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Real Estate & Construction

Accounting and Financial Reporting Update

December 22, 2017

Contents

Foreword

December 22, 2017

To our clients and colleagues in the real estate and construction sector:

We are pleased to present the 2017 edition of Deloitte's *Real Estate & Construction — Accounting and Financial Reporting Updat*e. Some of the notable standard-setting developments that occurred since the previous edition were the issuance of a standard that clarifies the definition of a business and the issuance of another standard that clarifies the scope of asset derecognition guidance and accounting for partial sales of nonfinancial assets.

In this publication, the Updates to Guidance section highlights changes to accounting and reporting standards that real estate and construction 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 annual accounting and financial reporting updates for the banking and securities, insurance, and investment management 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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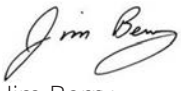

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Introduction

The real estate and construction sector is increasingly influenced by rapid technological advancements and significant demographic shifts, including growing urbanization, longevity of baby boomers, and differentiated lifestyle patterns of millennials. In addition, macroeconomic and regulatory developments continue to affect profitability. Executives have their hands full as they look to find ways to respond to these changes, gain a competitive advantage, and drive top- and bottom-line growth.

Accounting Changes

In January 2017, the FASB issued ASU 2017-01 to clarify the definition of a business in ASC 805. The standard was issued in response to stakeholder feedback that the existing definition of a business was difficult and costly to apply and was being applied too broadly. As a result of the standard, it is likely that more acquisitions will qualify as asset acquisitions rather than business combinations.

In February 2017, the FASB issued ASU 2017-05, which clarifies the scope of the recently established guidance on nonfinancial asset derecognition as well as the accounting for partial sales of nonfinancial assets, which include real estate assets. The ASU conforms the derecognition guidance on nonfinancial assets with the accounting model for transactions within the scope of the new revenue standard. Once implemented, the nonfinancial asset derecognition guidance in ASC 610-20 will govern the accounting for real estate sales.

Six months after the release of ASU 2017-05, the FASB issued ASU 2017-12, which amends the hedge accounting recognition and presentation requirements in ASC 815. This standard is intended to simplify hedge accounting as well as 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.

In addition to ASUs 2017-01, 2017-05, and 2017-12, real estate and construction entities should continue to focus on major accounting standards with approaching implementation dates. These include the new revenue recognition standard, the new leases standard, and the new standards on restricted cash and cash flow classification.

Updates to Guidance

Leases

Background

In February 2016, the FASB issued its new standard on accounting for leases, ASU 2016-02 (codified in ASC 842). The primary objective of issuing the new leases standard was to address the off-balance-sheet treatment of lessees' operating leases. The standard's lessee model requires a lessee to adopt a right-of-use (ROU) asset approach that brings substantially all leases, with the exception of short-term leases[1] (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. Although the project was a convergence effort and the boards conducted joint deliberations, there are several notable differences between the boards' respective leases standards.[2] One of the more significant differences is related to the classification of a lease by a lessee. Under the FASB's standard, an entity (lessee) is required to classify a lease as either an operating lease or a finance lease. Under the IASB's standard, however, an entity would classify all leases as finance leases.

Connecting the Dots

A lessee would include in the calculation of the ROU asset any initial direct costs related to a lease. A lessor's accounting for initial direct costs varies depending on the lease type, in a manner similar to the accounting required under current guidance. The definition of an initial direct cost, however, is more restrictive under the new standard and includes only those costs that are incremental to the arrangement and that the entity would not have incurred if the lease had not been obtained. The definition is consistent with that for incremental cost in the new revenue recognition standard (ASU 2014-09). Thus, costs such as commissions and payments made to existing tenants to obtain the lease would be considered initial direct costs. By contrast, costs such as allocated internal costs and costs to negotiate and arrange the lease agreement (e.g., professional fees such as those paid for legal and tax advice) would be excluded from the definition. As a result, practice is likely to change for many real estate lessors.

Considerations related to ASU 2016-02 are discussed below. For additional discussion about the ASU, see Deloitte's March 2016 ***Real Estate Spotlight*** (updated July 2016) and its *Heads Up* newsletters dated March 1, 2016 (updated July 12, 2016), and April 25, 2017.

Definition of a Lease and Scope of Lease Accounting Guidance

Although the FASB ultimately did not seek to significantly change the definition of a lease or the scope of its lease accounting guidance when it issued ASU 2016-02, issues related to whether certain arrangements qualify as a lease under the new leases standard have been raised. Specifically, stakeholders have questioned whether a land easement meets the definition of a lease (since it typically gives an entity the right to use or access property for a specified purpose) or whether it represents

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

an intangible asset. The FASB staff and a subset of Board members held roundtable discussions with various stakeholders to learn more about the current accounting for land easements and the perceived challenges in applying ASC 842 to these arrangements.

In response to those discussions and stakeholders' inquiries, the FASB in September 2017 issued a proposed ASU that would clarify the guidance in ASU 2016-02 by:

- Providing that an entity should first apply the guidance in ASC 842 to determine whether a land easement is or contains a lease.
- Permitting an entity to elect, as a practice expedient, not to apply the guidance in ASC 842 to land easements that existed before the effective date of ASC 842 and were not previously evaluated under ASC 840.
- Amending Example 10 in ASC 350-30-55-29 through 55-32 to clarify that an entity should apply the guidance illustrated in that example to a land easement only after concluding that the land easement does not represent a lease within the scope of ASC 842.

Comments on the proposed ASU were due by October 25, 2017.

Lease and Nonlease Components

As originally issued, ASU 2016-02 requires lessees and lessors to separate lease components and nonlease components (e.g., any services provided) in an arrangement and allocate the total transaction price to the individual components. Lessors would perform the allocation in accordance with the guidance in the new revenue standard, and lessees would do so on a relative stand-alone price basis (by using observable stand-alone prices or, if the prices are not observable, estimated stand-alone prices). However, ASU 2016-02 states that "[a]s a practical expedient, a lessee may, as an accounting policy election by class of underlying asset, choose not to separate nonlease components from lease components and instead to account for each separate lease component and the nonlease components associated with that lease component as a single lease component."

A similar practical expedient was not made available to lessors. However, the FASB received feedback from stakeholders indicating that the costs of complying with ASC 842's current separation and allocation requirements for such arrangements outweigh the benefits (i.e., when the separation and allocation guidance affects only presentation and disclosure). As a result, at the FASB's November 29, 2017, meeting, the Board tentatively decided to amend ASC 842 to provide lessors with an optional practical expedient that may be elected by class of underlying asset. We expect the FASB to issue a proposed ASU related to this tentative decision in January 2018. For further discussion of the tentative changes to the lessor's requirement to separate lease and nonlease components, see Deloitte's December 5, 2017, *Heads Up*.

Connecting the Dots

If an amount is identified as a lease component, the amount is included in the measurement of the ROU asset and liability. When evaluating whether an activity should be a separate nonlease component, an entity should consider whether the activity transfers a separate good or service to the lessee. For example, maintenance services (including common area maintenance services) and utilities paid by the lessor but consumed by the lessee would be separate nonlease components because the lessee would have been required to otherwise contract for these services separately. However, payments for property taxes or insurance would most likely not be considered a component because they do not transfer a separate good or service to the lessee and as a result should be allocated to the components identified.

Lessee Accounting

While the boards agreed that a lessee should record an ROU asset and a corresponding lease liability when the lease commences, they supported different approaches for the lessee's subsequent accounting. The FASB chose a dual-model approach under which a lessee classifies a lease by using criteria similar to the lease classification criteria currently in IAS 17. Under IAS 17, there are no "bright lines" such as those under current U.S. GAAP (e.g., the 90 percent fair value test in ASC 840). For leases that are considered finance leases (many current capital leases are expected to qualify as finance leases), the lessee would account for the lease in a manner similar to a financed purchase arrangement. That is, the lessee would recognize interest expense and amortization of the ROU asset, which typically would result in a greater expense during the early years of the lease. For leases that are considered operating leases (many current operating leases are expected to continue to qualify as operating leases), the lessee would recognize a straight-line total lease expense. For both types of leases, the lessee would recognize an ROU asset for its interest in the underlying asset and a corresponding lease liability.

Connecting the Dots

Under the FASB's dual-model approach, a lease would be classified as a finance lease if any of the following criteria are met at the commencement of the lease:

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

Each criterion except the last is essentially the same as (but not identical to) the existing lease classification criteria in ASC 840. The FASB decided to revise the criteria by eliminating their required bright-line thresholds — namely, whether the lease term is for 75 percent or more of the economic life of the asset or whether the present value of the lease payments (including any guaranteed residual value) is at least 90 percent of the fair value of the leased asset. The elimination of the bright-line thresholds could affect a lease's classification; however, the implementation guidance does allow an entity to establish a policy of consistently using the 75 percent and 90 percent thresholds in the classification test. Also, while the last criterion is new, we generally would not expect it to be met in isolation because a lessor would be likely to structure a lease that compensates for the asset's having no alternative use (thereby satisfying another criterion).

Although the classification criteria are similar to those under current U.S. GAAP, some differences affect the real estate and construction sector. First, ASU 2016-02 requires entities to account for land and other elements separately unless the effects of not doing so are immaterial (e.g., both elements, land and building, would be classified as operating leases). Under current U.S. GAAP, the lease classification of land is evaluated separately from the building if the land's fair value at lease inception is 25 percent or more of the fair value of the leased property and

the lease does not meet either the criteria related to transfer of ownership or the bargain purchase option criterion. This change may result in more bifurcation of real estate leases into separate land and building elements that are required to be (1) evaluated separately for lease classification purposes and (2) accounted for separately.

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 that is similar to the existing capital lease and operating lease models in ASC 840 and IAS 17. However, the FASB decided to align the U.S. GAAP classification requirements with the criteria in IAS 17. In addition, the FASB decided that for leases that are 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 (ASC 606).

Connecting the Dots

The inability to recognize profit on a transaction that would not have qualified as a sale under the new revenue recognition guidance is not likely to significantly affect real estate lessors since they typically do not enter into sales-type leases. However, the effect of the changes in ASU 2016-02 to conform the U.S. GAAP classification requirements to those under IFRSs may be similar to the effect discussed above for lessees. Specifically, real estate lessors may be more likely to have sales-type leases under the new guidance since there is no longer guidance specific to real estate that requires a lessor to transfer title before derecognizing an asset. In addition, the new guidance requires real estate lessors to disclose more information.

Allocating Contract Consideration Between Leases and Revenue

ASC 606 requires entities to assess whether a contract is partially within the scope of ASC 606 and partially within the scope of another ASC topic (e.g., ASC 840, ASC 842). ASC 606 also provides guidance on how to separate the components of a contract that are within the scope of different ASC topics. Separation is based on the separation guidance in the other ASC topic if such guidance exists; otherwise, separation is based on the guidance in ASC 606 (i.e., it is based on the relative stand-alone selling price). As a result, the adoption of ASC 606 could affect contracts that include both revenue and lease components.

However, the FASB clarified that an entity is not required to reallocate contract consideration between revenue and lease components when it adopts ASC 606. That is, application of the new revenue standard should affect only the accounting for the revenue components of contracts and should not affect the accounting for the lease components. For further discussion, see Section 15.2.5 of *A Roadmap to Applying the New Revenue Recognition Standard*.

Sales-Type Leases With Significant Variable Payments

Variable payments are included in the measurement of a lease only if they (1) are based on an index or rate or (2) are in-substance fixed lease payments. As a result, a lessor's initial measurement of a sales-type lease that includes a significant variable lease payment component may result in a loss at lease commencement (i.e., a day 1 loss) if the lease receivable plus the unguaranteed residual asset is less than the net carrying value of the underlying asset being leased. This could occur if payments on a lease are based entirely on the production of the underlying asset, for example. The FASB has commented that while stakeholders may disagree with the day 1 loss outcome, ASU 2016-02 is clear on how the

initial measurement guidance should be applied to sales-type leases. In addition, the Board has clarified that it would be inappropriate for a lessor to use a negative discount rate to avoid a day 1 loss when measuring a sales-type lease.

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. 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 ASU 2016-02 should include thoughtful consideration of internal controls, particularly in areas that require significant judgment. 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 about their expectations of exercising options in a lease.

Effective Date and Transition

ASU 2016-02 is effective for public business entities (PBEs) for annual periods beginning after December 15, 2018, including interim periods therein. For all other entities, the standard is effective for annual periods beginning after December 15, 2019, 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. However, at the FASB's November 29, 2017, meeting, the Board tentatively decided to amend ASU 2016-02 so that entities may elect not to restate their comparative periods in transition. Effectively, the amendment would allow entities to change their date of initial application to the beginning of the period of adoption. For more information on the proposed transition relief, see Deloitte's December 5, 2017, *Heads Up*.

Under ASU 2016-02 as initially issued, 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. However, entities may consider a transition relief package that limits the reevaluation of historical conclusions about:

- Whether any expired or existing contracts are leases or contain leases.
- The lease classification for any expired or existing leases.
- Initial direct costs for any existing leases.

An entity is permitted to elect the application of the transition relief package only if all of the package's provisions are adopted (e.g., an entity cannot revisit the lease classification of expired or existing leases but avoid evaluating the initial direct costs for existing leases). In addition, an entity cannot elect to apply the package of practical expedients only to contracts in which the entity is a lessee and not a lessor (i.e., the package is a single, entity-wide election).

Revenue Recognition

Background

In May 2014, the FASB issued ASU 2014-09 (codified primarily in ASC 606), which 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 360-20 and ASC 970-605). For additional information about ASU 2014-09 as issued, see Deloitte's *A Roadmap to Applying the New Revenue Recognition Standard*.

In response to concerns expressed to the FASB about applying the ASU's requirements, the Board in 2016 issued the following five ASUs, which amend the ASU's new revenue recognition guidance and rescind certain SEC staff guidance on revenue:

- *ASU 2016-08* — The ASU addresses issues related to how an entity should assess whether it is the principal or the agent in contracts involving three or more parties.
- *ASU 2016-10* — The ASU's amendments clarify the guidance on an entity's identification of certain performance obligations.
- *ASU 2016-11* — On the basis of SEC staff announcements at the March 3, 2016, meeting of the Emerging Issues Task Force (EITF), the ASU rescinds certain SEC staff guidance in the Codification upon an entity's adoption of ASU 2014-09.
- *ASU 2016-12* — The ASU provides narrow-scope improvements and practical expedients.
- *ASU 2016-20* — The ASU makes technical corrections (i.e., minor changes and improvements) to certain aspects of ASU 2014-09.

In 2017, the Board continued to issue amendments related to the new revenue recognition guidance, including those in the following ASUs:

- *ASU 2017-03* — The ASU, which amends certain SEC staff guidance in the Codification on the basis of SEC staff announcements at the EITF's meetings on September 22, 2016, and November 17, 2016, addresses the "additional qualitative disclosures" that an SEC registrant is expected to provide in applying the guidance in SAB Topic 11.M when it "cannot reasonably estimate the impact" that the adoption of ASUs 2014-09, 2016-02, and 2016-13 will have on its financial statements. At the September 22, 2016, meeting, the SEC staff indicated that when a registrant is unable to reasonably estimate the impact of adopting the new revenue, leases, or 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 the volume of a registrant's disclosures about the impact of adopting new standards to increase as the adoption dates approach. For more information, see Deloitte's September 2016 and November 2016 *EITF Snapshot* newsletters and its 2017 edition of *SEC Comment Letters — Including Industry Insights*.

On numerous occasions, members of the SEC staff have emphasized the importance of providing investors with transition-period disclosures in accordance with SAB 74 (codified in SAB Topic 11.M) as the new revenue standard's mandatory effective date approaches. Such disclosures should explain not only the transition method elected but also the new revenue standard's expected impact on the financial statements.

- *ASU 2017-05* — The FASB issued the ASU in response to stakeholder feedback indicating that (1) the meaning of the term "in substance nonfinancial asset" is unclear because the Board's new revenue standard does not define it and (2) the scope of the guidance on nonfinancial assets is confusing and complex and does not specify how a partial sales transaction should be accounted for or which model entities should apply.

  Specifically, ASU 2017-05:

  - Makes clear that ASC 610-20 applies to all nonfinancial assets, not only to those within the scope of ASC 350 and ASC 360, if there is no other applicable guidance. Accordingly, for each nonfinancial asset, an entity would first determine whether the transfer of the nonfinancial asset is within the scope of ASC 606, ASC 610-20, ASC 810, or any other U.S. GAAP.
  - Defines an "in substance nonfinancial asset" as "a financial asset (for example, a receivable) promised to a counterparty in a contract if substantially all of the fair value of the assets (recognized and unrecognized) that are promised to the counterparty in the contract is concentrated in nonfinancial assets." The current guidance in ASC 360-20 contains references to in-substance assets (e.g., in-substance real estate) but does not apply to transactions outside of real estate.
  - Clarifies that the unit of account is defined as a distinct nonfinancial asset. Therefore, at the inception of a contract, an entity should identify each distinct nonfinancial and in-substance nonfinancial asset in accordance with the guidance on identifying distinct performance obligations.
  - Clarifies the accounting for partial sales transactions and amends the guidance in ASC 970-323 to align it with the requirements of ASC 606 and ASC 610-20. As a result, all transfers of real estate in exchange for a noncontrolling interest in another entity should be accounted for in accordance with ASC 610-20.
  - Eliminates the guidance in ASC 845 on exchanges of nonfinancial assets for a noncontrolling interest. If the derecognition criteria are met, the noncontrolling interest received in connection with the partial sale should be measured at fair value and included in the transaction price.
  - Clarifies the guidance on measuring a gain or loss. If the derecognition criteria are met, an entity should recognize a full gain or loss on derecognition of any nonfinancial or in-substance nonfinancial assets. The entity should include in the consideration received any liability assumed (or relieved) by the counterparty (e.g., mortgage loan on the building) when determining the gain or loss on the derecognition. As discussed in the Basis for Conclusions of ASU 2017-05, the entity should account for the derecognition of the asset and assumption of the liability together and accordingly recognize a single gain or loss inclusive of any liability assumed by the counterparty. Further, the entity should account for any noncontrolling interest as noncash consideration, which should be measured at fair value in a manner consistent with the guidance on noncash consideration in ASC 606-10-32-21 through 32-24.

  As a reminder, entities will account for sales of real estate to customers under ASC 606. Entities will account for sales of real estate to noncustomers under ASC 610-20.

In addition to the above ASUs, entities should be aware of recent pronouncements and activities of the SEC staff, including the following:

- *SEC staff announcement at the July 20, 2017, EITF meeting* — The SEC staff provided significant relief to registrants that are required to include financial statements or financial information of other reporting entities in their SEC filings. Specifically, as reported in the minutes of the EITF meeting, the SEC staff announced that it would not object to elections by certain PBEs to use the non-PBE effective dates for the sole purpose of adopting the FASB's new standards on revenue (ASC 606) and leases (ASC 842). The staff announcement makes clear that the ability to use non-PBE effective dates for adopting the new revenue and leases standards is limited to the subset of PBEs "that otherwise would not meet the definition of a public business entity except for a requirement to include or the inclusion of its financial statements or financial information in another entity's filings with the SEC" (referred to herein as "specified PBEs").

  While the staff announcement is written in the context of specified PBEs, the principal beneficiaries of the relief will be SEC filers that include financial statements or financial information prepared by specified PBEs in their own filings, for example, under the following SEC Regulation S-X rules:

  - Rule 3-05, "Financial Statements of Businesses Acquired or to Be Acquired."
  - Rule 3-09, "Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons."
  - Rule 3-14, "Special Instructions for Real Estate Operations to Be Acquired."
  - Rule 4-08(g), "Summarized Financial Information of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons."

  See Deloitte's July 20, 2017, *Heads Up* for more information about the definition of a PBE.

- *The August 18, 2017, release of SAB 116* — SAB 116 provides that SAB Topic 13 will no longer be applicable when a registrant adopts ASC 606 since ASC 606 "eliminates the need for [SAB] Topic 13." In addition, SAB 116 modifies SAB Topic 11.A to clarify that "revenues from operating-differential subsidies presented under a revenue caption should be presented separately from revenue from contracts with customers accounted for under [ASC] 606." For more information about SAB 116, see Deloitte's August 22, 2017, journal entry.

Key Accounting Issues

Some of the key accounting issues and potential challenges arising from the new revenue guidance are discussed below.

Financing Arrangements (Existence of a Contract)

Under current guidance, when the seller of real estate also provides financing to the buyer, the seller must consider the buyer's initial and continuing investments in the property to determine whether they constitute a stake sufficient to ensure that the risk of loss will motivate the buyer to honor its obligation to the seller. If the specified investment requirements are not met, the seller accounts for the sale by using the installment method, the cost recovery method, or the deposit method.

Upon the adoption of ASC 606, an entity will need to evaluate several criteria to determine whether a contract exists. One particularly challenging criterion related to evaluating whether a real estate contract exists is that it must be "probable that the entity will collect the consideration to which it will be entitled." To make this determination, the entity should consider the buyer's ability and intention to pay the amount of consideration when it is due. ASC 606 does not retain the specific initial and continuing investment thresholds under current U.S. GAAP for performing this evaluation; however, some factors to consider may include the loan-to-value ratio of the property and the purchaser's intended use of the property.

Connecting the Dots

The collectibility criterion should be evaluated on the basis of the amount to which the entity expects to be entitled, which may not be the stated transaction price. For example, these two amounts may differ because an entity anticipates offering the customer a price concession. Accordingly, entities should carefully assess the facts and circumstances to determine whether, on the basis of their assessment of the customer's credit risk (for example), they expect to grant a price concession.

If a seller determines that a contract does not exist, it would account for any amounts received as a deposit (even if such payments are nonrefundable). In addition, the seller would continually evaluate the amounts received to determine whether the arrangement subsequently qualifies as a valid contract under the criteria in ASC 606. Once it becomes probable that the seller will collect the consideration to which it will be entitled, the seller would evaluate the arrangement under the derecognition criteria in ASC 606. If, instead, the contract is terminated, the seller would then recognize any nonrefundable deposits received.

Identifying Performance Obligations

Sometimes, a seller remains involved with property that has been sold (e.g., by providing additional services such as construction or development activities). Under current guidance, profit is generally deferred if a seller has continuing involvement with the sold property. Sometimes, instead of accounting for the transaction as a sale, the seller may be required to (1) apply the deposit method to the transaction or (2) account for the transaction as a financing, leasing, or profit-sharing arrangement. The current guidance focuses on whether the seller retains substantial risks or rewards of ownership as a result of its continuing involvement with the sold property.

In contrast, under ASC 606, if the arrangement includes ongoing involvement with the property, the seller must evaluate each promised good or service under the contract to determine whether it represents a "separate performance obligation," constitutes a guarantee, or prevents the transfer of control.[3] Goods and services are distinct (and considered separate performance obligations) if the two criteria in ASC 606-10-25-19 are met, including the requirement that goods or services are distinct in the context of the contract. Alternatively, an entity would bundle goods or services until they are distinct. Further, ASC 606-10-25-21 provides guidance on when goods or services would be distinct in the context of the contract. If a promised good or service is considered a separate performance obligation, an allocated portion of the transaction price should be recognized as revenue when (or as) the entity transfers control of the related good or service to the customer.

[3] Certain forms of continuing involvement would not constitute a separate performance obligation. For example, an option or obligation to repurchase a property is specifically addressed by ASC 606 and would preclude derecognition of the property. Further, a seller obligation that qualifies as a guarantee under ASC 460 would be outside the scope of ASC 606.

Connecting the Dots

After the issuance of ASU 2014-09, stakeholders questioned how real estate developers should account for contracts under which it is expected that certain amenities or common areas will be provided in a community development (to be owned either by a homeowners association or by the local municipality). Some stakeholders believed that a developer that intends to provide common areas (e.g., a community center, parks, tennis courts) to a homeowners association as part of a development would generally not consider such an arrangement to represent a promise to deliver goods or services in the separate contract to sell the real estate (e.g., a single-family home) to its other customers. That is, the agreement with the homeowners association would not be combined with the agreement to sell the real estate to a separate customer. Therefore, the arrangement with the homeowners association to provide the common areas would not be considered a performance obligation in the real estate contract with the separate customer. Others, however, believed that arrangements to develop common areas are separate performance obligations in the real estate contract with the customer to which a portion of the consideration received for the sale of real estate would be allocated and deferred until control of the common areas transfers to the homeowners association.

As part of implementation activities, the real estate and construction sector discussed this situation with standard setters and others to establish consistent application of the new revenue standard. It is our understanding that the FASB did not intend to change current practice related to these activities (i.e., generally the provision of common area items to a homeowners association would not constitute separate performance obligations). Note that ASU 2014-09 did not amend the guidance in ASC 970 that requires a developer to use a cost accrual approach upon sale of the real estate to account for costs of the common areas.

Contracts with entities in the real estate and construction sector — such as construction and engineering entities — often include deliverables that are completed over a number of phases. Such phases often are engineering, design, procurement, and construction of a facility or project. Stakeholders have raised questions and have had differing views about whether phases of a project (e.g., in typical design-and-build contracts) are distinct performance obligations or part of one combined performance obligation because they may not be distinct in the context of the contract.

Connecting the Dots

Under the new revenue standard, it may be difficult to assess whether phases of engineering, design, procurement, and construction are part of one combined performance obligation (e.g., because the phases are highly interdependent and highly interrelated or part of a significant service of integration) or are distinct performance obligations.

When identifying performance obligations, entities should consider the separability of the risks associated with delivering the various goods and services. If the risks associated with delivering the engineering and design are inseparable from the risks related to transferring the finished product, an entity may conclude that the promises in the contract represent a single performance obligation. The terms of the contract, such as acceptance terms or warranty provisions, may provide information that the entity can use to determine the risks.

Determining the Transaction Price

Under the new revenue standard, the determination of the transaction price includes an assessment of not only the stated contract price but also future events (e.g., exercise of contract options, issuance of change orders, filing of claims, or incurrence of penalty or incentive payments). For example, a sales contract may allow the seller to participate in future profits related to the underlying real estate. Under current U.S. GAAP, the amount of revenue recognized is generally limited to the amount that is not contingent on a future event. Any additional revenue would be recorded only when the contingent revenue is realized. Under ASC 606, some or all of the estimated variable consideration is included in the transaction price (and therefore eligible for recognition) to the extent that it is probable that the cumulative amount of the revenue recognized will not be subject to significant reversal (the "constraint").

Accordingly, an entity will need to estimate the portion of the contingent (or variable) consideration to include in the transaction price. As a result, revenue may be recognized earlier under ASC 606 than under current requirements.

ASC 606 also requires entities to adjust the transaction price for the time value of money when the arrangement gives either the buyer or the seller a significant benefit of financing the transfer of real estate to the buyer. In such instances, the seller will be required to adjust the promised amount of consideration to reflect what the cash selling price would have been if the buyer had paid cash for the promised property at the time control was transferred to the buyer. In calculating the amount of consideration attributable to the significant financing component, the seller should use an interest rate that reflects a hypothetical financing-only transaction between the seller and the buyer. As a practical expedient, ASC 606 does not require entities to account for a significant financing component in a contract if, at contract inception, the expected time between substantially all the payments and the transfer of the promised goods and services is one year or less.

Accordingly, if an entity enters into a contract that either requires an up-front deposit before the transaction date or gives the buyer the right to defer payments for a significant period from the transaction date, it will need to determine whether the contract's payment terms (1) give the buyer or the seller a significant benefit of financing the transfer of the real estate or (2) are intended for other purposes (e.g., to ensure full performance by the seller or the buyer).

Recognizing Revenue When (or as) Performance Obligations Are Satisfied

When evaluating whether the disposal of real estate qualifies for sale accounting under current U.S. GAAP, entities focus on whether the usual risks and rewards of ownership have been transferred to the buyer.

Under ASC 606, a seller of real estate would evaluate whether a performance obligation is satisfied (and the related revenue recognized) when "control" of the underlying assets is transferred to the purchaser.[4] An entity must first determine whether control is transferred over time or at a point in time. If control is transferred over time, the related revenue is recognized over time as the good or service is transferred. If control is transferred at a point in time, revenue is recognized when the good or service is transferred.

[4] ASC 606-10-25-25 states that "[c]ontrol of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset" and "includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset."

Under ASC 606, control of a good or service (and therefore satisfaction of the related performance obligation) is transferred over time when at least one of the following criteria is met:

- "The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs."
- "The entity's performance creates or enhances an asset . . . that the customer controls as the asset is created or enhanced."
- "The entity's performance does not create an asset with an alternative use to the entity . . . , and the entity has an enforceable right to payment for performance completed to date."

The AICPA's Engineering & Construction Contractors Revenue Recognition Task Force addressed acceptable measures of progress for contracts that meet the criteria for recognizing revenue over time. Selecting a measure of progress is not a free choice but requires an entity to select a measure that appropriately depicts the pattern of transfer. Output methods may not be appropriate when the customer can cancel for convenience and take possession of the work in process. Further, the use of a straight-line attribution method would not be appropriate when a performance obligation is not satisfied evenly throughout the period of performance; in such cases, it is likely that an input or output measure of progress will better depict the transfer of control.

Connecting the Dots

Real estate sales in most jurisdictions (including the United States) will typically not meet the criteria to be recognized as revenue over time because it is uncommon for the seller to either (1) have an enforceable right to payment for its cost plus a reasonable margin if the contract were to be canceled at any point during the construction period or (2) be legally restricted from transferring the asset to another customer, even if the contract were canceled at any point during the construction period. ASC 606 contains an example[5] in which a real estate developer enters into a contract to sell a specified condominium unit in a multifamily residential complex once construction is complete. In one scenario in this example, the seller does recognize revenue over time; however, the example indicates that this conclusion is based on legal precedent in the particular jurisdiction where the contract is enforceable.

If a performance obligation does not meet any of the three criteria for recognition over time, it is deemed satisfied at a point in time. Under ASC 606, entities would consider the following indicators in evaluating the point in time at which control of real estate has been transferred to the buyer and when revenue should be recognized:

- "The entity has a present right to payment for the asset."
- "The customer has legal title to the asset."
- "The entity has transferred physical possession of the asset."
- "The customer has the significant risks and rewards of ownership of the asset."
- "The customer has accepted the asset."

[5] ASC 606-10-55-173 through 55-182.

While entities will be required to determine whether they can derecognize real estate by using a control-based model rather than the risks-and-rewards model under current U.S. GAAP, the FASB decided to include "significant risks and rewards" as a factor for entities to consider in evaluating the point in time at which control of a good or service is transferred to a customer. Accordingly, although a seller of real estate would evaluate legal title and physical possession to determine whether control has transferred, it should also consider its exposure to the risks and rewards of ownership of the property as part of its "control" analysis under ASC 606.[6]

Contract Modifications and Claims

Entities in the real estate and construction sector that are involved with construction and engineering projects should consider how ASC 606 may affect the accounting for contract modifications, including unpriced change orders and claims. Examples of items that an entity will need to carefully assess before recognizing revenue related to such modifications include whether (1) the customer has approved scope or price changes and (2) the entity has an enforceable right to additional consideration (i.e., whether it has a legal basis for its claim). Examples such as these may indicate that the entity should include the change order or claim in its transaction price (i.e., as variable consideration under step 3 of the new revenue model) to the extent that it is probable that such an amount is not subject to significant revenue reversal in the future (i.e., the variable consideration constraint).

Other Issues That May Be Affected by the Adoption of the New Revenue Standard

Other issues that will often require significant judgment under ASC 606 and may result in a change from current practice for entities in the real estate and construction sector (particularly engineering and construction entities) include the following:

- The treatment of uninstalled materials (specifically, whether uninstalled materials should be included in an entity's measure of progress).
- Gross versus net presentation of revenue (i.e., whether an entity is the principal or the agent in a transaction involving three or more parties). Note that although the guidance states that this assessment is performed for each "specified good or service," such term is not meant to imply that the assessment is performed at a level that is more granular than the performance obligation.[7]
- Application of variable consideration guidance to milestone payments and what are commonly referred to in the real estate and construction sector as "extras," "add-ons," and "back charges."
- The types and amounts of costs that would meet the recognition criteria for capitalizing precontract costs.

These and other issues are the subject of papers drafted by the AICPA's revenue recognition task forces. Implementation issues identified and addressed by the AICPA's Engineering & Construction Contractors Revenue Recognition Task Force are listed on the AICPA's Web site. For more information, see Chapter 11 of the AICPA Audit and Accounting Guide *Revenue Recognition*.

[6] An entity would not consider parts of a contract that are accounted for under guidance outside of ASC 606 (e.g., guarantees within the scope of ASC 460) when determining whether control of the remaining goods and services in the contract has been transferred to a customer.

[7] The Basis for Conclusions of ASU 2016-08 clarifies that the FASB and IASB did not intend for their use of the term "specified good or service" to imply that the assessment needs to be made for activities at a more granular level. Specifically, paragraph BC10 of ASU 2016-08 states that the boards chose to use this term "because use of the term *performance obligation* would have been confusing if the entity is an agent. An agent's performance obligation is to arrange for the other party to provide its goods or services to the customer; [the agent] does not promise to provide the goods or services itself to the end customer. Accordingly, the specified good or service to be provided to the end customer is not the performance obligation of the agent."

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, the new revenue standard is effective for 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 new revenue 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.

Implementation and Transition Activities

A number of groups are involved in implementation activities related to the new standard, including the TRG (see Appendix D of Deloitte's *A Roadmap to Applying the New Revenue Recognition Standard*), the AICPA's revenue recognition task forces (e.g., the Engineering & Construction Contractors Revenue Recognition Task Force, information about which is available on the AICPA's Web site), various firms, the SEC, and the PCAOB. Preparers should continue to monitor the activities of these groups before adoption of the new guidance.

Connecting the Dots

Entities in the real estate and construction sector will need to reassess their historical accounting for all real estate disposals and construction contracts to determine whether any changes are necessary. They will also need to consider the guidance in ASU 2014-09 when accounting for repurchase options (the seller may be required to account for the transaction as a lease, a financing, or a sale with a right of return). In addition, they will be required to consider the guidance on partial sales in ASU 2017-05, which states that (1) any retained noncontrolling interest in a partial sale would be recorded at fair value and (2) the unit of account in the evaluation of whether control has transferred in a partial sale would be the distinct underlying asset(s). Further, entities will most likely be required to dual track revenue balances during the transition period given the potential difficulty associated with retroactively recalculating revenue balances when the new revenue standard becomes effective.

As a reminder, an entity will be required upon adoption to provide significantly expanded disclosures about revenue recognition, including both quantitative and qualitative information. Specifically, an entity will need to disclose (1) the amount, timing, and uncertainty of revenue (and related cash flows) from contracts with customers; (2) the judgment, and changes in judgment, used in the application of the revenue model; (3) the assets recognized from costs to obtain or fulfill a contract with a customer; and (4) information about unsatisfied performance obligations, including (a) the "aggregate amount of the transaction price allocated to the [unsatisfied] performance obligations" and (b) an "explanation of when the entity expect[ed] to recognize" that amount as revenue. To comply with the accounting and disclosure requirements, entities in the real estate and construction sector may want to consider whether they need to modify their systems, processes, and controls for gathering and reviewing information that may not have previously been monitored.

Business Combinations

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 was issued 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.

ASU 2017-01:

- 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 be consistent with how outputs are described in ASC 606.

Connecting the Dots

The ASU could significantly affect the real estate 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. For more information, see Deloitte's *A Roadmap to Accounting for Asset Acquisitions*.

"Single Identifiable Asset" or "Group of Similar Identifiable Assets" Screen

Under ASU 2017-01, if substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or a group of similar identifiable assets, the set would not be considered a business. Gross assets acquired would exclude cash and cash equivalents, DTAs, and goodwill resulting from the effects of DTLs. 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.

In the determination of gross asset concentration, a tangible asset that is attached to another tangible asset and cannot be physically removed and used separately from the other tangible asset without incurring significant cost or significant diminution in utility or fair value to either of the assets (e.g., land and building) would qualify as a single identifiable asset. The FASB also indicated that while tangible and intangible assets should generally not be combined, an in-place lease intangible asset, including any favorable and unfavorable intangible asset or liability, and the related real estate asset would qualify as a single identifiable asset.

Connecting the Dots

The introduction of a gross asset concentration threshold is likely to have a significant effect on the real estate industry since under the revised definition of a business, an entity is likely to consider fewer real estate transactions to be a business. Under previous guidance, the acquisition of property with an in-place lease would have been considered a business combination. However, under ASU 2017-01, even if the screen is not met, the acquisition of property with an in-place lease would be considered a single asset and would be accounted for as an asset acquisition.

Input and Substantive Process Requirement

ASU 2017-01 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), 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." ASU 2017-01 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

ASU 2017-01 is effective for public business entities 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 about ASU 2017-01, see Deloitte's January 13, 2017, *Heads Up*.

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 ASU 2017-04

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.

ASU 2017-04 does not change the qualitative assessment;[8] 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. Paragraph BC50 of ASU 2017-04 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." Further, paragraph BC51 of ASU 2017-04 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."

[8] 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.

ASU 2017-04 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.

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 ASU 2017-04 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,[9] ASU 2017-04 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.

Connecting the Dots

In January 2017, the FASB issued ASU 2017-03, which codified SAB Topic 11.M. This ASU requires SEC registrants to disclose the effect of new accounting standards that have been issued but are not yet effective. Further, if a new standard is adopted in an interim period, the adopting registrant must comply with all of the standard's disclosure requirements in addition to providing required transitional disclosures and those disclosures required by ASC 250 and ASC 270.

[9] 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 not included within this definition."

SEC filers do not include entities that are not otherwise SEC filers whose financial statements or financial information is required to be or is included in another entity's 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 of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons").

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 in ASU 2016-18 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 is permitted. A reporting entity will apply the guidance retrospectively.

Connecting the Dots

In August 2016, the FASB issued ASU 2016-15, which amends ASC 230 to add or clarify guidance on the classification of certain cash receipts and payments in the statement of cash flows. The ASU adds or clarifies guidance on items such as (1) debt prepayment or debt extinguishment costs, (2) contingent consideration payments made after a business combination, and (3) distributions received from equity method investees. See Deloitte's August 30, 2016, *Heads Up* for more information.

Financial Instruments

Credit Losses

Background

In June 2016, the FASB issued ASU 2016-13,[10] 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 (EIR) under the CECL model:
  - *Implementation issues* — Stakeholders have questioned whether an entity that applies a discounted cash flow (DCF) method under the CECL guidance to discount the expected cash flows should use the same EIR it applied to recognize interest income in accordance with ASC 310-20.
  - *Outcome* — The TRG generally agreed that entities should be given the choice, through an accounting policy election, of whether they would like to use a prepayment-adjusted EIR when applying a DCF method under the CECL guidance. Further, entities should make this accounting policy election at the "class of financing receivable" level (as defined in the ASC master glossary). Upon making the accounting policy election, entities should update the adjusted EIR periodically to match any changes in expected prepayments.
- Scope of the guidance on purchased financial assets with credit deterioration ("PCD assets") for beneficial interests accounted for under ASC 325-40:
  - *Implementation issues* — For purchased or retained beneficial interests that are (1) within the scope of ASC 325-40 and (2) classified as available for sale (AFS) or held to maturity, the ASU provides that entities should measure an impairment allowance the same way they measure PCD assets if the beneficial interest meets the definition of a PCD asset or there is a significant difference between the contractual cash flows and expected cash flows of the beneficial interest. Stakeholders have raised implementation questions regarding the scope of the PCD asset guidance on beneficial interests in ASC 325-40. For example, they have asked about (1) the meaning of "contractual cash flows" in ASC 325-40-30-1A(a) and (2) whether prepayment expectations can be included in those contractual cash flows.

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

  - *Outcome* — The TRG generally agreed that if contractual cash flows of a security are not specified, an entity should look through to the contractual cash flows of the underlying assets and include an estimate of prepayments to determine whether the security should be considered a PCD asset. The TRG generally agreed that this approach would appropriately isolate credit risk. In addition, the TRG generally agreed that the initial allowance should reflect only credit-related factors and not estimated prepayments.

- Applying the transition guidance to pools of purchased credit-impaired assets under ASC 310-30:
  - *Implementation issues* — While the transition guidance in ASU 2016-13 permits entities to elect to maintain pools of loans accounted for under ASC 310-30, the ASU is unclear about the extent to which entities may continue to apply the guidance in ASC 310-30 to the pools. Stakeholders have raised implementation questions regarding application of the transition guidance for pools of purchased credit-impaired assets within the scope of ASC 310-30. For example, they have asked about (1) the level of relief the FASB intended to give entities in transition under ASC 326-10-65-1, which states that an "entity may elect to maintain pools of loans accounted for under Subtopic 310-30 at adoption," and (2) whether the election is permitted only at transition or is also permitted in subsequent periods.
  - *Outcome* — The TRG generally acknowledged that allowing companies to make a policy election to apply the transition guidance in ASC 310-30 either at adoption or at adoption and in subsequent periods would address those stakeholders' questions. That is, entities would have the choice of either maintaining their existing pools accounted for under ASC 310-30 at adoption only or doing so on an ongoing basis after adoption of the ASU.
- Accounting for troubled debt restructurings (TDRs) under the CECL model:
  - *Implementation issues* — ASU 2016-13 requires an entity to forecast reasonably expected TDRs with a borrower and incorporate them into its estimate of expected credit losses. Specifically, ASC 326-20-30-6 states that an "entity shall not extend the contractual term for expected extensions, renewals, and modifications unless it has a reasonable expectation at the reporting date that it will execute a troubled debt restructuring with the borrower." Given this guidance, stakeholders have asked questions regarding the nature of TDRs that must be considered in the estimate (e.g., contractual term extensions, interest rate concessions), when and how to consider TDRs in the estimate, and whether to consider reasonably expected TDRs on a portfolio basis or at an individual-financial-asset level.
  - *Outcome* — The TRG did not agree on how to appropriately consider reasonably expected TDRs in an entity's estimate of credit losses under the ASU. As a result, the FASB staff subsequently performed additional analysis on the interaction between TDRs and expected credit losses, which was presented to the FASB at the Board's September 6, 2017, meeting. During that meeting, the FASB clarified when a creditor would recognize a TDR and how the creditor would measure the effects of the restructuring. Specifically, the FASB indicated that the ASU's guidance on TDRs was intended to accelerate the recognition of an economic concession granted in a TDR from when the TDR is executed (as required under existing U.S. GAAP) to when the TDR is reasonably expected. Consequently, the allowance for expected credit losses should include all effects of a TDR when an individual asset can be specifically identified as a reasonably expected TDR.

    In addition, the FASB acknowledged that depending on the nature of the economic concession granted in a TDR, the allowance for expected credit losses may not include the effects of the concession. For example, an entity's allowance for expected credit losses may not include the effects of the interest rate concession if the entity measures its allowance by using a principal-only loss rate approach. Because ASU 2016-13 requires an entity to include

all effects of TDRs in its allowance for expected credit losses, the FASB indicated that an entity must use a DCF method if the TDR involves a concession that can only be measured under a DCF method (e.g., an interest rate or term concession).

These clarifications are included in TRG Memo 6A, an addendum to the summary of the TRG's June 12, 2017, meeting.

- Estimating the life of a credit card receivable under the CECL model:
  - *Implementation issues* — ASU 2016-13 requires entities to determine the allowance for loan losses on financial assets on the basis of management's current estimate of expected credit losses on financial assets that exist as of the measurement date. Regardless of the method entities use to estimate expected credit losses, they must carefully consider all amounts expected to be collected (or not collected) over the life of the financial asset. Given the revolving nature of credit card lending arrangements, stakeholders have questioned how credit card issuers should determine the life of a credit card account balance to estimate expected credit losses.

    In addition, under the CECL model, an allowance must not include expected losses on "unconditionally cancellable loan commitments." Because credit card lines are unconditionally cancelable, expected losses on future draws are not to be accrued before such amounts are drawn. Accordingly, some stakeholders believe that an entity should apply a customer's expected payments only to funded commitments as of the measurement date when modeling the repayment period of the measurement date receivable. That is, an entity would estimate the life of a credit card receivable without considering the impact of future draws that are unconditionally cancelable.
  - *Outcome* — The TRG did not agree on how to appropriately consider the application of expected principal payments received after the measurement date under the ASU. As a result, the FASB staff subsequently performed additional analysis, which was presented to the FASB at the Board's October 4, 2017, meeting. During that meeting, the FASB discussed and agreed on two potential methods that entities may use to determine estimated expected future payments on credit card receivables: (1) "[i]nclude all payments expected to be collected from the borrower" or (2) "[i]nclude only a portion of payments expected to be collected from the borrower."[11]

    The FASB discussed the flexibility that entities have under the ASU when developing appropriate methods to estimate expected credit losses. It clarified that using either method to estimate future payments is acceptable and that an entity should consistently apply the selected method to similar facts and circumstances. The FASB also acknowledged that an entity may use other methods to estimate future payments. Further, the FASB stated that the determination of the appropriate method an entity will use to estimate the amount of expected future payments is separate from the determination of how to allocate the future payments to credit card balances.

    These clarifications are included in TRG Memo 6B, an addendum to the summary of the TRG's June 12, 2017, meeting.

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

[11] Quoted from the tentative Board decisions on the FASB's Web site.

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.

Ongoing Discussions

Industry groups, accounting firms, standard setters, and regulators are engaged in ongoing discussions of issues related to the implementation of ASU 2016-13, including (1) the identification of financial instruments that are potentially eligible for zero credit losses, (2) the determination of 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.

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 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 investment would be measured at cost less impairment, if any, plus or minus observable price changes in orderly transactions. This measurement alternative would not be available to reporting entities that are investment companies, broker-dealers, 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

Under current U.S. GAAP, marketable equity securities that are not accounted for as equity method investments are classified as either (1) held for trading, with changes in fair value recognized in earnings, or (2) AFS, with changes in fair value recognized in other comprehensive income (OCI). For AFS investments, changes in fair value are accumulated in OCI and not recognized in earnings until the investment is sold or has an other-than-temporary impairment. Investments in nonmarketable equity securities other than equity method investments are measured at cost (less impairment) unless the fair value option is elected. Under the new guidance, since equity securities can no longer be accounted for as AFS or cost method investments and will need to be recorded at fair value with changes in fair value recorded through earnings, real estate entities holding such investments could see more volatility in earnings under the new guidance.

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

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

Valuation Allowance on a DTA Related to an AFS Debt Security

The new guidance eliminates the diversity in practice related to the evaluation of the need for a valuation allowance for DTAs related to debt securities that are classified as AFS. Under current U.S.

GAAP, entities may perform this evaluation either separately from their other DTAs or in combination with them. The new guidance clarifies that an entity should "evaluate the need for a valuation allowance on a [DTA] related to [AFS] securities in combination with the entity's other [DTAs]."

Changes to Disclosure Requirements

For 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 would not be required to disclose (1) the information related to the methods and significant assumptions used to estimate fair value or (2) a description of the changes in the methods and significant assumptions used to estimate fair value. The guidance also clarifies U.S. GAAP by eliminating the provisions in ASC 825 that had been interpreted to permit an "entry" price notion for estimating the fair value of loans for disclosure purposes. The amendments require a PBE to disclose the fair value in accordance with the exit price notion in ASC 820. In addition, all entities are required to 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.

Hedging

Background

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

For PBEs, 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[12] will make that entity's risk management activities and their effect on the financial statements more transparent to financial statement users.

[12] 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.

Under this rationale, even a portion of the change in a hedging instrument's fair value that is excluded from a hedging relationship's effectiveness assessment is considered part of the hedging relationship and should be recognized in the same income statement line item as the earnings effect of the hedged item (other than amounts excluded from the assessment of effectiveness of net investment hedges). However, in a departure from the proposed ASU that formed the basis for the guidance in ASU 2017-12, the Board determined that presentation should not be prescribed for "missed forecasts" in cash flow hedges. Thus, an entity that ultimately determines that it is probable that a hedged forecasted transaction will not occur will not be required to record the amounts reclassified out of 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 OCI (or, for net investment hedges, the cumulative translation adjustment (CTA) portion of OCI) any difference between (1) the change in fair value of the excluded component and (2) the amount recognized in earnings under that systematic and rational method.

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

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

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

(Table continued)

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

(Table continued)

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

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 ASU 2017-12, 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, the ASU 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, ASU 2017-12 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 adoption of ASU 2017-12, 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

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

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

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

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

Connecting the Dots

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

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 guidance in ASU 2017-12 by applying a modified retrospective approach to existing hedging relationships[13] 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.

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 ASU 2017-12'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.

Ongoing Discussions

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

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.

[13] 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.

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 (DACs) 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.

Connecting the Dots

Under ASU 2017-08, 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. Early 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.

Employee Share-Based Payment Accounting Improvements

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 provisions of ASU 2017-09 (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 ASU 2017-09

Scope of Modification Accounting

ASU 2017-09 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 ASU 2017-09, 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 Basis for Conclusions of ASU 2017-09 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 • 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 • Changes in a service condition • Changes in a performance condition or a market condition • Changes in an award that result in a reclassification of the award (equity to liability or vice versa) • 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, ASU 2017-09 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 amendments in ASU 2017-09 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.

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 were due by December 4, 2017.	November 8, 2016, and March 14, 2017, journal entries; October 5, 2017, *Heads Up*
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 amend the accounting and disclosure model under U.S. GAAP for certain long-duration insurance contracts. The Board believes that its proposal will improve the following aspects of financial reporting for long-duration insurance contracts: • Measurement of the liability for future policy benefits for certain types of long-duration insurance contracts. • Measurement and presentation of market risk benefits. • Amortization of DAC. • Presentation and disclosures. The proposed amendments would not change the scope of ASC 944. Therefore, they would not change the types of entities that are subject to the long-duration insurance contract accounting and disclosure guidance in ASC 944. Comments on the proposal were due by December 15, 2016. A public roundtable was held in April 2017, and the Board began its redeliberations in August 2017. In redeliberations, the Board tentatively reaffirmed key aspects of the proposed accounting model related to the liability for future policy benefits, including the requirement for an insurer to calculate and record the effect of updating cash flow assumptions on a catch-up basis in net income; however, the Board tentatively decided to limit the application of that model to nonparticipating traditional and limited-payment contracts. The Board also tentatively decided that an insurer should discount the future cash flows by using a current upper-medium grade (low credit risk) fixed-income instrument yield. In addition, the Board tentatively decided to (1) retain the existing accounting model for participating insurance contracts (although changes to the DAC amortization model would also apply to such contracts), (2) expand the scope of the market risk benefit accounting model to include general account deposit (or account balance) products, and (3) revise certain disclosure requirements. Further, the Board changed the proposed transition provisions to require an insurer to apply the proposed amendments to all contracts in force on the basis of their existing carrying amounts as of the transition date and updated future assumptions (adjusted to remove any related amounts in AOCI); however, the insurer could elect to apply a retrospective transition method (with a cumulative catch-up adjustment to opening retained earnings) by using actual historical experience as of contract inception. Insurers that elect to apply a retrospective transition method to the liability for future policy benefits would also need to apply a retrospective transition method to their DAC. The Board has not yet deliberated the effective date of a final ASU. All of these tentative decisions are subject to change in further redeliberations. It is anticipated that a final standard will be issued in 2018.	October 2016, *Insurance Spotlight*; August 4, 2017, and November 8, 2017, journal entries

(Table continued)

Project	Status and Next Steps	Deloitte Resources
Recognition and Measurement Projects		
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 2017-05, *Other Income — Gains and Losses From the Derecognition of Nonfinancial Assets (Subtopic 610-20): Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets*

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

ASU 2017-03, *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 326, *Financial Instruments — Credit Losses*

ASC 340, *Other Assets and Deferred Costs*

ASC 350, *Intangibles — Goodwill and Other*

ASC 360, *Property, Plant, and Equipment*

ASC 405, *Liabilities*

ASC 460, *Guarantees*

ASC 605, *Revenue Recognition*

ASC 606, *Revenue From Contracts With Customers*

ASC 610, *Other Income*

ASC 718, *Compensation — Stock Compensation*

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 842, *Leases*

ASC 860, *Transfers and Servicing*

ASC 944, *Financial Services — Insurance*

ASC 970, *Real Estate — General*

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 2017-290, *Leases (Topic 842): Land Easement Practical Expedient for Transition to 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 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)*

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

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

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

SEC Staff Accounting Bulletin (SAB) Topic

SAB Topic 11.A, "Operating-Differential Subsidies"

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)

SAB Topic 13, "Revenue Recognition"

SAB 116

International Standards

IFRS 16, *Leases*

IAS 36, *Impairment of Assets*

IAS 17, *Leases*

Appendix D — Abbreviations

Abbreviation	Description
AFS	available for sale
AICPA	American Institute of Certified Public Accountants
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
DAC	deferred acquisition cost
DCF	discounted cash flow
DTA	deferred tax asset
EIR	effective interest rate
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
PCD asset	purchased financial asset with credit deterioration
ROU	right-of-use
SAB	SEC Staff Accounting Bulletin
SEC	U.S. Securities and Exchange Commission
SIFMA	Securities Industry and Financial Markets Association
TDR	troubled debt restructuring
TRG	transition resource group
VIE	variable interest entity