, and simplify the application, of hedge accounting by preparers.

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

Entities are permitted to early adopt the new guidance in any interim or annual period after issuance of the ASU. An entity that early adopts the updated guidance in an interim period should record any transition adjustments as of the beginning of the fiscal year that includes that interim period.

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

### Key Changes to the Hedge Accounting Model

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

#### *Elimination of the Concept of Separately Recognizing Periodic Hedge Ineffectiveness*

ASU 2017-12 eliminates the concept of separately recognizing periodic hedge ineffectiveness for cash flow and net investment hedges (however, under the mechanics of fair value hedging, economic ineffectiveness will still be reflected in current earnings for those hedges). The Board believes that requiring an entity to record the impact of both the effective and ineffective components of a hedging relationship in the same financial reporting period and in the same income statement line item[5] will make that entity's risk management activities and their effect on the financial statements more transparent to financial statement users.

Under this rationale, even a portion of the change in a hedging instrument's fair value that is excluded from a hedging relationship's effectiveness assessment is considered part of the hedging relationship and should be recognized in the same income statement line item as the earnings effect of the hedged item (other than amounts excluded from the assessment of effectiveness of net investment hedges).

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

However, in a departure from the proposed ASU that formed the basis for the guidance in ASU 2017-12, the Board determined that presentation should not be prescribed for "missed forecasts" in cash flow hedges. Thus, an entity that ultimately determines that it is probable that a hedged forecasted transaction will not occur will not be required to record the amounts reclassified out of accumulated other comprehensive income (AOCI) for that hedging relationship into earnings in the same income statement line item that would have been affected by the forecasted transaction.

### *Components Excluded From the Hedge Effectiveness Assessment*

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

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

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

## *Changes in the Fair Value of the Hedging Instrument and the Hedged Item*

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

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

(Table continued)

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

(Table continued)

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

## *Hedge Effectiveness Assessments and Documentation Requirements — Quantitative Versus Qualitative Assessments of Hedge Effectiveness*

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

Further, if (1) an entity's initial prospective quantitative hedge effectiveness assessment of a hedging relationship demonstrates that there is a highly effective offset and (2) the entity can, at hedge inception, "reasonably support an expectation of high effectiveness on a qualitative basis in subsequent periods," the entity may elect to perform subsequent retrospective and prospective effectiveness assessments qualitatively. To do so, in the hedge documentation it prepares at hedge inception, the entity must

(1) specify how it will perform the qualitative assessments and (2) document the alternative quantitative assessment method that it would use if it later concludes, on the basis of a change in the hedging relationship's facts and circumstances, that subsequent quantitative assessments will be necessary. The entity may make this election on a hedge-by-hedge basis.

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

## *Shortcut Method and Critical-Terms-Match Method*

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

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

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

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

ASU 2017-12 also expands an entity's ability to apply the critical-terms-match method to cash flow hedges of groups of forecasted transactions. If all other critical-terms-match criteria are satisfied, such hedges will qualify for the critical-terms-match method "if those forecasted transactions occur and the derivative matures within the same 31-day period or fiscal month."

## *Hedges of Interest Rate Risk*

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

## *Other Targeted Improvements to Fair Value Hedges of Interest Rate Risk*

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

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

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

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

### Measuring the Fair Value of a Prepayable Instrument

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

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

### Partial-Term Hedges of Interest Rate Risk

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

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

## Last-of-Layer Method

To address constituent feedback received on the hedge accounting improvements project after the initial proposal, the FASB added to ASU 2017-12 a last-of-layer method that enables an entity to apply fair value hedging to closed portfolios of prepayable assets without having to consider prepayment risk or credit risk when measuring those assets. An entity can also apply the method to one or more beneficial interests (e.g., a mortgage-backed security) secured by a portfolio of prepayable financial instruments.

Under the last-of-layer method, an entity would designate as the hedged item in a fair value hedge of interest rate risk a stated amount of the asset or assets that the entity does not expect "to be affected by prepayments, defaults, and other factors affecting the timing and amount of cash flows" (the "last of layer"). This designation would occur in conjunction with the partial-term hedging election discussed above.

To support the designation, the initial hedge documentation should include evidence that the entity performed an analysis that supported its expectation that the hedged item (i.e., the last of layer) would be outstanding as of the assumed maturity date of the hedged item that was documented in the partial-term hedge election. That analysis should reflect the entity's current expectations about factors that can affect the timing and amount of the closed portfolio's (or, for beneficial interests, the underlying assets') cash flows (e.g., prepayments and defaults); however, the ASU allows the entity to assume that the effects of any events that occur, such as prepayments or defaults, would first apply to the portion of the closed portfolio or beneficial interests that is not part of the hedged item (last-of-layer) designation.

On each subsequent hedge effectiveness assessment date, the entity must continue to prepare and document its analysis supporting the expectation that the hedged item (i.e., the last of layer) will be outstanding on the assumed maturity date. The updated analysis should reflect the entity's current expectations about the level of prepayments, defaults, or other factors that could affect the timing and amount of cash flows, and it should use the same methods as those used at hedge inception. Also, on each reporting date, the entity will adjust the basis of the hedged item for the gain or loss on the hedged item attributable to changes in the hedged risk (i.e., interest rate risk), as it would do for any other fair value hedge.

**Connecting the Dots**

When an entity considers how it will allocate the basis adjustments that result from hedge accounting by using the last-of-layer method, it should factor in possible interactions with the application of other accounting requirements. For example, adjustments to the carrying value of the assets in the closed portfolio that are being hedged under the last-of-layer method might affect multiple pools of financial assets for which credit losses will be estimated on a collective basis. The identification of such pools may become an even more significant issue when an entity adopts ASU 2016-13.

An entity that concludes on any hedge effectiveness assessment date that it no longer expects the entire hedged last of layer to be outstanding on its assumed maturity date must, at a minimum, discontinue hedge accounting for that portion of the hedged last of layer that is not expected to be outstanding. Moreover, the entity must discontinue the entire hedging relationship on any assessment date on which it determines that the hedged last of layer currently exceeds the outstanding balance of the closed portfolio of prepayable assets or one or more beneficial interests in prepayable assets. A full or partial hedge discontinuation will also trigger the need for the entity to allocate, in a systematic and rational manner, the outstanding basis adjustment (or portion thereof) that resulted from the previous hedge accounting to the individual assets in the closed portfolio. Such allocated amounts must be amortized over a period "that is consistent with the amortization of other discounts or premiums associated with

the respective assets" under U.S. GAAP. The last-of-layer method does not, however, incorporate a tainting threshold; therefore, an entity that is required to discontinue a last-of-layer hedging relationship is not precluded from designating similar hedging relationships in the future.

### *Ability to Designate Components of Nonfinancial Assets as Hedged Items*

Under U.S. GAAP before the ASU's adoption, when an entity desired to cash flow hedge a risk exposure associated with a nonfinancial asset, it could designate as the hedged risk only the risk of changes in cash flows attributable to (1) all changes in the purchase or sales price or (2) changes in foreign exchange rates. Alternatively, for cash flow hedges of financial instruments, an entity could designate as the hedged risk either the risk of overall changes in cash flows or one or more discrete risks.

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

**Connecting the Dots**

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

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

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

In addition, the ASU permits an entity to designate a hedge of a contractually specified component (1) for a period that extends beyond the contractual term or (2) when a contract does not yet exist to sell or purchase the nonfinancial asset if the criteria specified above will be met in a future contract and all the other cash flow hedging requirements are met. When the entity executes the contract, it will reassess the criteria specified above to determine whether the contractually specified component continues to qualify for designation as the hedged risk. If, at the time the contract is executed, there is a change in the contractually specified component (e.g., the hedge documentation specified a commodity grade different from that in the executed contract), the entity will not be required to automatically

dedesignate the hedging relationship; however, the entity must demonstrate that the hedging relationship continues to be highly effective at achieving offsetting cash flows attributable to the revised hedged risk to justify continuation of hedge accounting.

**Connecting the Dots**

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

### *Disclosure Requirements*

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

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

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

## Transition

Entities will adopt the ASU's provisions by applying a modified retrospective approach to existing hedging relationships[6] as of the adoption date. Under this approach, entities with cash flow or net investment hedges will make (1) a cumulative-effect adjustment to AOCI so that the adjusted amount represents the cumulative change in the hedging instruments' fair value since hedge inception (less any amounts that should have been recognized in earnings under the new accounting model) and (2) a corresponding adjustment to opening retained earnings as of the most recent period presented on the date of adoption.

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

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

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

**Connecting the Dots**

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

# Leases

## Background

In February 2016, the FASB issued ASU 2016-02, its long-awaited new standard on accounting for leases. As discussed in last year's publication, the ASU responds to concerns related to the off-balance-sheet treatment of operating lease arrangements by a lessee, requiring the lessee to adopt a right-of-use (ROU) asset approach that brings substantially all leases, with the exception of short-term leases[7] (i.e., those with a lease term of less than 12 months), on the balance sheet. Under this approach, the 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).

The development of the new leases standard began as a convergence project between the FASB and the IASB. However, the boards' final standards[8] contain several notable differences, one of the more significant of which is related to a lessee's subsequent accounting of a lease. Under the FASB's approach, a lease is classified as either an operating lease or a finance lease, with different expense profiles for each. Under the IASB's guidance, an entity would classify all leases as finance leases. The FASB decided to retain today's dual classification approach to limit the ASU's effects on the income statement. Accordingly, while the FASB's new guidance is expected to significantly affect the balance sheet of most investment advisers, the effects of the new guidance on an investment adviser's income statement may not be as significant.

**Connecting the Dots**

ASU 2016-02 defines a lease as a "contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration." While this definition may seem straightforward, judgment is crucial to identifying a complete population of leases. At first glance, a contract may not seem to meet a conventional understanding of a lease (e.g., a lease of a specific building).

However, entities should evaluate their contracts and determine whether those contracts in their entirety or in part convey the right to use property, plant, or equipment. Because most leases will be recognized "on balance sheet" under the ASU, the financial statement implications of erroneously not identifying a lease in, for example, a service contract are far more significant than under ASC 840.

[7] Assuming that the lessee has made an accounting policy election not to account for short-term leases on the balance sheet.
[8] The IASB issued IFRS 16, *Leases*, in January 2016.

## Lessee Accounting

The FASB chose a dual-model approach under which a lessee classifies a lease by using criteria that are similar to the existing lease classification criteria under ASC 840, with minor changes. For leases considered finance leases (many of today's 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 considered operating leases (many of today's 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.

**Example**

A lessee enters into a three-year lease and agrees to make the following annual payments at the end of each year: $10,000 in year 1, $15,000 in year 2, and $20,000 in year 3. The initial measurement of the ROU asset and liability to make lease payments is $38,000 at a discount rate of 8 percent.

This table highlights the differences in accounting for the lease under the financing approach and straight-line expense approach:

| | Both Methods | Finance Lease Approach | | | | Operating Lease Approach | | |
|---|---|---|---|---|---|---|---|---|
| Year | Lease Liability | Interest Expense <X> | Amortization Expense <Y> | Total Lease Expense <X> + <Y> | ROU Asset | Lease Expense <Z> | Reduction in ROU Asset <Z> – <X> | ROU Asset |
| 0 | $ 38,000 | | | | $ 38,000 | | | $ 38,000 |
| 1 | 31,038 | $ 3,038 | $ 12,666 | $ 15,704 | 25,334 | $ 15,000 | $ 11,962 | 26,038 |
| 2 | 18,519 | 2,481 | 12,667 | 15,148 | 12,667 | 15,000 | 12,519 | 13,519 |
| 3 | — | 1,481 | 12,667 | 14,148 | — | 15,000 | 13,519 | — |
| Total | | $ 7,000 | $ 38,000 | $ 45,000 | | $ 45,000 | $ 38,000 | |

## Lessor Accounting

The boards considered constituent feedback and decided not to make significant changes to the existing lessor accounting model. Rather, they agreed to adopt an approach similar to the existing capital lease and operating lease models. However, the FASB decided to align the U.S. GAAP classification requirements with the criteria in IFRSs. In addition, the FASB decided that for leases similar to current sales-type leases, the lessor would be permitted to recognize the profit on the transaction only if the arrangement would have qualified as a sale under the new revenue recognition guidance.

## Options in a Lease

Under legacy lease accounting guidance, entities are required to evaluate whether they expect to exercise term renewal options, purchase options, and termination options. However, conclusions about the expectation of exercising such options typically do not significantly affect the resulting accounting for the associated leases unless they result in a change in lease classification. Under the new leases standard, by contrast, conclusions about the lease term and any payments associated with the exercise of purchase or termination options can have a more significant impact on the financial statements as a result of the measurement of the lease liability on the balance sheet. For example, if lessees are

"reasonably certain" that they will exercise an option, the corresponding impact of that option is included in the measurement of the lease liability.

**Connecting the Dots**

Implementation of the ASU should include thoughtful consideration of internal controls, particularly in areas that require significant judgment and involve identification of the full population of leases (including embedded leases). Entities that may have placed less importance on the review of such conclusions under legacy GAAP should ensure that appropriate processes and controls are established to support appropriate conclusions in these key areas.

### Effective Date and Transition

The new guidance is effective for PBEs 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. Although the FASB has received a formal request to defer the effective date of ASU 2016-02 to annual periods beginning after December 15, 2020, we expect the FASB to proceed with the initial effective date for PBEs.

Lessees and lessors are required to use a modified retrospective transition method for existing leases. Accordingly, they would apply the new accounting model for the earliest year presented in the financial statements.

**Connecting the Dots**

The new standard requires a lessee to record its lease arrangements by using the rate the lessor charges in the lease, if readily determinable, or alternatively to use the lessee's incremental borrowing rate. For leases that are currently accounted for as operating leases, an investment manager will be required, upon adopting the new guidance, to determine the appropriate discount rate to apply when the lease arrangements are initially recorded on the balance sheet.

For discussion of additional implementation considerations, see Deloitte's March 1, 2016, *Heads Up* (as updated on July 12, 2016), which addresses the basic technical elements of the standard, and Deloitte's April 25, 2017, *Heads Up*, which addresses FAQs about the standard.

# Business Combinations

## Intangibles — Goodwill and Other

### Background

In January 2017, the FASB issued ASU 2017-04, which amends the guidance in ASC 350 on the accounting for goodwill impairment. The ASU was issued as part of the FASB's simplification initiative and in response to stakeholder feedback regarding the cost and complexity of the annual goodwill impairment test.

### Key Provisions of the ASU

Under the current guidance in ASC 350, impairment of goodwill "exists when the carrying amount of goodwill exceeds its implied fair value." To determine the implied fair value of goodwill, an entity must "assign the fair value of a reporting unit to all of the assets and liabilities of that unit (including any

unrecognized intangible assets) as if the reporting unit had been acquired in a business combination." This process, known as step 2, is often expensive and complicated given the inability to measure goodwill directly. ASU 2017-04 seeks to simplify the accounting for goodwill impairments by eliminating step 2 from the goodwill impairment test and enabling an entity to recognize an impairment loss when the "carrying amount of a reporting unit exceeds its fair value." Any such loss will be "limited to the total amount of goodwill allocated to that reporting unit."

**Connecting the Dots**

The ASU requires goodwill impairment to be measured on the basis of the fair value of a reporting unit relative to the reporting unit's carrying amount rather than on the basis of the implied amount of goodwill relative to the goodwill balance of the reporting unit. The goodwill impairment test under the ASU is therefore less precise than the test performed under current guidance. As a result of applying the new guidance, an entity may record a goodwill impairment that is entirely or partly due to a decline in the fair value of other assets that, under existing GAAP, would not be impaired or have a reduced carrying amount.

The ASU does not change the qualitative assessment;[9] however, it removes "the requirements for any reporting unit with a zero or negative carrying amount to perform a qualitative assessment and, if it fails that qualitative test, to perform Step 2 of the goodwill impairment test." Rather, all reporting units, including those with a zero or negative carrying amount, will apply the same impairment test.

**Connecting the Dots**

Under ASU 2017-04, reporting units with a zero or negative carrying value would essentially never be impaired. Accordingly, judgments related to the assignment of assets and liabilities to a reporting unit may become more relevant. The FASB considered, but ultimately rejected, prescribing additional guidance on allocating assets and liabilities to reporting units. The ASU's Basis for Conclusions states that "the amendments in this Update should not necessarily trigger changes to the composition of a reporting unit," noting that "preparers, auditors, and regulators should pay close attention to any change to a reporting unit that results in a zero or negative carrying amount, including changes made leading up to the adoption of the new guidance given the length of time until the effective dates." It further states that "the allocation of assets and liabilities to reporting units should not be viewed as an opportunity to avoid impairment charges and should only be changed if there is a change in facts and circumstances for a reporting unit."

The ASU also:

- Clarifies the requirements for excluding and allocating foreign currency translation adjustments to reporting units related to an entity's testing of reporting units for goodwill impairment.
- Clarifies that "an entity should consider income tax effects from any tax deductible goodwill on the carrying amount of the reporting unit when measuring the goodwill impairment loss, if applicable."
- Makes minor changes to the Overview and Background sections of certain ASC subtopics and topics as part of the Board's initiative to unify and improve those sections throughout the Codification.

See Deloitte's February 1, 2017, *Heads Up* for additional information about ASU 2017-04.

[9] The optional assessment described in ASC 350-20-35-3A through 35-3G to determine whether it is more likely than not that the carrying amount of a reporting unit exceeds its fair value is commonly referred to as the qualitative assessment or step 0.

## Convergence With IFRSs

The removal of step 2 from the goodwill impairment test under ASC 350 more closely aligns U.S. GAAP with IFRSs, which also prescribe a one-step goodwill impairment test. However, the impairment test required under IAS 36 is performed at the cash-generating-unit or group-of-cash-generating-units level rather than the reporting-unit level as required by U.S. GAAP. Further, IAS 36 requires an entity to compare the cash-generating unit's carrying amount with its recoverable amount, whereas the ASU requires an entity to compare a reporting unit's carrying amount with its fair value.

## Effective Date and Transition

For PBEs that are SEC filers,[10] the ASU is effective for annual and any interim impairment tests for periods beginning after December 15, 2019. PBEs that are not SEC filers should apply the new guidance to annual and any interim impairment tests for periods beginning after December 15, 2020. For all other entities, the ASU is effective for annual and any interim impairment tests for periods beginning after December 15, 2021. Early adoption is allowed for all entities as of January 1, 2017, for annual and any interim impairment tests occurring on or after January 1, 2017.

# Clarifying the Definition of a Business

## Background

In January 2017, the FASB issued ASU 2017-01, which provides guidance related to the first phase of the Board's project on the definition of a business. The ASU is in response to concerns that the current definition of a business is too broad and that many transactions are accounted for as business combinations when they are more akin to asset acquisitions.

The ASU:

- Provides a "screen" that, if met, eliminates the need for further evaluation. Entities are required to use this screen when determining whether an integrated set of assets and activities (commonly referred to as a "set") is a business. When substantially all of the fair value of the gross assets acquired (or disposed of) is concentrated in a single identifiable asset or a group of similar identifiable assets, the screen is met and the set is therefore **not** a business. The objective of the screen is to reduce the number of transactions that need to be further evaluated.
- Provides that if the screen is not met, a set constitutes a business only if it includes, at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs.
- Removes the evaluation of whether a market participant could replace missing elements.
- Narrows the definition of the term "output" to make it consistent with how outputs are described in ASC 606.

[10] The ASC master glossary defines an "SEC filer" 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 a submission by another SEC filer are no included within this definition."

An SEC filer does not include an entity's financial statements or financial information that is required to be or is included in a filing with the SEC (e.g., in accordance with SEC Regulation S-X, Rule 3-09, "Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons," or SEC Regulation S-X, Rule 3-05, "Financial Statements of Businesses Acquired or to Be Acquired," and SEC Regulation S-X, Rule 4-08(g), "Summarized Financial Information").

**Connecting the Dots**

The ASU could affect the investment management industry as a result of the different accounting for business combinations and asset acquisitions. For example, acquisition costs are expensed in a business combination and capitalized in an asset acquisition. Thus, a more narrow definition of a business will result in more asset acquisitions and, therefore, more capitalized costs.

## Single or Similar Asset Concentration

Under the ASU, cash and cash equivalents, DTAs, and goodwill resulting from the effects of deferred tax liabilities would be excluded from an entity's assessment of gross asset concentration when an entity applies the screen described above. If the fair value of the gross assets is not concentrated in accordance with the screen, the entity would apply the ASU's framework for evaluating whether an input and a substantive process are both present and together contribute to the ability to produce outputs.

**Connecting the Dots**

In the determination of gross asset concentration, neither a financial asset and a nonfinancial asset (e.g., investments and customer relationships) nor different major classes of financial assets (e.g., cash, accounts receivable, and marketable securities) could be combined. Also, identifiable assets within the same major asset class that have significantly different risk characteristics could not be combined.

## Input and Substantive Process Requirement

The ASU provides a framework for determining whether a set has an input and a substantive process that collectively contribute to the ability to create outputs. When a set does not yet have outputs, the set would have a substantive process only if it has an organized workforce that has the necessary skills, knowledge, or experience to perform an acquired process (or group of processes) that, when applied to an acquired input or inputs, is critical to the ability to continue producing outputs. For a set with outputs, the ASU includes less stringent criteria for determining that the set has a substantive process. An organized workforce may represent a substantive process. However, a set may have a substantive process even without an organized workforce if an acquired process or processes contribute to the ability to continue producing outputs and cannot be replaced without significant cost, effort, or delay or are considered unique or scarce.

## Definition of Outputs

Under current guidance (ASC 805-10-55-4(c)), outputs are defined as the "result of inputs and processes applied to those inputs that provide or have the ability to provide a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants." The ASU amends the definition of an output to be the "result of inputs and processes applied to those inputs that provide goods or services to customers, investment income (such as dividends or interest), or other revenues." The revised definition of outputs aligns with the description of outputs in ASC 606 (the new revenue standard).

## Effective Date and Transition

The ASU is effective for PBEs for annual periods beginning after December 15, 2017, including interim periods within those periods. 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 application is permitted as follows:

- For transactions for which the acquisition date occurs before the issuance date or effective date of the ASU, application is permitted only when the transaction has not been reported in financial statements that have been issued or made available for issuance.
- For transactions in which a subsidiary is deconsolidated or a group of assets is derecognized that occur before the issuance date or effective date of the ASU, application is permitted only when the transaction has not been reported in financial statements that have been issued or made available for issuance.

For additional information, see Deloitte's January 13, 2017, *Heads Up*.

# Employee Share-Based Payment Accounting Improvements

## Employee Share-Based Payments — Modification Accounting

In May 2017, the FASB issued ASU 2017-09, which amends the scope of modification accounting for share-based payment arrangements. The ASU provides guidance on the types of changes to the terms or conditions of share-based payment awards to which an entity would be required to apply modification accounting under ASC 718. Specifically, an entity would not apply modification accounting if the fair value, vesting conditions, and classification of the awards are the same immediately before and after the modification.

### Background

The Board decided to change the scope of the modification guidance in ASC 718 given that ASC 718-20-20 defines a modification as a "change in **any** of the terms or conditions of a share-based payment award" (emphasis added). As a result of that broad definition, there may be diversity in practice regarding the types of changes to share-based payment awards to which an entity applies modification accounting. Accordingly, to provide clarity and reduce diversity, cost, and complexity, the FASB issued ASU 2017-09.

Examples 1 and 2 below illustrate the effects of an entity's application of modification accounting depending on whether the original awards are expected to vest.

**Example 1**

Entity A grants employees restricted stock units that are classified as equity and have a fair-value-based measure of $1 million on the grant date. Before the awards vest, A subsequently modifies them to provide dividend participation during the vesting period. Assume that the addition of dividend participation changes the fair-value-based measurement of the awards and that the fair-value-based measure on the modification date is $1.5 million immediately before the modification and $1.6 million immediately after it. In addition, there are no other changes to the awards (including their vesting conditions or classification). If A applies modification accounting, and the awards are expected to vest on the modification date, A would recognize incremental compensation cost of $100,000 over the remaining requisite service period (for a total of $1.1 million of compensation cost). However, if A applies modification accounting, and the awards are not expected to vest on the modification date, any compensation cost to be recognized (if the awards are subsequently expected to vest or actually do vest) will be based on the modification-date fair-value-based measure of $1.6 million.

**Example 2**

Entity B grants employees restricted stock units that are classified as equity and have a fair-value-based measure of $1 million on the grant date. Before the awards vest, B subsequently modifies them to add a contingent fair-value repurchase feature on the underlying shares. Assume that the addition of the repurchase feature **does not** change the fair-value-based measurement of the awards or their classification and that the fair-value-based measure on the modification date is $1.5 million (both immediately before and after the modification). In addition, there are no other changes to the awards (including their vesting conditions). If B applies modification accounting, and the awards are expected to vest on the modification date, there is no accounting consequence associated with the modification because there is no increase in the fair-value-based measurement; any compensation cost will continue to be based on the grant-date fair-value-based measure of $1 million. However, if B applies modification accounting, and the awards are not expected to vest on the modification date, any compensation cost to be recognized (if the awards are subsequently expected to vest or actually do vest) will be based on the modification-date fair-value-based measure of $1.5 million.

In accordance with the ASU's provisions (see discussion below), B would not apply modification accounting because the fair-value-based measurement, vesting conditions, and classification of the awards are the same immediately before and after the modification. Accordingly, irrespective of whether the awards are expected to vest on the modification date, any compensation cost recognized will continue to be based on the grant-date fair-value-based measure of $1 million.

## Key Provisions of the ASU

### *Scope of Modification Accounting*

The ASU limits the circumstances in which an entity applies modification accounting. When an award is modified, an entity does not apply the guidance in ASC 718-20-35-3 through 35-9 if it meets all of the following criteria:

- "The fair value (or calculated value or intrinsic value, if such an alternative measurement method is used) of the modified award is the same as the fair value (or calculated value or intrinsic value, if such an alternative measurement method is used) of the original award immediately before the original award is modified."
- "The vesting conditions of the modified award are the same as the vesting conditions of the original award immediately before the original award is modified."
- "The classification of the modified award as an equity instrument or a liability instrument is the same as the classification of the original award immediately before the original award is modified."

**Connecting the Dots**

Upon an equity restructuring, it is not uncommon for an entity to make employees "whole" (in accordance with a preexisting nondiscretionary antidilution provision) on an intrinsic-value basis when the awards are stock options. In certain circumstances, the fair-value-based measurement of modified stock options could change as a result of the equity restructuring even if the intrinsic value remains the same. Under the ASU, an entity compares the intrinsic value before and after a modification in determining whether to apply modification accounting only "if such an alternative measurement method is used"; thus, if an entity uses a fair-value-based measure to calculate and recognize compensation cost for its share-based payment awards, it would still be required to apply modification accounting when the fair-value-based measurement has changed, even if the intrinsic value is the same immediately before and after the modification.

### *Clarification Related to the Fair Value Assessment*

ASC 718-20-35-2A(a) states, "If the modification does not affect any of the inputs to the valuation technique that the entity uses to value the award, the entity is not required to estimate the value immediately before and after the modification."

**Connecting the Dots**

In paragraph BC16 of ASU 2017-09, the Board noted that it does not expect that an entity will always need to estimate the fair-value-based measurement of a modified award. An entity might instead be able to determine whether the modification affects any of the inputs used in the valuation technique performed for the award. For example, if an entity changes the net-settlement terms of its share-based payment arrangements related to statutory tax withholding requirements, that change is not likely to affect any inputs used in the method performed by the entity to value the awards. If none of the inputs are affected, the entity would not be required to estimate the fair-value-based measurement immediately before and after the modification (i.e., the entity could conclude that the fair-value-based measurement is the same).

### *Examples From the ASU's Basis for Conclusions*

The ASU's Basis for Conclusions provides examples (that "are educational in nature, are not all-inclusive, and should not be used to override the guidance in paragraph 718-20-35-2A") of (1) changes to awards for which modification accounting generally would not be required and (2) those for which it generally would be required. The following table summarizes those examples:

| Examples of Changes for Which Modification Accounting *Would Not* Be Required | Examples of Changes for Which Modification Accounting *Would* Be Required |
|---|---|
| • Administrative changes, such as a change to the company name, company address, or plan name<br>• Changes in net-settlement provisions related to tax withholdings that do not affect the classification of the award | • Repricings of stock options that result in a change in value<br>• Changes in a service condition<br>• Changes in a performance condition or a market condition<br>• Changes in an award that result in a reclassification of the award (equity to liability or vice versa)<br>• Addition of an involuntary termination provision in anticipation of a sale of a business unit that accelerates vesting of an award |

**Connecting the Dots**

Share-based payment plans commonly contain clawback provisions that allow an entity to recoup awards upon certain contingent events (e.g., termination for cause, violation of a noncompete provision, material financial statement restatement). Under ASC 718-10-30-24, such clawback provisions are generally not reflected in estimates of the fair-value-based measure of awards. Accordingly, we believe that the addition of a clawback provision to an award would typically not result in the application of modification accounting because such clawbacks generally do not change the fair value, vesting conditions, or classification of an award.

## Effective Date

For all entities, the ASU is effective for annual reporting periods, including interim periods within those annual reporting periods, beginning after December 15, 2017.

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

## Transition and Related Disclosures

The ASU's amendments should be applied prospectively to awards modified on or after the effective date. Transition disclosures are not required, because modifications typically are not recurring events for most entities.

# Retirement Benefits

## Background

In March 2017, the FASB issued ASU 2017-07, which amends the requirements in ASC 715 related to the income statement presentation of the components of net periodic benefit cost for an entity's sponsored defined benefit pension and other postretirement plans.

Under current U.S. GAAP, net benefit cost (i.e., defined benefit pension cost and postretirement benefit cost) consists of several components that reflect different aspects of an employer's financial arrangements as well as the cost of benefits earned by employees. These components are aggregated and reported net in the financial statements. However, many stakeholders have criticized such net presentation because it does not permit financial statement users to evaluate different types of components separately when they assess an entity's current and future financial performance. In addition, there is currently no specific guidance on where in the income statement an entity should present net benefit cost.

## Key Provisions of the ASU

ASU 2017-07 requires entities to (1) disaggregate the current service cost component from the other components of net benefit cost (the "other components") and present it with other current compensation costs for related employees in the income statement and (2) present the other components of net benefit cost elsewhere in the income statement and outside of income from operations if such a subtotal is presented.

The ASU also requires entities to disclose the income statement lines that contain the other components if they are not presented on appropriately described separate lines.

### Connecting the Dots

While the ASU does not require entities to further disaggregate the other components, they may do so if they believe that the information would be helpful to financial statement users. However, entities must disclose which financial statement lines contain the disaggregated components.

In addition, only the service cost component of net benefit cost is eligible for capitalization (e.g., as part of inventory or property, plant, and equipment). This is a change from current practice, under which entities capitalize the aggregate net benefit cost when applicable.

## Effective Date and Transition

The ASU's amendments are effective for PBEs for interim and annual periods beginning after December 15, 2017. For other entities, the amendments are effective for annual periods beginning after December 15, 2018, and interim periods in the subsequent annual period. Early adoption is permitted as of the beginning of any annual period for which an entity's financial statements (interim or annual) have not been issued or made available for issuance (i.e., an entity should early adopt the amendments within the first interim period if it issues interim financial statements).

Entities must use (1) a retrospective transition method to adopt the requirement for separate presentation in the income statement of service costs and other components and (2) a prospective transition method to adopt the requirement to limit the capitalization of benefit costs (e.g., as part of inventory) to the service cost component. Further, entities must disclose the nature of and reason for the change in accounting principle in both the first interim and annual reporting periods in which they adopt the amendments.

The ASU also establishes a practical expedient upon transition that permits entities to use their previously disclosed service cost and other costs from the prior years' pension and other postretirement benefit plan footnotes in the comparative periods as appropriate estimates when retrospectively changing the presentation of these costs in the income statement. Entities that apply the practical expedient need to disclose that they did so.

For additional information, see Deloitte's March 14, 2017, *Heads Up*.

# Restricted Cash

## Background

In November 2016, the FASB issued ASU 2016-18, which amends ASC 230 to clarify guidance on the classification and presentation of restricted cash. The ASU is the result of the following consensuses reached by the EITF:

- 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 Task Force decided not to define the terms "restricted cash" and "restricted cash equivalents" but observed that an entity should continue to provide appropriate disclosures about its accounting policies pertaining to restricted cash in accordance with other GAAP. The Task Force also observed 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.

## Effective Date and Transition

For PBEs, the guidance is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. For all other entities, it is effective for annual periods beginning after December 15, 2018, and interim periods beginning after December 15, 2019. Early adoption of the guidance in the ASU is permitted. A reporting entity will apply the guidance retrospectively.

# Appendixes

# Appendix A — Summary of Accounting Pronouncements Effective in 2017

The table below lists selected ASUs that became effective for calendar year 2017. (Note that it is assumed that the ASUs were not early adopted before 2017 if early adoption was permitted.)

| ASU (Issuance Date) | Effective Date for PBEs | Effective Date for Non-PBEs | Early Adoption Allowed? | Deloitte Resources |
|---|---|---|---|---|
| ASU 2017-03, *Accounting Changes and Error Corrections (Topic 250) and Investments — Equity Method and Joint Ventures (Topic 323): Amendments to SEC Paragraphs Pursuant to Staff Announcements at the September 22, 2016 and November 17, 2016 EITF Meetings* (January 23, 2017) | Effective upon issuance | Effective upon issuance | N/A | January 24, 2017, news article |
| ASU 2016-09, *Improvements to Employee Share-Based Payment Accounting* (March 30, 2016) | Annual periods, and interim periods within those annual periods, beginning after December 15, 2016 | Annual periods beginning after December 15, 2017, and interim periods within fiscal years beginning after December 15, 2018 | Yes | April 21, 2016, *Heads Up* |
| ASU 2015-16, *Simplifying the Accounting for Measurement-Period Adjustments* (September 25, 2015) | Fiscal years beginning after December 15, 2015, including interim periods within those fiscal years | Fiscal years beginning after December 15, 2016, and interim periods within fiscal years beginning after December 15, 2017. The amendments in the ASU should be applied prospectively to adjustments to provisional amounts that occur after the effective date of the ASU. | Yes | September 30, 2015, *Heads Up* |

(Table continued)

| ASU (Issuance Date) | Effective Date for PBEs | Effective Date for Non-PBEs | Early Adoption Allowed? | Deloitte Resources |
|---|---|---|---|---|
| ASU 2015-09, *Disclosures About Short-Duration Contracts* (May 21, 2015) | Annual periods beginning after December 15, 2015, and interim periods within annual periods beginning after December 15, 2016 | Annual periods beginning after December 15, 2016, and interim periods within annual periods beginning after December 15, 2017 | Yes | May 2015 *Insurance Spotlight* |
| ASU 2015-05, *Customer's Accounting for Fees Paid in a Cloud Computing Arrangement* (April 15, 2015) | Annual periods, including interim periods within those annual periods, beginning after December 15, 2015 | Annual periods beginning after December 15, 2015, and interim periods within annual periods beginning after December 15, 2016 | Yes | April 17, 2015, *Heads Up* |
| ASU 2015-04, *Practical Expedient for the Measurement Date of an Employer's Defined Benefit Obligation and Plan Assets* (April 15, 2015) | Fiscal years beginning after December 15, 2015, and interim periods within those fiscal years | Fiscal years beginning after December 15, 2016, and interim periods within fiscal years beginning after December 15, 2017 | Yes | April 17, 2015, *Heads Up* |
| ASU 2015-03, *Simplifying the Presentation of Debt Issuance Costs* (April 7, 2015) | Fiscal years beginning after December 15, 2015, and interim periods within those fiscal years | Fiscal years beginning after December 15, 2015, and interim periods within fiscal years beginning after December 15, 2016 | Yes | June 18, 2015, *Heads Up* |
| ASU 2015-02, *Amendments to the Consolidation Analysis* (February 18, 2015) | Fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015 | Fiscal years beginning after December 15, 2016, and interim periods within fiscal years beginning after December 15, 2017 | Yes | December 29, 2015, *Heads Up* (originally issued May 26, 2015) |

(Table continued)

| ASU (Issuance Date) | Effective Date for PBEs | Effective Date for Non-PBEs | Early Adoption Allowed? | Deloitte Resources |
|---|---|---|---|---|
| ASU 2014-16, *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 (November 3, 2014) | Fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015 | Fiscal years beginning after December 15, 2015, and interim periods within fiscal years beginning after December 15, 2016 | Yes | September 2014 *EITF Snapshot* |
| ASU 2014-15, *Disclosure of Uncertainties About an Entity's Ability to Continue as a Going Concern* (August 27, 2014) | Annual periods ending after December 15, 2016, and interim periods thereafter | Annual periods ending after December 15, 2016, and interim periods thereafter | Yes | August 28, 2014, *Heads Up* |
| ASU 2014-13, *Measuring the Financial Assets and the Financial Liabilities of a Consolidated Collateralized Financing Entity* — a consensus of the FASB Emerging Issues Task Force (August 5, 2014) | Annual periods, and interim periods within those annual periods, beginning after December 15, 2015 | Annual periods ending after December 15, 2016, and interim periods beginning after December 15, 2016 | Yes | June 2014 *EITF Snapshot* |

# Appendix B — Current Status of FASB Projects

The table below summarizes the current status of, and next steps for, active standard-setting projects of the FASB (selected projects only and excluding research initiatives).

| Project | Status and Next Steps | Deloitte Resources |
|---|---|---|
| **Recognition and Measurement Projects** | | |
| Consolidation reorganization and targeted improvements | On September 20, 2017, the FASB issued a proposed ASU that would reorganize the consolidation guidance in ASC 810 by dividing it into separate subtopics for voting interest entities and variable interest entities (VIEs). The new subtopics would be included in a new topic, ASC 812, which would supersede ASC 810. Comments on the proposal are due by December 4, 2017. | November 8, 2016, and March 14, 2017, journal entries |
| Consolidation: targeted improvements to related-party guidance for VIEs | On June 22, 2017, the FASB published a proposed ASU under which (1) private companies "would not have to apply VIE guidance to legal entities under common control . . . if both the parent and the legal entity being evaluated for consolidation are not public business entities"; (2) "[i]ndirect interests held through related parties in common control arrangements would be considered on a proportional basis for determining whether fees paid to decision makers and service providers are variable interests"; and (3) consolidation would no longer be mandatory when "power is shared among related parties or when commonly controlled related parties, as a group, have the characteristics of a controlling financial interest but no reporting entity individually has a controlling financial interest." Comments on the proposal were due by September 5, 2017. | July 14, 2017, *Heads Up* |
| Distinguishing liabilities from equity | The FASB added this project to its technical agenda on September 20, 2017. The purpose of the project is to "improve understandability and reduce complexity — without sacrificing the relevance of information provided to financial statement users — with a focus on indexation and settlement (within the context of the derivative scope exception), convertible debt, disclosures, and earnings per share." | |

(Table continued)

| Project | Status and Next Steps | Deloitte Resources |
|---|---|---|
| **Recognition and Measurement Projects** | | |
| Insurance: targeted improvements to the accounting for long-duration contracts | On September 29, 2016, the FASB issued a proposed ASU that would make targeted improvements to the recognition, measurement, presentation, and disclosure requirements for long-duration contracts issued by insurance entities. The proposed approach would affect the assumptions used to measure the liability for future policy benefits, the measurement of market risk benefits, and the amortization of deferred acquisition costs. Comments on the proposal were due by December 15, 2016. On August 2, 2017, the Board began redeliberating the amendments and made decisions related to the liability for future policy benefits for nonparticipating traditional and limited-payment insurance contracts. | October 2016, *Insurance Spotlight*; August 4, 2017, and November 8, 2017, journal entries |
| Nonemployee share-based payment accounting improvements | On March 7, 2017, the FASB issued a proposed ASU that would simplify the accounting for share-based payments granted to nonemployees for goods and services. Under the proposal, most of the guidance on such payments would be aligned with the requirements for share-based payments granted to employees. Comments on the proposed ASU were due by June 5, 2017. | March 10, 2017, *Heads Up* |
| **Presentation and Disclosure Projects** | | |
| Simplifying the balance sheet classification of debt | On January 10, 2017, the FASB issued a proposed ASU that would reduce the complexity of determining whether debt should be classified as current or noncurrent in a classified balance sheet. Comments on the proposal were due by May 5, 2017. On June 28, 2017, the Board discussed a summary of comments received. On September 13, 2017, the Board concluded its redeliberations and directed the staff to draft a final ASU for a vote by written ballot. The FASB expects to issue this ASU in the first quarter of 2018. | January 12, 2017, *Heads Up*; September 15, 2017, journal entry |

# Appendix C — Glossary of Standards and Other Literature

The following are the titles of standards and other literature mentioned in this publication:

## AICPA Audit and Accounting Guide

*Revenue Recognition*

## FASB Accounting Standards Updates (ASUs)

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

ASU 2017-09, *Compensation — Stock Compensation (Topic 718): Scope of Modification Accounting*

ASU 2017-08, *Receivables — Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities*

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

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

ASU 2017-03, *Accounting Changes and Error Corrections (Topic 250) and Investments — Equity Method and Joint Ventures (Topic 323): Amendments to SEC Paragraphs Pursuant to Staff Announcements at the September 22, 2016 and November 17, 2016 EITF Meetings*

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 2016-13, *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 2016-02, *Leases (Topic 842)*

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

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 2015-09, *Financial Services — Insurance (Topic 944): Disclosures About Short-Duration Contracts*

ASU 2015-05, *Intangibles — Goodwill and Other — Internal-Use Software (Subtopic 350-40): Customer's Accounting for Fees Paid in a Cloud Computing Arrangement*

ASU 2015-04, *Compensation — Retirement Benefits (Topic 715): Practical Expedient for the Measurement Date of an Employer's Defined Benefit Obligation and Plan Assets*

ASU 2015-03, *Interest — Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs*

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

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*

ASU 2014-13, *Consolidation (Topic 810): Measuring the Financial Assets and the Financial Liabilities of a Consolidated Collateralized Financing Entity* — a consensus of the FASB Emerging Issues Task Force

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

## FASB Accounting Standards Codification (ASC) Topics

ASC 230, *Statement of Cash Flows*

ASC 250, *Accounting Changes and Error Corrections*

ASC 310, *Receivables*

ASC 320, *Investments — Debt and Equity Securities*

ASC 321, *Investments — Equity Securities*

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

ASC 325, *Investments — Other*

ASC 340, *Other Assets and Deferred Costs*

ASC 350, *Intangibles — Goodwill and Other*

ASC 470, *Debt*

ASC 605, *Revenue Recognition*

ASC 606, *Revenue From Contracts With Customers*

ASC 715, *Compensation — Retirement Benefits*

ASC 718, *Compensation — Stock Compensation*

ASC 720, *Other Expenses*

ASC 805, *Business Combinations*

ASC 810, *Consolidation*

ASC 815, *Derivatives and Hedging*

ASC 820, *Fair Value Measurement*

ASC 825, *Financial Instruments*

ASC 840, *Leases*

ASC 946, *Financial Services — Investment Companies*

## FASB Proposed Accounting Standards Updates

Proposed ASU 2017-310, *Technical Corrections and Improvements to Recently Issued Standards: I. Accounting Standards Update No. 2016-01, Financial Instruments — Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities and II. Accounting Standards Update No. 2016-02, Leases (Topic 842)*

Proposed ASU 2017-280, *Consolidation (Topic 812): Reorganization*

Proposed ASU 2017-240, *Consolidation (Topic 810): Targeted Improvements to Related Party Guidance for Variable Interest Entities*

Proposed ASU 2016-330, *Financial Services — Insurance (Topic 944): Targeted Improvements to the Accounting for Long-Duration Contracts*

Proposed ASU 2017-220, *Compensation — Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting*

Proposed ASU 2017-200, *Debt (Topic 470): Simplifying the Classification of Debt in a Classified Balance Sheet (Current Versus Noncurrent)*

## EITF Topic

Topic No. D-96, "Accounting for Management Fees Based on a Formula"

## SEC Final Rule

33-10233, *Investment Company Liquidity Risk Management Programs* (Rule 22e-4)

## SEC Regulation S-X

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

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

Rule 4-08, "General Notes to Financial Statements"

## SEC Staff Accounting Bulletin (SAB) Topic

SAB Topic 11.M, "Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period" (SAB 74)

## International Standards

IFRS 16, *Leases*

IFRS 15, *Revenue From Contracts With Customers*

IAS 36, *Impairment of Assets*

# Appendix D — Abbreviations

| Abbreviation | Description |
|---|---|
| **AFS** | available for sale |
| **AICPA** | American Institute of CPAs |
| **AOCI** | accumulated other comprehensive income |
| **ASC** | FASB Accounting Standards Codification |
| **ASU** | FASB Accounting Standards Update |
| **CDSC** | contingent deferred sales charge |
| **CECL** | current expected credit loss |
| **CTA** | cumulative translation adjustment |
| **DTA** | deferred tax asset |
| **EITF** | FASB's Emerging Issues Task Force |
| **ETF** | exchange-traded fund |
| **FASB** | Financial Accounting Standards Board |
| **FAQ** | frequently asked question |
| **GAAP** | generally accepted accounting principles |

| Abbreviation | Description |
|---|---|
| **IAS** | International Accounting Standard |
| **IASB** | International Accounting Standards Board |
| **IFRS** | International Financial Reporting Standard |
| **OCC** | Office of the Comptroller of the Currency (U.S. Department of the Treasury) |
| **OCI** | other comprehensive income |
| **PBE** | public business entity |
| **ROU** | right-of-use |
| **SAB** | SEC Staff Accounting Bulletin |
| **SEC** | U.S. Securities and Exchange Commission |
| **SIFMA** | Securities Industry and Financial Markets Association |
| **TRG** | transition resource group |
| **VIE** | variable interest entity |

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