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January 15, 2016

To our clients and colleagues in the real estate sector:

We are pleased to announce our eighth annual accounting and financial reporting update. Some of the notable standard-setting developments that occurred since the previous edition were (1) the issuance of new guidance on the consolidation framework and amendments to the classification and measurement of financial instruments and (2) the continued work of the FASB on accounting for leases and financial instruments, the definition of a business, and simplification.

This publication is divided into three sections: (1) “Updates to Guidance,” which highlights changes to accounting and reporting standards that real estate entities need to start preparing for now; (2) “On the Horizon,” which discusses standard-setting topics that will affect real estate entities as they plan for the future; and (3) “Other Topics” that may be of interest to entities in the real estate sector.

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, Deloitte’s Web site for accounting and financial reporting news.

In addition, don’t miss the ninth edition of our SEC Comment Letters — Including Industry Insights — What “Edgar” Told Us, which discusses our perspective on topics the SEC staff has focused on in comment letters issued to registrants over the past year, including an analysis of comment letter trends in each financial services sector.

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

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Introduction

The real estate market continued its modest recovery from 2013 into 2015. Through late 2015, gains in the national home price index were modest compared with the double-digit growth seen in 2013. Factors contributing to the continued increase in home prices include shrinking unemployment, low mortgage rates, and rising income for consumers. The commercial real estate market has also seen steady increases in value over the past five years. Companies have turned the page from the 2008–2009 collapse and are now focused on potential disruptions that may affect the industry’s future. Industry leaders are increasingly thinking about longer-term strategic issues and how they can stay ahead of the potential disruptions.

Economic Growth by Major Group

Commercial Real Estate

In 2009 and 2010, rental revenues in the commercial real estate industry declined dramatically because of weakened demand for commercial spaces. The U.S. markets are recovering on the backs of stronger economic fundamentals and, most importantly, falling unemployment. In 2015, revenues increased marginally, resulting in a five-year compound average revenue growth rate of about 3 percent. However, many factors could constrain long-term increases, including rises in mobility, cloud computing, urbanization, e-commerce, and the war for talent.

Growth in REITs

REIT1 fundraising has been increasing in recent years. REIT IPOs have been at their highest level (in terms of number and value of transactions) since 2005 and have involved both traditional and nontraditional real estate asset classes (e.g., single-family rentals, cell towers, billboards, data centers, and storage facilities). The volume of REIT conversions and spin-offs continues to increase such that the IRS has put entities that own nontraditional real estate on notice that it has decided to study the definition of “real estate” in the context of REIT conversions.

Property Management

As a result of the economic downturn in 2008 and 2009, rental vacancy rates decreased as more consumers opted to rent rather than purchase. Depending on geographies and asset class, demand for office and industrial space continues to be mixed as entities have reduced their workforces, closed operations, or expanded through growth opportunities. Nationally, growth in property management was strong in 2015 and is forecasted to remain so.

Accounting Changes

During 2015, the FASB issued ASU 2015-02,2 which amends the consolidation guidance in ASC 810 and contains new requirements for assessing whether a decision maker’s fee is a variable interest and whether an entity is a variable interest entity. The ASU also eliminates the guidance on evaluating limited partnerships that are not variable interest entities by incorporating the concepts from ASC 810-20 into the general consolidation requirements. See the Consolidation section below for a discussion of key accounting issues and potential challenges related to limited partnerships and similar entities. For a comprehensive discussion of the new guidance, see Deloitte’s Consolidation — A Roadmap to Identifying a Controlling Financial Interest.

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1 For a list of abbreviations used in this publication, see Appendix B.
2 For the full titles of standards, topics, and regulations referred to in this publication, see Appendix A.
On January 5, 2016, the FASB issued ASU 2016-01, which amends the guidance on the classification and measurement of financial instruments. The new standard significantly revises an entity’s accounting related to (1) investments in equity securities and (2) the presentation of certain fair value changes for financial liabilities measured at fair value. It also amends certain disclosure requirements associated with the fair value of financial instruments. See the Classification and Measurement section below for a discussion of the key changes as a result of the ASU.

In addition, over the past few years the FASB has issued ASUs as part of its simplification initiative on topics including discontinued operations, extraordinary items, debt issuance costs, and private-company accounting alternatives for goodwill and acquired intangibles. Items on the horizon include the implementation of the new revenue recognition standard and the release of new standards on leasing, impairment, hedging of financial instruments, and the definition of a business. Real estate entities should continue to monitor the progress on these projects.

For additional information about industry issues and trends, see Deloitte’s 2015 Financial Services Industry Outlooks.
Updates to Guidance
Revenue Recognition

Background
In May 2014, the FASB and IASB issued their final standard on revenue recognition. The standard, issued as ASU 2014-09 by the FASB and as IFRS 15 by the IASB, outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance (e.g., certain sections of ASC 360-20 and ASC 970-605). Financial instruments within the scope of other Codification topics (e.g., the recognition of interest income and dividends) are excluded from the ASU’s scope. For additional information about ASU 2014-09 as issued, see Deloitte’s May 28, 2014, Heads Up and July 2014 Financial Services Spotlight.

In response to concerns received by the FASB related to applying the new revenue recognition requirements, the Board issued the following three proposed ASUs in 2015 (currently in different stages of consideration), which would revise the new revenue recognition guidance in ASU 2014-09:1

- **Principal Versus Agent Considerations (Reporting Revenue Gross Versus Net)** — The proposal would address issues related to how an entity should assess whether it is the principal or the agent in contracts that include three or more parties. Guidance would include (1) how to determine the unit of account, (2) whether the indicators in ASU 2014-09 are intended to help entities perform a single evaluation of control or represent an additional evaluation, and (3) how certain indicators are related to the general control principle. The proposal would also clarify that an entity should evaluate whether it is the principal or the agent for each good or service specified in a contract and thus whether an entity could be both the principal and agent for different performance obligations in the same contract. See Deloitte’s September 1, 2015, Heads Up for more information.

- **Identifying Performance Obligations and Licensing** — The proposed amendments would clarify the guidance on an entity’s identification of certain performance obligations. Proposed changes include guidance on immaterial promised goods and services and separately identifiable promises as well as (1) a policy election for shipping and handling fees incurred after control transfers and (2) clarifications related to licenses. The FASB directed its staff to draft a final ASU at its October 5, 2015, meeting. See Deloitte’s May 13, 2015, Heads Up and October 8, 2015, journal entry for more information.

- **Narrow-Scope Improvements and Practical Expedients** — The proposed guidance would (1) clarify how to assess whether collectibility is probable in certain circumstances to support the existence of a contract, (2) add a practical expedient for the presentation of sales taxes on a net basis in revenue, (3) clarify how to account for noncash consideration at contract inception and throughout the contract period, and (4) establish a practical expedient to address contract modifications upon transition. See Deloitte’s October 2, 2015, Heads Up for more information.

Thinking It Through
ASU 2014-09 will significantly affect the accounting for real estate sales. The ASU eliminates the bright-line guidance that entities currently apply under ASC 360-20 when evaluating when to derecognize real estate assets and how to measure the profit on the disposal. It will change the accounting for both real estate sales that are part of an entity’s ordinary activities (i.e., real estate transactions with customers) and real estate sales that are not part of the entity’s ordinary activities. While the ASU eliminates the guidance in ASC 360-20 on real estate sales, entities will still need to apply ASC 360-20 to sales of real estate that are part of sale-leaseback transactions, at least until the FASB has completed its project on leasing.

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1 The IASB’s July 2015 ED also proposes changes to IFRS 15.
Key Accounting Issues
Some of the key accounting issues and potential challenges as a result of 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.

Under ASU 2014-09, 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. The ASU 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.

Thinking It Through
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 ASU’s criteria. 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 the ASU. If, instead, the contract is terminated, the seller would then recognize any nonrefundable deposits received as a gain.

Identifying Performance Obligations
Sometimes, a seller remains involved with property that has been sold. 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 the ASU, 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.2 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.

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2 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 the ASU 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 the ASU.
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 the related good or service to the customer.

**Thinking It Through**

Different views currently exist on 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). For example, we believe 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, believe 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. We understand that the industry is in discussions with standard setters and others to establish consistent application of the revenue standard in these situations. Note that the ASU 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 industry — 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.

**Thinking It Through**

Under the new 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 dependent and highly interrelated or part of a significant service of integration) or are distinct performance obligations. Such difficulty may also affect the way revenue is recognized (e.g., point in time or over time and the measure of progress if revenue is recognized over time). Accordingly, entities will need to exercise significant judgment and consider the specific facts and circumstances of each contract. Entities are also encouraged to follow the FASB’s standard-setting activities, particularly the proposed changes to identifying performance obligations mentioned above.

**Determining the Transaction Price**

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 the ASU, 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, which may be recognized up front. As a result, revenue may be recognized earlier under the ASU than under current requirements.
The ASU also requires entities to adjust the transaction price for the time value of money when the arrangement provides either the buyer or the seller with 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, the ASU does not require entities to account for a significant financing component in a contract if, at contract inception, the expected time between substantially all of 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 the ASU, 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. 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.

Under ASU 2014-09, 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.”

Thinking It Through

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. The ASU contains an example 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.

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1 ASC 606-10-25-25 (added by the ASU) 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.”

4 ASC 606-10-55-173 through 55-182.
If a performance obligation does not meet any of the three criteria for recognition over time, the performance obligation is deemed satisfied at a point in time. Under the ASU, 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.”

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 the ASU.5

Contract Modifications and Claims

Real estate entities that are involved with construction and engineering projects should consider how the ASU 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 or (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).

**Thinking It Through**

Compared with current guidance, adoption of the ASU may result in the acceleration of revenue related to claims and unapproved change orders.

Other issues that are often subject to significant judgment under the ASU and may affect real estate entities (particularly engineering and construction entities) include (1) the treatment of uninstalled materials; (2) gross versus net presentation of revenue (i.e., whether an entity is the principal or agent in a transaction with three or more parties); (3) the identification and recording of significant financing components (i.e., time value of money considerations) and warranties; (4) application of variable consideration guidance to milestone payments and what are commonly referred to in the real estate industry as “extras,” “add-ons,” and “back charges”; and (5) the types and amounts of costs that would meet the recognition criteria for recording precontract costs.

**Effective Date and Transition**

In August 2015, as a result of stakeholder concerns, the FASB issued ASU 2015-14,6 which delays the effective date of ASU 2014-09. Accordingly, the ASU is effective for public business entities 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.

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5 An entity would not consider parts of a contract that are accounted for under guidance outside the ASU (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.

6 The IASB amended IFRS 15 a month later to delay its effective dates.
For nonpublic entities, the standard is effective for annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019. Nonpublic entities can also elect to early adopt the standard as of the following:

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

Implementation and Transition Activities

A number of groups are actively involved in implementation activities related to the new standard, including the TRG (see Deloitte’s TRG Snapshot), the AICPA’s revenue recognition task forces (including the Construction Contractors Revenue Recognition Task Force and the Timeshare Entities Revenue Recognition Task Force), various firms, the SEC, and the PCAOB. Preparers should continue to monitor the activities of these groups before their adoption of the new guidance.

Thinking It Through

Real estate entities will need to reassess their historical accounting for all real estate disposals and construction contracts to determine whether any changes are necessary. In addition to the issues discussed above, real estate entities will need to consider the ASU’s guidance 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). Real estate entities will also need to consider any guidance issued as a result of the FASB’s current project on partial sales. Under that project, the FASB has tentatively decided that any retained noncontrolling interest in a partial sale would be recorded at fair value, and the unit of account in the evaluation of whether control has transferred in a partial sale would be the underlying asset (see the FASB’s project page for more information). In addition, entities will most likely be required to perform dual tracking of revenue balances during the transition period, given the potential difficulty associated with retroactively recalculating revenue balances when the ASU becomes effective.

Under the ASU, entities must also provide significantly expanded disclosures about revenue recognition, including both quantitative and qualitative information regarding (1) the amount, timing, and uncertainty of revenue (and related cash flows) from contracts with customers; (2) the judgment, and changes in judgment, entities used in applying the revenue model; and (3) the assets recognized from costs to obtain or fulfill a contract with a customer. To comply with the ASU’s new accounting and disclosure requirements, real estate entities may want to consider whether they need to modify their systems, processes, and controls to gather and review information that may not have previously been monitored.

Discontinued Operations Reporting

Background

In April 2014, the FASB issued ASU 2014-08, which amends the definition of a discontinued operation in ASC 205-20 and requires entities to provide additional disclosures about disposal transactions that do not meet the discontinued-operations criteria. The revised guidance will change how entities identify and disclose information about disposal transactions under U.S. GAAP. The FASB issued the ASU to provide more decision-useful information to users and to elevate the threshold for a disposal transaction to qualify as a discontinued operation because it believed that too many disposal transactions were qualifying as discontinued operations under existing guidance. The new guidance is likely to have the greatest impact on entities that enter into routine real estate disposal transactions.

7 The SEC has indicated that it plans to review and update the revenue recognition guidance in SAB Topic 13 in light of the ASU. The extent to which the ASU’s guidance will affect a public entity will depend on whether the SEC removes or amends the guidance in SAB Topic 13 to be consistent with the new revenue standard.
Under the previous guidance in ASC 205-20-45-1, the results of operations of a component of an entity were classified as a discontinued operation if all of the following conditions were met:

- The component “has been disposed of or is classified as held for sale.”
- “The operations and cash flows of the component have been (or will be) eliminated from the ongoing operations of the entity as a result of the disposal transaction.”
- “The entity will not have any significant continuing involvement in the operations of the component after the disposal transaction.”

The new guidance eliminates the second and third criteria and instead requires discontinued-operations presentation for disposals of a component or group of components that represents a strategic shift that has or will have a major impact on an entity’s operations or financial results. In addition, the ASU notes that a “business or nonprofit activity that, on acquisition, meets the criteria to be classified as held for sale is reported in discontinued operations” regardless of whether the activity represents a strategic shift. Finally, investments accounted for under the equity method are no longer excluded from the scope of ASC 205-20. The ASU eliminates that scope exception other than for oil and gas properties accounted for under the full-cost method.

**Definition of a Discontinued Operation**

ASU 2014-08 defines a discontinued operation as a component or group of components of an entity that (1) is classified as held for sale or has been disposed of by sale or other than by sale and (2) “represents a strategic shift that has (or will have) a major effect on an entity’s operations and financial results.” According to the ASU, a strategic shift that has (or will have) a major effect on an entity’s operations and results includes the disposal of any of the following:

- A major geographical area.
- A major line of business.
- A major equity method investment.
- Other major parts of an entity.

The ASU does not define the terms “major,” “line of business,” or “geographical area.” It does, however, provide examples illustrating the evaluation of whether a disposal qualifies as a discontinued operation. These examples illustrate the quantitative thresholds of various metrics (e.g., assets, revenue, net income) — ranging from 15 percent to 20 percent — in various scenarios in which there was a strategic shift in an entity’s operations that has (or will have) a major effect on the entity’s financial results.

**Thinking It Through**

Entities will need to use judgment in determining what constitutes “major.” Some may interpret the illustrative guidance in ASC 205-20-55-83 through 55-101 as implying that breaching quantitative thresholds in the range of 15 percent to 20 percent indicates that a disposal is major. However, note that the FASB intentionally avoided creating a bright-line quantitative threshold because qualitative factors may also affect this assessment.

Entities may also find it challenging to define the terms “line of business” and “geographical area.” For example, some entities may define a geographical area as a county, state, country, or continent, while others may base this definition on how management determines its regions. Further, there may be differences in how entities define a major line of business: some may place more weight on quantitative considerations while others may emphasize qualitative factors. At the 2015 AICPA Conference on Current SEC and PCAOB Developments, an SEC staff member, discussed the evaluation of whether a disposal meets the definition of a discontinued operation. See Deloitte’s December 15, 2015, *Heads Up* for more information.
A publicly traded REIT in the United States has a regional mall division, a shopping center division, and a commercial property division. The REIT’s regional mall division consists of shopping malls in cities across the United States. In October, the REIT decides to sell two shopping malls in Washington because of declining operations. The two malls in Washington comprise 2 percent of the REIT’s total net income and 5 percent of its total assets. Because the sale of the malls in Washington does not represent a strategic shift in the REIT’s operations and because the quantitative thresholds are not significant, the sale does not meet the criteria for presentation as a discontinued operation, although disclosures may be required.

Disclosures

The ASU introduces several new disclosure requirements for both (1) disposals that meet the criteria for a discontinued operation and (2) individually significant disposals that do not meet these criteria. For example, entities must now disclose:

- Major line items constituting the pretax profit or loss for all periods for which the discontinued operation’s results of operations are reported in the income statement. Some examples of major line items are (1) revenue, (2) depreciation and amortization, and (3) interest expense.
- For most discontinued operations, either of the following in the statement of cash flows or the notes to the financial statements:
  - Operating and investing cash flows for the periods for which the discontinued operation’s results of operations are reported in the income statement.
  - Depreciation and amortization, capital expenditures, and significant operating and investing noncash items for the periods for which the discontinued operation’s results of operations are reported in the income statement.
- “For the initial period in which the disposal group is classified as held for sale and for all prior periods presented in the statement of financial position, a reconciliation of” (1) the “amounts disclosed in paragraph 205-20-50-5B(e)” to (2) “[t]otal assets and total liabilities of the disposal group classified as held for sale that are presented separately on the face of the [balance sheet].”
- For a disposal of an individually significant component that does not meet the definition of a discontinued operation, entities must disclose pretax profit or loss reported in the income statement for the period in which the disposal group is sold or is classified as held for sale. In addition, public entities must also disclose pretax profit or loss for all prior periods presented in the income statement.

These disclosures are required for both interim and annual reporting periods.

Transition Guidance

Public business entities, as well as not-for-profit entities that have issued, or that are conduit bond obligors for, securities that are traded, listed, or quoted on an exchange or over the counter, must apply the ASU prospectively to all disposals (or assets classified as held for sale) that occur in annual periods (and interim periods therein) beginning on or after December 15, 2014 (i.e., January 1, 2015, for calendar year-end entities). For all other entities, the ASU is effective prospectively for annual periods beginning on or after December 15, 2014, and interim periods with annual periods beginning a year thereafter.

Early adoption is permitted for any annual or interim period for which an entity’s financial statements have not yet been previously issued or made available for issuance. Entities are prohibited from applying the ASU to any component, equity method investment, or acquired business that was classified as held for sale before the adoption date.

Consolidation

Background

In February 2015, the FASB issued ASU 2015-02, which amends the consolidation requirements in ASC 810, significantly changing the consolidation analysis required under U.S. GAAP. While the Board’s focus during deliberations was largely on the investment management industry, the ASU could have a significant impact on the consolidation conclusions of reporting entities in other industries. For example:

- Limited partnerships will be VIEs unless the limited partners (LPs) have either substantive kick-out or participating rights.
- The ASU amends the effect that fees paid to a decision maker or service provider have on the consolidation analysis.
- The ASU significantly amends how variable interests held by a reporting entity’s related parties or de facto agents affect its consolidation conclusion.
- For entities other than limited partnerships, the ASU clarifies how to determine whether the equity holders (as a group) have power over the entity (this is likely to result in a change to current practice).
- The deferral of ASU 2009-17 for investments in certain investment funds has been eliminated. Therefore, investment managers, general partners (GPs), and investors in these investment funds will need to perform a drastically different consolidation evaluation.


Determining Whether Fees Paid to Decision Makers or Service Providers Are Variable Interests

One of the first steps in assessing whether a fund manager or property manager is required to consolidate a real estate fund is to determine whether the fund manager or property manager holds a variable interest in that legal entity. A fund manager’s or property manager’s determination that its decision-making fee arrangement is not a variable interest would generally result in a conclusion that the fund manager or property manager is not required to consolidate the legal entity. In addition, it could affect whether the legal entity being evaluated is a VIE. While ASU 2015-02 retains the current definition of a variable interest, it modifies the criteria for determining whether fees paid to a decision maker represent a variable interest.

Before the ASU, six criteria needed to be met before a reporting entity could conclude that a decision maker’s or service provider’s fee does not represent a variable interest. The ASU eliminates the criteria related to subordination of the fees (ASC 810-10-55-37(b)) and significance of the fees (ASC 810-10-55-37(e) and (f)). Accordingly, after adoption of ASU 2015-02, the evaluation of whether fees paid to a decision maker represent a variable interest focuses on whether (1) the fees are commensurate with the services provided, (2) the fee arrangement includes only customary terms and conditions (i.e., they are “at market”), and (3) the decision maker (including certain of its related parties) has any other variable interests that would absorb more than an insignificant amount of expected losses or returns. As a result, it is expected that fewer fee arrangements would be considered variable interests under the ASU.

Although the requirement to evaluate whether a fee arrangement is commensurate and at market existed before the ASU, different views have evolved regarding the evidence a reporting entity needs to support its conclusion that a fee arrangement is commensurate and at market. At the 2015 AICPA Conference on Current SEC and PCAOB Developments, an SEC staff member, Professional Accounting Fellow Chris Semesky, stated the following:

I would also like to address the evaluation of whether a decision-maker’s fee arrangement is customary and commensurate. [Footnote omitted] This evaluation is done at inception of a service arrangement or upon a reconsideration event, such as the modification of any germane terms, conditions or amounts in the arrangement.
The determination of whether fees are commensurate with the level of service provided often may be determined through a qualitative evaluation of whether an arrangement was negotiated on an arm’s length basis when there are no obligations beyond the services provided to direct the activities of the entity being evaluated for consolidation. This analysis requires a careful consideration of the services to be provided by the decision-maker in relation to the fees.

The evaluation of whether terms, conditions and amounts included in an arrangement are customarily present in arrangements for similar services may be accomplished in ways such as benchmarking the key characteristics of the subject arrangement against other market participants’ arrangements negotiated on an arm’s length basis, or in some instances against other arm’s length arrangements entered into by the decision-maker. There are no bright lines in evaluating whether an arrangement is customary, and reasonable judgment is required in such an evaluation. A decision-maker should carefully consider whether any terms, conditions, or amounts would substantively affect the decision-maker’s role as an agent or service provider to the other variable interest holders in an entity.

Therefore, we believe that the evaluation should focus on whether the fee arrangements are negotiated at arm’s length (i.e., between unrelated parties) or have been implicitly accepted by market participants. Most decision-maker or service-provider fee arrangements are negotiated at arm’s length or have been implicitly accepted by market participants when a more than insignificant amount of the investor interests in the potential VIE are held by an unrelated party or parties (e.g., when an asset manager has marketed a fund to outside investors).

In these situations, there is a presumption that the fees will be commensurate (even if the services are not provided by others in the marketplace). To support a conclusion that the arrangement is at market (i.e., customary) a reporting entity would, in addition to demonstrating that negotiations were at arm’s length or there was implicit acceptance by market participants, compare its fee arrangement with other arrangements it negotiated with third parties. Therefore, in these situations, it would typically not be necessary for a reporting entity to compare its fee arrangement to others in the marketplace to support its conclusion that the fee arrangement is commensurate and at market unless the reporting entity has no other internal benchmarks.

Determining Whether a Limited Partnership or Similar Entity Is a VIE

The ASU amends the definition of a VIE for limited partnerships and similar entities. Under the ASU, a limited partnership is considered a VIE regardless of whether it has sufficient equity or meets the other requirements to qualify as a voting interest entity unless a single LP or a simple majority of all partners (excluding those held by the GP, entities under common control with the GP, and entities acting on behalf of the GP) has substantive kick-out rights (including liquidation rights) or the LPs have participating rights. As a result of the amendments to the definition of a VIE for limited partnerships and similar entities (such as LLCs), entities historically not considered VIEs may need to be evaluated under the new VIE consolidation model. Conversely, partnership arrangements that include simple-majority kick-out or participating rights (rather than single-partner rights) may no longer be VIEs.

Although the ASU may not have caused a reporting entity’s consolidation conclusion to change, an updated analysis on the basis of the revised guidance would be required. In addition, even if a reporting entity determines that it does not need to consolidate a partnership that is a VIE, it would have to provide the existing extensive disclosures for any VIEs in which it holds a variable interest.
A limited partnership is formed to acquire a real estate property. The partnership has a GP that holds a 20 percent LP interest in the partnership, and eight unrelated LPs equally hold the remaining equity interests. Profit and losses of the partnership (after payment of GP fees, which represent a variable interest in the entity) are distributed in accordance with the partners’ ownership interests. There are no other arrangements between the partnership and the GPs/LPs.

The GP is the property manager and has full discretion to buy and sell properties, manage the properties, and obtain financing. In addition, the GP can be removed without cause by a simple majority of all of the LPs (including the LP interests held by the GP). The removal rights are held by all the partners in proportion to their partnership interests.

In this example, the LP interests held by the GP are permitted to vote on the removal of the GP. The GP, through its LP interests, will therefore vote 20 percent of the overall interests voting on the removal. The unrelated LP interests only hold 80 percent of the interests voting on removal. Since the unrelated LPs are unable to remove the GP unless more than a simple majority of the LP interests vote on the removal (i.e., the GP’s presumed no vote on removal will require 75 percent of the unrelated LP interests — six of the eight unrelated LPs — to remove the GP), the kick-out rights would not be substantive, and the limited partnership would be considered a VIE.

Determining Whether an Entity Other Than a Limited Partnership (or Similar Entity) Is a VIE

The ASU clarifies how a reporting entity should evaluate the condition in ASC 810-10-15-14(b)(1) (whether the equity holders (as a group) have power) for entities other than limited partnerships. Specifically, the ASU clarifies that in situations in which the equity holders have delegated the decision-making responsibility, and the decision maker’s fee arrangement is a variable interest under ASC 810-10-55-37, the evaluation should focus on whether the equity holders have power over the legal entity’s most significant activities through their equity interests. In making this assessment, the reporting entity should consider whether the equity holders (e.g., investors in a fund) have the right to replace the fund manager as the decision maker. This is a significant change from the previous guidance, under which kick-out rights were only considered if they were held by a single party.

Which Party Should Consolidate?

In a manner consistent with the current guidance, the determination of whether a reporting entity is required to consolidate a VIE under the ASU focuses on whether the reporting entity has (1) the power to direct the activities that most significantly affect the economic performance of the VIE (power condition) and (2) a potentially significant interest in the VIE (economics condition). Although the ASU does not amend the existing threshold for evaluating whether reporting entity meets the economics condition, under the new consolidation requirements, if the fees paid to a VIE’s decision maker are commensurate and at market, they should not be considered in the evaluation of the decision maker’s economic exposure to the VIE, regardless of whether the reporting entity has other economic interests in the VIE. Under this new requirement, certain structures that were consolidated as a result of the significance of the fee arrangement would potentially need to be deconsolidated. This guidance applies to all entities that are VIEs, including limited partnerships and similar entities that are VIEs.

The evaluation of which party controls a legal entity that is not considered a VIE focuses on the rights of the equity investors. Specifically, the analysis for limited partnerships would focus on whether any of the LPs have the substantive ability to unilaterally dissolve the limited partnership or otherwise remove the GP without cause and, if so, should consolidate the partnership. For all other entities, a party with a majority voting interest (i.e., greater than 50 percent) will generally be required to consolidate the entity.
Effects of Related Parties

The ASU significantly amends how variable interests held by a reporting entity’s related parties or de facto agents affect its consolidation conclusion. Specifically, the ASU reduces the effects of interests held by a reporting entity’s related parties in the evaluation of (1) whether the reporting entity’s fee arrangement is a variable interest and (2) the reporting entity’s economic exposure to the VIE.

In addition, the need to perform the related-party tiebreaker test (as well as mandatory consolidation by one of the related parties) will be less frequent under the ASU than under current U.S. GAAP. Specifically, the related-party tiebreaker test would need to be performed if power is considered shared among the related parties (including de facto agents) or if the parties in the decision maker’s related-party group are under common control and together possess the characteristics of a controlling financial interest.

Finally, if neither the decision maker nor any of its related parties are required to consolidate a VIE but the related-party group (including de facto agents) possesses the characteristics of a controlling financial interest, and substantially all of the VIE’s activities are conducted on behalf of a single entity in the related-party group, that entity would be the primary beneficiary of the VIE. However, this requirement would not apply to certain qualified affordable housing projects that are currently within the scope of ASU 2014-01.

Example

Fund Manager A is the GP (decision maker) for Partnership Z but does not own any of the limited partnership interests. The LP interests are held by multiple parties, and no party holds more than 5 percent of the limited partnership interests. The partnership is considered a VIE because the LPs do not have kick-out or participating rights. In addition, the LPs are considered de facto agents (a related party of A) because of a single-sided transfer restriction.

<table>
<thead>
<tr>
<th>Equity A (GP)</th>
<th>De Facto Agent</th>
<th>LPs</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.1%</td>
<td></td>
<td>99.9%</td>
</tr>
</tbody>
</table>

Limited Partnership

Under the ASU, when A and the LPs each consider only their own respective interests, no party individually would have both of the characteristics of a controlling financial interest. Specifically, A would conclude that it has a nominal economic interest in the partnership. In addition, the LPs would conclude that they do not have the power to direct the activities that most significantly affect the partnership (power criterion). In addition, A and the LPs would not be required to apply the related-party tiebreaker test because they are not under common control. This is a significant change from current guidance, under which the related-party tiebreaker test must be performed when related parties (including de facto agents) together have the characteristics of a controlling financial interest.

Elimination of the ASU 2010-10 Deferral

ASU 2015-02 eliminated the deferral under ASU 2010-10 for investment funds. As a result, all entities that qualified for the deferral (which applies primarily to investment companies and certain real estate entities) will need to be evaluated under an approach similar to that in ASU 2009-17. Even if the new evaluation does not result in a different consolidation conclusion, reporting entities will need to update their analysis and may be required to provide additional disclosures.

Effective Date and Transition

For public business entities, the ASU’s guidance is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2015. For entities other than public business entities, the ASU’s guidance is effective for annual periods beginning after December 15, 2016, and interim periods beginning after December 15, 2017. The ASU would allow early adoption for all entities but would require entities to apply the guidance as of the beginning of the annual period containing the adoption date. Modified retrospective application (including a practicability exception) would be required, with an option for full retrospective application.
Thinking It Through

More entities are likely to qualify as VIEs under the ASU than under current guidance, and real estate entities would be required to provide additional disclosures regardless of whether they consolidate the VIE. Specifically, any real estate venture or fund that is formed as a limited partnership would automatically be a VIE unless the partners hold simple majority kick-out or participating rights. However, the real estate entities may be able to apply the disclosure exemption criterion in ASC 810-10-50-5B (which exempts a reporting entity from providing certain of the VIE disclosures) if the reporting entity’s interest is considered a “majority voting interest.” Accordingly, a reporting entity (e.g., a REIT that consolidates an operating limited partnership) would be exempt from providing the disclosures in ASC 810-10-50-5A only if the criteria in ASC 810-10-50-5B are met.

Real estate fund managers and property managers should start considering the extent to which they may need to change their processes and controls to apply the revised guidance, including those related to obtaining additional information that may have to be provided under the disclosure requirements. Changing such processes and controls may be particularly challenging for entities that intend to early adopt the proposed guidance. In addition, companies should consider the effect of the revised guidance as they enter into new transactions.

Classification and Measurement

Background

The FASB recently issued ASU 2016-01, which amends its guidance on the classification and measurement of financial instruments. During its deliberations, the FASB decided to abandon a converged approach with the IASB and instead chose to retain much of the existing requirements in U.S. GAAP. However, 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.
- Disclosure requirements for financial assets and financial liabilities.

For public business entities, the new standard is effective for fiscal years beginning after December 15, 2017, including interim periods therein. For all other entities, it is effective for fiscal years beginning after December 15, 2018, and interim periods for the following year. Early adoption of certain of the standard’s provisions is permitted for all entities. Nonpublic business entities are permitted to adopt the standard in accordance with the effective date for public business entities. For more information, 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 (FVTNI), unless the equity investments are accounted for under the equity method or are consolidated. For equity investments that do not have a readily determinable fair value, the guidance will permit a practicability exception under which the equity investment would be measured at cost less impairment, if any, plus or minus observable price changes in orderly transactions. This exception would not be available to reporting entities that are investment companies or broker-dealers in securities.
An entity that has elected the practicability exception for equity investments that do not have a readily determinable fair value is required to assess whether the equity investment is impaired by qualitatively considering the following indicators (from ASC 321-10-35-3 in the ASU):

- A significant deterioration in the earnings performance, credit rating, asset quality, or business prospects of the investee
- A significant adverse change in the regulatory, economic, or technological environment of the investee
- A significant adverse change in the general market condition of either the geographical area or the industry in which the investee operates
- A bona fide offer to purchase, an offer by the investee to sell, or a completed auction process for the same or similar investment for an amount less than the carrying amount of that investment
- Factors that raise significant concerns about the investee’s ability to continue as a going concern, such as negative cash flows from operations, working capital deficiencies, or noncompliance with statutory capital requirements or debt covenants.

If, on the basis of the qualitative assessment, the equity investment is impaired, the investee would be required to record an impairment equal to the amount by which the carrying value exceeds fair value. The investee would no longer be required to evaluate whether such impairment was other than temporary.

**Thinking It Through**

Under current U.S. GAAP, marketable equity securities that are not accounted for as equity-method investments are classified as either held for trading, with changes in fair value recognized in earnings, or available for sale (AFS), with changes in fair value recognized in 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. Since equity securities can no longer be accounted for as AFS or cost method investments and will be required to record them at FVTNI, 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.

**Changes to Disclosure Requirements**

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

Debt Issuance Costs

Background
In April 2015, the FASB issued ASU 2015-03, which changes the presentation of debt issuance costs in financial statements. The ASU specifies that “debt issuance costs related to a note shall be reported in the balance sheet as a direct deduction from the face amount of that note” and that “[a]mortization of debt issuance costs also shall be reported as interest expense.” Under previous guidance, an entity reported debt issuance costs in the balance sheet as deferred charges (i.e., as an asset).

The amendments do not affect the current guidance on the recognition and measurement of debt issuance costs. For example, the costs of issuing convertible debt would not change the calculation of the intrinsic value of an embedded conversion option that represents a beneficial conversion feature under ASC 470-20-30-13. Thus, entities may still need to track debt issuance costs separately from a debt discount.

Thinking It Through
Requiring presentation of debt issuance costs as a direct reduction of the related debt liability (rather than as an asset) is consistent with the presentation of debt discounts under U.S. GAAP. In addition, it converges the guidance in U.S. GAAP with that in IFRSs, under which transaction costs that are directly attributable to the issuance of a financial liability are treated as an adjustment to the initial carrying amount of the liability. It also reflects the SEC staff’s views regarding the treatment of equity issuance costs as a reduction of the gross proceeds of an equity offering. Further, it conforms U.S. GAAP to FASB Concepts Statement No. 6, which states, “Debt issue cost is not an asset for the same reason that debt discount is not — it provides no future economic benefit. Debt issue cost in effect reduces the proceeds of borrowing and increases the effective interest rate and thus may be accounted for the same as debt discount.”

Since the ASU’s issuance, practitioners have inquired about the appropriate balance sheet presentation of costs incurred in connection with revolving-debt arrangements. At the June 2015 EITF meeting, the SEC staff announced that it would “not object to an entity deferring and presenting [such] costs as an asset and subsequently amortizing the . . . costs ratably over the term of the line-of-credit arrangement.” While the SEC staff’s announcement, which was codified in August 2015 by the issuance of ASU 2015-15, clarifies that revolving-debt arrangements are outside the scope of ASU 2015-03, it does not address whether the ASU’s presentation approach is an acceptable accounting policy for such arrangements and, if so, how an entity should implement such an approach. Under the ASU, an entity would deduct debt issuance costs from the related debt liability. But it is unclear how the entity would present any remaining unamortized debt issuance costs if it repaid the amounts outstanding under the revolving-debt arrangement and still had an option to make new borrowings under the same arrangement. In this case, there would no longer be a liability with which to associate the costs. It is also unclear how the entity would present any remaining unamortized costs if the costs exceeded the amount currently outstanding under the revolving-debt arrangement.

Given the implementation questions associated with application of the ASU’s presentation approach to revolving-debt arrangements, as well as questions about the acceptability of such application, we expect that many, if not most, entities will elect to apply the accounting policy outlined by the SEC staff at the June 2015 EITF meeting. Under that policy, an entity presents remaining unamortized debt issuance costs associated with a revolving-debt arrangement as an asset even if the entity currently has a recognized debt liability for amounts outstanding under the arrangement. Further, such costs are amortized over the life of the arrangement even if the entity repays previously drawn amounts.
Thinking It Through

Before adopting ASU 2015-03, an entity may have remeasured debt issuance costs into its functional currency by using historical exchange rates because (1) it presented debt issuance costs in the balance sheet as deferred charges under ASC 835-30 and (2) ASC 830-10-45-18(i) requires that deferred charges be treated as a nonmonetary balance sheet item that is remeasured by using historical rates.

Upon adopting ASU 2015-03, however, an entity presents debt issuance costs (other than costs related to line-of-credit or revolving-debt arrangements) in the balance sheet as a direct deduction from the related debt liability (in accordance with ASC 835-30-45-1A, as amended by ASU 2015-03) rather than as a deferred charge. The remeasurement of the carrying amount of the debt liability into the entity’s functional currency, therefore, reflects any deduction related to debt issuance costs. Under ASC 830-10-45-17, monetary liabilities (including the carrying amount of a monetary debt liability that has been adjusted for debt issuance costs) are remeasured into the entity’s functional currency by using current exchange rates.

Notwithstanding the Board’s stated intention of not changing the recognition and measurement guidance on debt issuance costs, an entity that presented debt issuance costs (other than issuance costs associated with line-of-credit or revolving debt arrangements) as deferred charges and treated such costs as a nonmonetary item under ASC 830-10 before adopting ASU 2015-03 would need to (1) retrospectively adjust, upon transition to ASU 2015-03, its accounting for debt issuance costs under ASC 830-10 in accordance with ASC 835-30-65-1(c) and (2) perform remeasurement as of each subsequent reporting period by using current exchange rates.

Effective Date and Transition

For public business entities, the guidance in ASU 2015-03 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. For entities other than public business entities, the guidance is effective for fiscal years beginning after December 15, 2015, and interim periods beginning after December 15, 2016. Early adoption is allowed for all entities for financial statements that have not been previously issued. Entities should apply the new guidance retrospectively to all prior periods (i.e., the balance sheet for each period is adjusted).

The ASU requires an entity to “disclose in the first fiscal year after the entity’s adoption date, and in the interim periods within the first fiscal year, the following:

1. The nature of and reason for the change in accounting principle
2. The transition method
3. A description of the prior-period information that has been retrospectively adjusted
4. The effect of the change on the financial statement line item (that is, the debt issuance cost asset and the debt liability).”

Measurement-Period Adjustments

Background

In September 2015, the FASB issued ASU 2015-16, which amended the guidance in ASC 805 on the accounting for measurement-period adjustments. The ASU was issued as part of the FASB’s simplification initiative in response to stakeholder feedback that restating prior periods to reflect adjustments made to provisional amounts recognized in a business combination adds cost and complexity to financial reporting but does not significantly improve the usefulness of the information provided to users.
Key Provisions of the ASU

Under previous guidance, when an acquirer identified an adjustment to provisional amounts during the measurement period, the acquirer was required to revise comparative information for prior periods, including making any change in depreciation, amortization, or other income effects recognized in completing the initial accounting, as if the accounting for the business combination had been completed as of the acquisition date.

The ASU requires an acquirer to recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined. The effect on earnings of changes in depreciation or amortization, or other income effects (if any) as a result of the change to the provisional amounts, calculated as if the accounting had been completed as of the acquisition date, must be recorded in the reporting period in which the adjustment amounts are determined rather than retrospectively.

Thinking It Through

Although the ASU changes the accounting for measurement-period adjustments, it does not change the definition of a measurement-period adjustment, which is an adjustment to the amounts provisionally recognized for the consideration transferred, the assets acquired, and the liabilities assumed as a result of “new information obtained about facts and circumstances that existed as of the acquisition date that, if known, would have affected the measurement of the amounts recognized as of that date.” Errors, information received after the measurement period ends, or information received about events or circumstances that did not exist as of the acquisition date are not measurement-period adjustments.

Disclosure Requirements

The ASU also requires that the acquirer present separately on the face of the income statement, or disclose in the notes, the portion of the amount recorded in current-period earnings by line item that would have been recorded in previous reporting periods if the adjustment to the provisional amounts had been recognized as of the acquisition date.

Effective Date and Transition

For public business entities, the ASU is effective for fiscal years beginning after December 15, 2015, including interim periods within those fiscal years. For all other entities, the ASU is effective for fiscal years beginning after December 15, 2016, and interim periods within fiscal years beginning after December 15, 2017. The ASU must be applied prospectively to adjustments to provisional amounts that occur after the effective date. Early application is permitted for financial statements that have not been issued.

The only disclosures required at transition will be the nature of and reason for the change in accounting principle. An entity should disclose that information in the first annual period of adoption and in the interim periods within the first annual period if there is a measurement-period adjustment during the first annual period in which the changes are effective. For more information about the ASU, see Deloitte’s September 30, 2015, Heads Up.

Elimination of Extraordinary Items

Background

In January 2015, the FASB issued ASU 2015-01 as part of its simplification initiative. The ASU eliminates from U.S. GAAP the concept of an extraordinary item (as defined in the Codification Master Glossary).
Key Provisions
To be considered an extraordinary item under existing U.S. GAAP, an event or transaction must be unusual in nature and must occur infrequently. Stakeholders often questioned the decision-usefulness of labeling a transaction or event as extraordinary and indicated that it is difficult to ascertain whether an event or transaction satisfies both criteria. In light of this feedback and in a manner consistent with its simplification initiative, the FASB decided to eliminate the concept of an extraordinary item. As a result, an entity will no longer (1) segregate an extraordinary item from the results of ordinary operations; (2) separately present an extraordinary item on its income statement, net of tax, after income from continuing operations; and (3) disclose income taxes and earnings-per-share data applicable to an extraordinary item. However, the ASU does not affect the reporting and disclosure requirements for an event that is unusual in nature or that occurs infrequently.

Effective Date
For all entities, the ASU is effective for annual periods beginning after December 15, 2015, and interim periods within those annual periods. Entities may apply the guidance prospectively or retrospectively to all prior periods presented in the financial statements. If an entity chooses to apply the guidance prospectively, it must disclose whether amounts included in income from continuing operations after adoption of the ASU are related to events and transactions previously recognized and classified as extraordinary items before the date of adoption. Early adoption is permitted if the guidance is applied as of the beginning of the annual period of adoption.

Thinking It Through
While the ASU eliminates the need for an entity to classify and separately report certain unusual and infrequent events as extraordinary items in its income statement, the entity must continue to use significant judgment in identifying such events because the ASU does not remove the disclosure requirements for them.

Accounting Alternatives for Private Companies

Background
The following guidance (developed in 2014 by the Private Company Council (PCC)) is effective in 2015:

- **Goodwill** — In January 2014, the FASB issued ASU 2014-02, which allows private companies to use a simplified approach to account for goodwill after an acquisition. Under such approach, an entity would (1) amortize goodwill on a straight-line basis, generally over 10 years; (2) test goodwill for impairment only when a triggering event occurs; and (3) make an accounting policy election to test for impairment at either the entity level or the reporting-unit level. The ASU also eliminates “step 2” of the goodwill impairment test; as a result, an entity would measure goodwill impairment as the excess of the entity’s (or reporting unit’s) carrying amount over its fair value. An entity that elects the simplified approach should adopt the ASU’s guidance prospectively and apply it to all existing goodwill (and any goodwill arising from future acquisitions) existing as of the beginning of the period of adoption. The ASU is effective for annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015. See Deloitte’s January 27, 2014, Heads Up for more information.

- **Hedge accounting** — In January 2014, the FASB issued ASU 2014-03, which gives private companies a simplified method of accounting for certain receive-variable, pay-fixed interest rate swaps used to hedge variable-rate debt. An entity that elects to apply the simplified hedge accounting to a qualifying hedging relationship would continue to account for the interest rate swap and the variable-rate debt separately on the face of the balance sheet. However, the entity would be able to assume no ineffectiveness in the hedging relationship, thereby essentially achieving the same income statement profile as with a fixed-rate borrowing expense. In addition, the entity is allowed more time to complete its initial hedge documentation. An entity that applies the simplified
approach also may elect to measure the related swap at its settlement value rather than at fair value. Financial institutions (including banks, savings and loan associations, savings banks, credit unions, finance companies, and insurance entities) are specifically ineligible to elect this accounting alternative. The ASU is effective for annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015. Entities that elect the simplified approach should adopt the ASU under either a full retrospective or a modified retrospective method. See Deloitte’s January 27, 2014, Heads Up for more information.

- **Identified intangible assets** — In December 2014, the FASB issued ASU 2014-18, which gives private companies an exemption from having to recognize certain intangible assets for (1) assets acquired in a business combination or (2) investments accounted for under the equity method or upon the adoption of fresh-start accounting. Specifically, an entity would not be required to separately recognize intangible assets for noncompete agreements and certain customer-related intangible assets that arise within the scope of the ASU. Because the amounts associated with these items would be subsumed into goodwill, an entity that elects this accounting alternative would also be required to adopt ASU 2014-02 (see discussion above), resulting in the amortization of goodwill. Entities that elect the alternative should adopt the ASU prospectively to the first eligible transaction within the scope of the ASU that occurs in the annual period beginning after December 15, 2015 (with early adoption permitted), and all transactions thereafter. See Deloitte’s December 30, 2014, Heads Up for more information.

**Proposed Changes to Effective Date and Transition Guidance in Certain Private-Company ASUs**

In September 2015, the FASB issued for public comment a proposed ASU that would give private companies a one-time unconditional option to forgo a preferability assessment the first time they elect a PCC accounting alternative within the proposal’s scope. It would also eliminate the effective dates of PCC accounting alternatives that are within the proposal’s scope as well as extend the transition guidance in ASU 2014-02 and ASU 2014-03. The proposal’s amendments could affect all private companies within the scope of ASUs 2014-02 and 2014-03 as well as ASU 2014-07 and ASU 2014-18. See Deloitte’s October 6, 2015, Heads Up for more information.

**Other Private-Company Matters**

Throughout 2015, the PCC has discussed aspects of financial reporting that are complex and costly for private companies, including stock-based compensation, the application of VIE guidance to nonleasing common-control arrangements, and the balance sheet classification of debt.

At a recent meeting, the PCC agreed that it would continue to deliberate stock-based compensation and consider feedback received in connection with the FASB’s proposed ASU on employee share-based payment accounting improvements. See Deloitte’s June 12, 2015, Heads Up for more information.

The PCC also asked the FASB staff to research (1) examples that would clarify the application of VIE guidance to nonleasing common-control arrangements and (2) potential modifications to existing business scope exceptions to address application issues.

In addition, the PCC decided in February 2015 that it would not “amend the existing definitions of a nonpublic entity at this time. The existing definitions will remain in the FASB Codification until potentially amended at a later date by the FASB. The definition of a public business entity, [as amended by ASU 2013-12] should continue to be used for future accounting and reporting guidance.”

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9 See the PCC’s overview of decisions reached on PCC Issue No. 14-01.
Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share or Its Equivalent

Background
In May 2015, the FASB issued ASU 2015-07, which is based on the final consensus reached by the EITF on Issue 14-8. The ASU removes the disclosure requirement to categorize investments\textsuperscript{10} for which the practical expedient\textsuperscript{11} is used to measure fair value at net asset value (NAV) within the fair value hierarchy. The ASU also amends or removes other disclosure requirements for eligible investments measured at NAV and contains consequential amendments to ASC 230-10 related to the statement of cash flows and to ASC 715-20 regarding sponsors of defined benefit plans.

Key Provisions
Rather than categorizing within the fair value hierarchy\textsuperscript{12} eligible investments that are measured by using the NAV practical expedient, the ASU requires an entity to disclose the NAV of those investments to reconcile the fair value of the investments within the fair value hierarchy to the line item(s) presented in the statement of financial position. In addition, eligible investments that apply the NAV practical expedient no longer need to disclose the other information required by ASC 820-10-50-2, such as transfers between fair value levels, a level-three rollforward schedule, or the description of the valuation techniques for certain assets and liabilities.

Thinking It Through
Entities must still comply with the requirements in ASC 820-10-50-6A, which include disclosing the investment’s NAV and the nature, risk, and redeemability of eligible investments that apply the NAV practical expedient in measuring fair value.

Also, in instances in which the practical expedient is used to measure fair value at NAV for all of an entity’s investments, the information required by ASC 820-10-50-6A may be disclosed in a manner that complies with the ASU’s requirement to reconcile the fair value of the investments in the disclosure to the line item(s) presented in the statement of financial position. Accordingly, an entity would not present a blank fair value hierarchy leveling tabular disclosure to meet the ASU’s reconciliation requirement.

In addition, the ASU amends the scope of the disclosure requirements in ASC 820-10-50-6A to include only investments that (1) are eligible for the practical expedient and (2) have elected to apply the practical expedient in measuring fair value at NAV. The ASU also removes the guidance in ASC 820-10-50-6A(g), under which certain disclosures were required when it was probable that an investment would be sold for an amount different from the NAV.

Thinking It Through
ASU 2015-07 simplifies the reporting requirements by limiting the disclosures required by ASC 820-10-50-6A to those investments measured under the NAV practical expedient (rather than all eligible investments that may apply the practical expedient).

\textsuperscript{10} ASC 820-10-15-4 and 15-5 provide the requirements for an investment’s eligibility to apply the NAV per share (or its equivalent) practical expedient in measuring fair value.

\textsuperscript{11} The NAV practical expedient is discussed in ASC 820-10-35-59 through 35-62.

\textsuperscript{12} Under ASU 2015-07, sponsors of defined benefit plans within the scope of ASC 715-20 that elect the NAV practical expedient to measure plan investments at fair value are also no longer permitted to be categorized within the levels of the fair value hierarchy in the plan investment footnote.
Effective Date and Transition

For public business entities, the ASU is effective for fiscal years beginning after December 15, 2015, including interim periods within those fiscal years. The effective date is deferred by one year for entities other than public business entities. Early adoption is permitted. The ASU should be applied retrospectively to all periods presented.

Going Concern

Background

In August 2014, the FASB issued ASU 2014-15, which provides guidance on determining when and how to disclose going-concern uncertainties in the financial statements. The standard requires management to perform interim and annual assessments of an entity’s ability to continue as a going concern within one year of the date the financial statements are issued. An entity must provide certain disclosures if “conditions or events raise substantial doubt about [the] entity’s ability to continue as a going concern.”

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

The ASU extends the responsibility for performing the going-concern assessment to management and contains guidance on (1) how to perform a going-concern assessment and (2) when going-concern disclosures would be required under U.S. GAAP.

Key Provisions of the ASU

Disclosure Thresholds

An entity would be required to disclose information about its potential inability to continue as a going concern when there is “substantial doubt” about its ability to continue as a going concern, which the ASU defines as follows:

Substantial doubt about an entity’s ability to continue as a going concern exists when conditions and events, considered in the aggregate, indicate that it is probable that the entity will be unable to meet its obligations as they become due within one year after the date that the financial statements are issued . . . . The term probable is used consistently with its use in Topic 450 on contingencies.

In applying this disclosure threshold, entities would be required to evaluate “relevant conditions and events that are known and reasonably knowable at the date that the financial statements are issued.” Reasonably knowable conditions or events are those that an entity may not readily know of but can be identified without undue cost and effort.

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13 An entity that is neither an SEC filer nor a conduit bond obligor for debt securities that are traded in a public market would use the date the financial statements are available to be issued (in a manner consistent with the ASU’s definition of “issued”).
14 In accordance with ASC 205-30, an entity must apply the liquidation basis of accounting once liquidation is deemed imminent.
15 PCAOB AU Section 341.
Time Horizon
In each reporting period (including interim periods), an entity would be required to assess its ability to meet its obligations as they become due for one year after the date the financial statements are issued.

Thinking It Through
The ASU’s assessment period is longer than that in current auditing literature, which requires auditors to “evaluate whether there is substantial doubt about an entity’s ability to continue as a going concern for a reasonable period of time not to exceed one year beyond the date of the financial statements being audited” (emphasis added).¹⁶ For users, the benefits of this change include (1) more current and relevant information; (2) potentially earlier disclosures about a going-concern issue; (3) a look-forward period that is still one year, even if financial statement issuance is delayed; and (4) inclusion of known events in the substantial-doubt assessment after one year from the balance sheet date. Implications of the amendments to the look-forward period for entities applying the standard include the need to change forecasting to reflect the period as modified, which may be a period that is not typically assessed, and a potential need to obtain debt covenant waivers for an additional period.

The change in the look-forward period is expected to have a greater impact on private entities, which typically issue financial statements later than public entities and may not prepare rolling forecasts. Users of private entities’ financial statements will often benefit from having a significantly longer look-forward period over which the going-concern presumption is assessed.

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

<table>
<thead>
<tr>
<th>Substantial Doubt Is Raised but Is Alleviated by Management’s Plans</th>
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<tbody>
<tr>
<td>• Principal conditions or events.</td>
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<td>• Management’s evaluation.</td>
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<td>• Management’s plans.</td>
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<td>• Management’s evaluation.</td>
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<tr>
<td>• Management’s plans.</td>
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<tr>
<td>• Statement that there is “substantial doubt about the entity’s ability to continue as a going concern.”</td>
</tr>
</tbody>
</table>

The ASU explains that these disclosures may change over time as new information becomes available.

Effective Date
The guidance in the ASU is effective for annual periods ending after December 15, 2016, and interim periods within annual periods beginning after December 15, 2016. Early application is permitted.

For additional information, see Deloitte’s August 28, 2014, Heads Up.

¹⁶ PCAOB AU Section 341.02.
Pushdown Accounting

Background
In November 2014, the FASB issued ASU 2014-17, which gives an acquired entity the option of applying pushdown accounting in its stand-alone financial statements upon a change-in-control event.

Before ASU 2014-17, there was limited guidance in U.S. GAAP on determining whether an acquired entity can establish a new accounting and reporting basis in its stand-alone financial statements (commonly referred to as “pushdown” accounting). ASC 805-50-S99-1 through S99-4 contained pushdown accounting requirements for SEC registrants. Under this guidance, pushdown accounting is (1) prohibited when 80 percent or less of an entity’s ownership is acquired, (2) permitted when between 80 percent and 95 percent is acquired, and (3) required when 95 percent or more is acquired.

Key Provisions of ASU 2014-17
An acquired entity that elects pushdown accounting would apply the measurement principles in ASC 805 to push down the measurement basis of its acquirer to its stand-alone financial statements. In addition, the acquired entity would be required to provide disclosures that enable “users of financial statements to evaluate the effect of pushdown accounting.”

ASU 2014-17 also concluded that when applying pushdown accounting, an acquired entity would be:

- Prohibited from recognizing acquisition-related debt incurred by the acquirer unless the acquired entity is required to do so in accordance with applicable U.S. GAAP (e.g., because the acquired entity is legally obligated).
- Required to recognize the acquirer’s goodwill.
- Prohibited from recognizing bargain purchase gains that resulted from the change-in-control transaction or event and instead the acquiree would recognize such gains as an adjustment to equity (i.e., APIC).

The ASU also gives a subsidiary of an acquired entity the option of applying pushdown accounting to its stand-alone financial statements, even if the acquired entity (i.e., the direct subsidiary of the acquirer) elected not to apply pushdown accounting.

The ASU does not apply to common-control transfers; the guidance on accounting for transactions by entities under common control is included in ASC 805-50. A company that receives the net assets or equity interests in a common-control transfer should record those net assets or equity interests at the transferor’s carrying amounts. However, if pushdown accounting was not applied by the transferor, then the financial statements of the receiving entity would reflect the transferred net assets at the historical cost of the parent of the entities under common control, which would result in the parent’s basis being pushed down to the receiving entity.

Conforming SEC and FASB Guidance
In a related development, the SEC has rescinded SAB Topic 5.J, which contained the SEC staff’s views on how an SEC registrant should apply pushdown accounting. Thus, all entities — regardless of whether they are SEC registrants — will now apply the guidance in ASU 2014-17.

In May 2015, the FASB issued ASU 2015-08, which removes references to the SEC’s SAB Topic 5.J on pushdown accounting from ASC 805-50. The SEC’s SAB 115 had superseded the guidance in SAB Topic 5.J in connection with the FASB’s November 2014 release of ASU 2014-17. The amendments in ASU 2015-08 therefore conform the FASB’s guidance on pushdown accounting with the SEC’s.

17 Entities would achieve that disclosure objective by providing the relevant disclosures required by ASC 805.
Effective Date

The guidance in ASU 2014-17 became effective November 14, 2014. As of the effective date, an acquired entity would be permitted to elect to apply pushdown accounting arising as a result of change-in-control events occurring before the standard’s effective date as long as (1) the change-in-control event is the most recent change-in-control event for the acquired entity and (2) the election is preferable. Entities would not be permitted to unwind a previous application of pushdown accounting (i.e., an acquired entity can change its election for the most recent change-in-control transaction or event from not applying pushdown accounting to applying pushdown accounting, if preferable, but not vice versa).

For more information about ASU 2014-17, see Deloitte’s September 2014 EITF Snapshot.

Determining Whether the Host Contract in a Hybrid Financial Instrument Is More Akin to Debt or to Equity

In November 2014, the FASB issued ASU 2014-16 to reduce the diversity in practice related to how entities determine the nature of the host contract of a hybrid instrument issued in the form of a share (e.g., convertible preferred stock) as part of the analysis for determining whether the hybrid instrument contains any embedded derivatives that must be bifurcated under ASC 815-15.

Currently, reporting entities use one of two acceptable methods (and must apply it consistently) for determining the nature of a host contract: the chameleon approach18 and the whole-instrument approach.19

There is little to no diversity in the application of the chameleon approach. However, in practice, there is diversity in the application of the whole-instrument approach to a convertible preferred share with noncontingent fixed-price redemption features. That is, entities place varying degrees of weight on the various embedded features.

For example, some place significant weight on the fixed-price redemption feature and conclude that the host is debt-like. These entities are of the opinion that the existence of a noncontingent fixed-price redemption feature is a presumptive factor in the conclusion that the host contract is debt-like because it does not expose the holder to any residual risk. As a result, the embedded conversion feature could be bifurcated under this approach.

Others are of the opinion that all relevant terms and features must be taken into account and that an entity should also consider equity-like features (including the conversion option) in evaluating the nature of the host contract under the whole-instrument approach. This would result in a conclusion that (1) the host contract is equity-like (as a result of placing more emphasis on the contract’s equity-like features, including the conversion feature), (2) the conversion option is clearly and closely related to that host contract, and (3) accordingly, the embedded conversion feature should not be bifurcated.

Under the ASU, entities whose instruments are within the scope of the guidance are required to apply the whole-instrument approach when determining the nature of the host contract in a hybrid financial instrument issued in the form of a share. That is, the chameleon approach is no longer permitted.

The ASU also contains implementation guidance to help reporting entities apply the whole-instrument approach. Under the implementation guidance, a reporting entity would (1) identify all stated and implied substantive terms and features of the instrument and whether those terms and features are debt-like or equity-like, (2) analyze the substance and relative weight

18 Under the chameleon approach, an entity determines the nature of the host contract by considering all stated and implied substantive terms and features of the hybrid instrument, except for the particular embedded feature being analyzed for bifurcation. When the chameleon approach is used to analyze a hybrid instrument with multiple embedded features, the nature of the host contract may change as each embedded feature is analyzed separately.

19 Under the whole-instrument approach, an entity determines the nature of the host contract by considering all stated and implied substantive terms and features of the hybrid instrument, including the embedded feature being analyzed for bifurcation. When the whole-instrument approach is used to analyze a hybrid instrument with multiple embedded features, the nature of the host contract should not change as each embedded feature is analyzed separately.
of each characteristic, and (3) on the basis of all terms and features, and considering the substance and relative weight of each, determine the nature of the host contract. The ASU does not require any new disclosures.

For public business entities, the ASU’s guidance is effective for annual periods (and interim periods therein) beginning after December 15, 2015. For all other entities, the guidance is effective for annual periods beginning after December 15, 2015, and interim periods thereafter. Early adoption is permitted.

A reporting entity may adopt the guidance by using either a modified or full retrospective approach. Under either approach, the reporting entity would be required to determine the nature of a host contract by taking into account the facts and circumstances that existed on the date it issued or acquired the instrument.

**Thinking It Through**

Application of the whole-instrument approach in lieu of the chameleon approach may increase the likelihood that an entity would conclude that an embedded feature is clearly and closely related to the host because that feature is viewed as an attribute of the host contract. However, under the ASU, an entity must carefully evaluate the substance of all relevant terms and features — and assess their relative strength — in reaching a conclusion about the nature of the host. For example, the ASU states that “an entity shall not presume that the presence of a fixed-price, noncontingent redemption option held by the investor in a convertible preferred stock contract, in and of itself, determines whether the nature of the host contract is more akin to a debt instrument or more akin to an equity instrument.” Thus, in determining the nature of the host, an entity must conduct a robust analysis of all terms and features of the hybrid instrument.
On the Horizon
Leases

Background

The FASB has been working with the IASB for almost a decade to address concerns related to the off-balance-sheet treatment of certain lease arrangements by lessees. The boards’ proposed model would require lessees to adopt a right-of-use (ROU) asset approach that would bring substantially all leases, with the exception of short-term leases (i.e., those with a lease term of less than 12 months), on the balance sheet. Under this approach, a lessee would record an ROU asset representing its right to use the underlying asset during the lease term and a corresponding lease liability (in a manner similar to the current approach for capital leases).

Thinking It Through

A lessee would include in the calculation of the ROU asset any initial direct costs related to a lease. A lessor would continue to account for initial direct costs in a manner consistent with the current requirements. However, in 2014 the boards tentatively decided to amend the definition of initial direct costs to include only those costs that are incremental to the arrangement and that the entity would not have incurred if the lease had not been obtained. This definition would be consistent with the definition of incremental cost in the new revenue recognition standard. Thus, costs such as commissions and payments made to existing tenants to obtain the lease would be considered initial direct costs. In 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 this definition. This is likely to result in changes in practice for many real estate lessors.

Lessee and Nonlease Components

Lessees and lessors would be required 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 recognition 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, the boards have noted that lessees would be permitted “to elect, as an accounting policy by class of underlying asset, to not separate lease components from nonlease components, and instead account for the entire contract . . . as a single lease component.”

Thinking It Through

The boards agreed that an activity should be considered a separate nonlease component when the activity transfers a separate good or service to the lessee. For example, maintenance services (including common area maintenance services) and utilities paid for 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 be considered a part of the lease component.

Lessee Accounting

While the boards agree that a lessee should record an ROU asset and a corresponding lease liability when the lease commences, the FASB and the IASB support different approaches for the lessee’s subsequent accounting. The FASB decided on a dual-model approach under which a lessee would classify a lease by using criteria that are 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.

1 Quoted text is from the boards’ May 2014 agenda paper.
arrangement. That is, the lessee would recognize interest expense and amortization of the ROU asset, which typically would result in a greater expense during the early years of the lease. For leases that are considered operating leases (many current operating leases are expected to continue to qualify as operating leases), the lessee would recognize a straight-line total lease expense. For both types of leases, the lessee would recognize an ROU asset for its interest in the underlying asset and a corresponding lease liability.

**Thinking It Through**

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.”
- It is reasonably certain that a lessee will “exercise an option to purchase the underlying asset.”
- “The lessee otherwise has the ability to obtain substantially all of the remaining benefits of the underlying asset as a result of the lease.”

These criteria are essentially the same as the existing lease classification criteria in IAS 17 but are not identical to the requirements in ASC 840. For example, under the proposed criteria, a lessee would be required to assess land and other elements separately unless the land element is clearly immaterial, whereas under ASC 840 the land would only be evaluated separately if its fair value at lease inception was 25 percent or more of the fair value of the leased property. This change may result in more bifurcation of real estate leases into separate land and building elements that would be evaluated separately for lease classification purposes.

In addition, the FASB’s tentative decision effectively eliminates the bright-line rules under the ASC 840 lease classification requirements — 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 decision could also affect a lease’s classification.

Real estate developers are currently permitted to capitalize costs associated with a ground lease during the construction period as part of the construction project if the project will be sold or rented. The FASB has not discussed whether the new leasing guidance will permit entities to capitalize these payments under ASC 970 after adoption.

**Lessor Accounting**

In 2014, the boards discussed constituent feedback on the ED and decided not to make significant changes to the existing lessor accounting model. Rather, they agreed to adopt an approach similar to the existing capital/finance 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 only be permitted to recognize the profit on the transaction if the arrangement would have qualified as a sale under the new revenue recognition guidance (ASC 606).

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1 Quoted text is from the boards’ January 2014 agenda paper.
2 “Clearly immaterial” is not a defined term or threshold under U.S. GAAP. It is expected, however, that few land elements would qualify as clearly immaterial.
Thinking It Through

The inability to recognize profit on a transaction that would not have qualified as a sale under the new revenue recognition guidance will probably not significantly affect real estate lessors since they typically do not enter into sale-type leases. However, the effect of the proposed changes to conform the U.S. GAAP classification requirements to those under IFRSs may be similar to the effect discussed above for lessees. In addition, the proposed guidance would require real estate lessors to disclose more information.

During their redeliberations, the FASB and IASB decided that a lessor would recognize rental income on a systematic basis that is not straight line if that basis was more representative of the pattern in which income is earned from the underlying asset. That is, a lessor would recognize uneven fixed lease payments (step payments) on a straight-line basis only when the payments are uneven for reasons other than to reflect or compensate for market rentals or market conditions (e.g., when there is significant front loading or back loading of payments or when rent-free periods exist in a lease). This may have a significant effect on a lessor’s recognition of revenue for operating leases related to real estate since many such leases contain rent steps that are intended to reflect expected increases in market rents over the lease term.

Next Steps

The FASB has completed its redeliberations on leases and is expected to issue a final standard in early 2016. The new guidance will be effective for public business entities for fiscal years beginning after December 15, 2018 (i.e., calendar periods beginning on January 1, 2019), including interim periods therein. For all other entities, the standard will be effective for annual periods beginning after December 15, 2019 (i.e., calendar periods beginning on January 1, 2020), and interim periods thereafter. Early adoption will be permitted.

Definition of a Business

In November 2015, the FASB issued a proposed ASU on the first phase of its project on the definition of a business. The proposal is in response to concerns that as a result of the current broad definition of a business, many transactions are accounted for as business combinations when they are more akin to asset acquisitions. Comments on the proposed guidance are due by January 22, 2016.

Under the proposal:

- A set of assets and activities ("set") must include an input and a substantive process that together contribute to the ability to create outputs in order to be a business.
- If substantially all of the fair value of the gross assets is concentrated in a single identifiable asset or group of similar identifiable assets, the set would not be a business.
- The definition of outputs is narrowed to be consistent with ASC 606.
Thinking It Through

The proposed 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.

In addition, real estate asset disposals are currently accounted for under ASC 360-20 whether or not they are deemed to be a business. However, the FASB is discussing as part of this project whether the sale of real estate that meets the definition of a business should always be accounted for under ASC 810 (on consolidation) rather than under ASC 606 or ASC 610.

Single Asset Concentration

An entity can now first determine whether substantially all of the fair value of the gross assets is concentrated in a single identifiable asset or group of similar identifiable assets and, if so, then conclude that the set is not a business. If this threshold is not met, the entity can apply the proposed ASU’s framework for evaluating whether an input and a substantive process are both present and together contribute to the ability to produce outputs.

This assessment incorporates the concept of “integral equipment” into current accounting whereby a tangible nonfinancial asset that is attached to and cannot be physically separated from another tangible nonfinancial asset without incurring significant costs or diminution in value to either asset would be viewed as a single identifiable asset.

The proposed guidance also indicates that tangible assets and intangible assets cannot be combined into a single asset and would not be viewed as similar assets under this threshold test.

Thinking It Through

Many real estate transactions may meet this threshold, particularly those that are included in single-asset legal entities, such as a purchase of a single-family home. If a real estate entity determines that it meets the “substantially all” threshold, it is not required to further evaluate whether the set includes an input and substantive process and will automatically not be a business.

In addition, since tangible assets and intangible assets cannot be combined in this assessment, real estate entities acquiring a property with an in-place lease cannot combine the property with the in-place lease since the in-place lease represents an intangible asset. In situations in which the in-place lease has significant fair value, the set may not meet this threshold. It would then need to be determined whether the set meets the definition of a business.

Input and Process Requirement

The proposal provides a framework for determining whether a set has an input and a substantive process that collectively together contribute to the ability to create outputs ("input and process requirement").

In situations in which a set does not have outputs, the set would meet the input and process requirement if it includes an organized workforce that has the necessary skills, knowledge, or experience to perform an acquired process that, when applied to another acquired input(s), is critical to the ability to develop or convert that acquired input(s) into outputs.
In situations in which a set has outputs, the set would meet the input and process requirement if any of the following are present:

- 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.”
- The “acquired process (or group of processes), when applied to an acquired input or inputs, contributes to the ability to continue producing outputs and cannot be replaced without significant cost, effort, or delay in the ability to continue producing outputs.”
- The “acquired process (or group of processes), when applied to an acquired input or inputs, contributes to the ability to continue producing outputs and is considered unique or scarce.”

In addition, if a set has outputs, a continuation of revenues does not result in the conclusion that a substantive process has been acquired. In fact, any contracts with continued revenue streams, such as in-place leases or customer contracts, are excluded from the analysis of the input and process requirement, and only those factors listed above would be evidence that this requirement has been met.

**Thinking It Through**

Real estate entities will not be able to consider in-place contracts, such as leases, that provide a continued revenue stream in determining whether they have acquired a business. Under the proposal, since these contracts are excluded, a real estate entity can only conclude that a set is a business if there is a substantive process as indicated by the presence of one of the factors listed above. Under the current definition of a business (in which the focus is on inputs, outputs, and processes), a real estate entity would often conclude that an in-place lease providing a continued revenue stream before and after the acquisition reflected a process that was embedded in the acquisition and, therefore, that the asset was a business. The proposed ASU includes an example of an office building acquisition that highlights the “substantive process” issue.

**Definition of Outputs**

Under current guidance, outputs are defined as “the result of inputs and processes applied to those inputs that provide or have the ability to provide a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants.” The proposal would change this definition to the “result of inputs and processes applied to those inputs that provide goods or services to customers, other revenues, or investment income, such as dividends or interest.” The revised definition of outputs aligns with how outputs are considered in the new revenue guidance in ASC 606 and narrows the definition to not include just any form of return as an output.

**Transition and Effective Date**

The amendments in the proposal would be applied prospectively to any transaction that occurs on or after the effective date. No disclosures would be required at transition. The FASB will determine the effective date and whether the proposed amendments may be applied before the effective date after it considers stakeholder feedback on the proposed amendments.

For additional information, see Deloitte’s December 4, 2015, *Heads Up.*
Financial Instrument Impairment

Background
The FASB spent much of 2015 drafting amendments to its impairment guidance. The amendments will introduce the current expected credit loss (CECL) model, which is a new impairment model for certain financial instruments that is based on expected losses rather than incurred losses. Under the CECL model, an entity would recognize as an allowance its estimate of the contractual cash flows not expected to be collected. The FASB believes that the CECL model will result in more timely recognition of credit losses and will reduce the complexity of U.S. GAAP by decreasing the number of credit impairment models used to account for debt instruments.

Under the existing impairment models (often referred to as incurred loss models), an impairment allowance is recognized only after a loss event (e.g., default) has occurred or its occurrence is probable. In assessing whether to recognize an impairment allowance, an entity may only consider current conditions and past events; it may not consider forward-looking information.

The CECL Model
Scope
The CECL model will apply to most debt instruments (other than those measured at FVTNI), trade receivables, lease receivables, reinsurance receivables that result from insurance transactions, financial guarantee contracts, and loan commitments. However, AFS debt securities will be excluded from the model’s scope and will continue to be assessed for impairment under ASC 320 (the FASB has proposed limited changes to the impairment model for AFS debt securities, as discussed below).

Recognition of Expected Credit Losses
Unlike the incurred loss models in existing U.S. GAAP, the CECL model does not specify a threshold for the recognition of an impairment allowance. Rather, an entity will recognize an impairment allowance equal to the current estimate of expected credit losses (i.e., all contractual cash flows that the entity does not expect to collect) for financial assets as of the end of the reporting period. Credit impairment will be recognized as an allowance — or contra-asset — rather than as a direct write-down of the amortized cost basis of a financial asset.

Thinking It Through
Because the CECL model does not have a minimum threshold for recognition of impairment losses, entities will need to measure expected credit losses on assets that have a low risk of loss (e.g., investment-grade held-to-maturity debt securities). However, an “entity would not be required to recognize a loss on a financial asset in which the risk of nonpayment is greater than zero [but] the amount of loss would be zero.” Although the Board decided not to specify the exact types of assets for which it would allow an entity to recognize zero credit losses, we believe that U.S. Treasury securities and certain highly rated debt securities may have been contemplated by the FASB.

Although impairment began as a joint FASB and IASB project, constituent feedback on the boards’ “dual-measurement” approach led the FASB to develop its own impairment model. The IASB, however, continued to develop the dual-measurement approach and issued final impairment guidance based on it as part of the July 2014 amendments to IFRS 9. For more information about the IASB’s impairment model, see Deloitte’s August 8, 2014, Heads Up.

Note that the proposed CECL model would replace or amend several existing U.S. GAAP impairment models. See Appendix B of Deloitte’s March 13, 2015, Heads Up, for a tabular summary of those models.

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

The CECL model would not apply to financial guarantee contracts that are accounted for as insurance or measured at FVTNI.
Measurement of Expected Credit Losses

Under the amendments, an entity’s estimate of expected credit losses represents all contractual cash flows that the entity does not expect to collect over the contractual life of the financial asset. When determining the contractual life of a financial asset, the entity would consider expected prepayments but would not be allowed to consider expected extensions unless it “reasonably expects that it will execute a troubled debt restructuring with the borrower.”

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

Thinking It Through

Measuring expected credit losses will most likely be a significant challenge for all entities, particularly mortgage REITs and other financial institutions. Entities may also incur one-time or recurring costs associated with implementing the CECL model, such as those related to system changes, data collection, and using forward-looking information to estimate expected credit losses over the contractual life of an asset.

AFS Debt Securities

The impairment of AFS debt securities will continue to be accounted for under ASC 320. However, the amendments revise that guidance by:

- Limiting the credit losses recognized to the difference between the security’s amortized cost and its fair value.
- Requiring an entity to use an allowance approach (vs. permanently writing down the security’s cost basis).
- Removing the requirement that an entity must consider the length of time fair value has been less than amortized cost when assessing whether a security is other-than-temporarily impaired.
- Removing the requirement that an entity must consider recoveries in fair value after the balance sheet date when assessing whether a credit loss exists.

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8 Quoted text is from the FASB’s summary of tentative Board decisions reached at its September 3, 2014, meeting.
Thinking It Through
The Board did not revise (1) step 1 of the existing other-than-temporary impairment model (i.e., an “investment is impaired if the fair value of the investment is less than its cost”) or (2) the requirement under ASC 320 that entities recognize the impairment amount only related to credit in net income and the noncredit impairment amount in OCI. However, entities would use an allowance approach when recognizing credit losses (as opposed to a permanent write-down of the AFS security’s cost basis). As a result, in both of the following instances, an entity would reverse credit losses through current-period earnings on an AFS debt security:

• If the fair value of the debt security exceeds its amortized cost in a period after a credit loss had been recognized through earnings (because fair value was less than amortized cost), the entity would reverse the entire credit loss previously recognized and recognize a corresponding adjustment to its allowance for credit losses.

• If the fair value of the debt security does not exceed its amortized cost in a period after a credit loss had been recognized through earnings (because fair value was less than amortized cost) but the credit quality of the debt security improves in the current period, the entity would reverse the credit loss previously recognized only in an amount that would reflect the improved credit quality of the debt security.

These revisions to the impairment model in ASC 320 could result in earlier recognition of impairment.

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

Other Significant Decisions
The new guidance will also reflect the FASB’s tentative decisions related to the following:

• Practical expedients when measuring expected credit losses.
• Write-offs.
• Modifications.
• PCI assets.
• Certain beneficial interests within the scope of ASC 325-40.
• Loan commitments.
• Disclosures.

Effective Date and Early Adoption
The Board tentatively decided the following:

• For public business entities that meet the definition under U.S. GAAP of an SEC filer, the final standard will be effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

• For public business entities that do not meet the definition of an SEC filer, the final standard will be effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years.

• For all other entities, the final standard will be effective for fiscal years beginning after December 15, 2020.
The Board also tentatively decided that public business entities that meet the definition under U.S. GAAP of an SEC filer will not be permitted to early adopt the final standard. All other entities will be permitted to early adopt the final standard, but not before an SEC filer would adopt the standard.

Next Steps
The FASB expects to issue a final standard in the first quarter of 2016. For a comprehensive summary of the impairment project to date, see the project update page on the FASB’s Web site.

Hedging

Background
As part of its project on targeted improvements to hedge accounting, the FASB held several educational sessions during 2015. Those sessions have thus far culminated in two decision-making meetings at which the FASB made a number of tentative decisions that, if ultimately adopted, would significantly modify certain aspects of the existing hedge accounting model. The Board hopes to issue a proposed ASU reflecting these tentative conclusions in the second quarter of 2016.

Overall Hedging Model
The FASB tentatively decided to retain, for both fair value and cash flow hedges, (1) the highly effective threshold used to qualify for hedge accounting under current U.S. GAAP and (2) the current guidance allowing an entity to voluntarily redesignate a hedging relationship. Further, under the proposal, an entity would still need specified documentation in place at hedge inception, including a description of its method for quantitatively assessing hedge effectiveness (unless the criteria for using the shortcut or critical-terms-match methods are met, obviating the need for quantitative assessments). However, an entity would not have to actually complete that initial quantitative assessment of hedge effectiveness until the end of the reporting period in which it designated the hedge (i.e., an entity could have up to three months to complete the initial quantitative assessment of effectiveness). Also under the proposal, after hedge inception, an entity would need to perform quantitative assessments of hedge effectiveness only when facts and circumstances change.

The Board also tentatively decided to eliminate the traditional concept of hedge ineffectiveness:

- For highly effective cash flow hedging relationships, the entire change in the fair value of the hedging instrument included in an entity’s hedge effectiveness assessment would initially be recorded in OCI. When the hedged item affects earnings, the amount in accumulated OCI would be reclassified to the same income statement line as the earnings effect of the hedged item. Any portion of the change in the fair value of the hedging instrument that is excluded from an entity’s hedge effectiveness assessment would be recognized immediately in earnings (but presented on the same income statement line as the earnings effect of the hedged item).
- For highly effective fair value hedging relationships, the entire change in the fair value of the hedging instrument would be recorded in earnings immediately in the same income statement line as the hedged item.
- For highly effective net investment hedging relationships, the entire change in the fair value of the hedging instrument included in an entity’s hedge effectiveness assessment would initially be recorded as part of the cumulative-translation adjustment in OCI. When the hedged item affects earnings, the amount in accumulated OCI would be reclassified to the same income statement line as the earnings effect of the hedged item. Any portion of the change in the fair value of the hedging instrument that is excluded from an entity’s hedge effectiveness assessment would be recognized immediately in earnings.

In addition, the FASB tentatively decided to require additional disclosure about (1) cumulative-basis adjustments for fair value hedges and (2) the effect of hedging on individual income statement line items. It also tentatively decided to require expanded qualitative disclosures about the quantitative goals, if any, that an entity set to achieve its hedging objectives.
**Nonfinancial Hedging Relationships**

For hedges of nonfinancial items, the Board tentatively decided to change existing U.S. GAAP to permit an entity to designate as a hedged item a contractually specified component or ingredient that is linked to a contractually stated rate or index. Any cap, floor, or negative basis that is related to the pricing of a contractually specified component of a nonfinancial item would not preclude designation of that component as a hedged item — an entity would just need to consider such pricing features in its assessment of hedge effectiveness.

**Financial Hedging Relationships**

For hedges of financial items, the FASB tentatively decided to (1) allow the contractually specified index rate in a variable-rate hedged item to be the designated interest rate risk (thereby relieving entities of the need to designate a benchmark interest rate for cash flow hedges of variable-rate instruments); (2) retain the existing benchmark interest rate definition for hedges of fixed-rate instruments, with minor modifications to eliminate inconsistencies; and (3) designate the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap index as a permitted benchmark interest rate.

In addition, the tentative decisions would allow an entity, for fair value hedges of interest rate risk, to:

- Consider only the effects of the designated hedged risk (e.g., interest rate risk) on a prepayment option when determining the change in the value of the debt for hedges of callable debt.
- Designate as the hedged risk only a portion of the hedged item’s term (i.e., compute the change in the hedged item’s fair value by using the same term as that of the hedging instrument).
- Calculate the change in the fair value of the hedged item attributable to changes in the benchmark interest rate by using either (1) total coupon cash flows or (2) only those cash flows related to the benchmark interest rate. However, an entity would be required to use total coupon cash flows when the effective interest rate of the hedged item is less than the benchmark interest rate on the date of hedge designation.

**Shortcut Method**

The FASB tentatively decided to retain the shortcut method in current U.S. GAAP. However, the Board also tentatively decided to allow an entity to document at hedge inception the long-haul method it would use to measure hedge ineffectiveness if the shortcut method could not be applied. That is, if the entity later determines that continued use of the shortcut method is inappropriate, it can continue the hedging relationship by using the long-haul method designated at inception as long as the hedging relationship has been highly effective since inception.

**Next Steps**

The FASB staff will (1) continue deliberations, including consideration of whether alternative hedge documentation requirements for private companies are warranted; (2) develop a staff draft reflecting the Board’s decisions; (3) analyze the costs, benefits, and potential complexity of the tentative decisions; and (4) identify any issues that need to be brought back to the Board for a vote. In addition, the FASB will need to address transition and the comment period of the proposed ASU.

**Thinking It Through**

When the proposal is issued, companies should carefully analyze it to assess its possible ramifications on their hedging strategies, systems, and internal controls, and they are encouraged to provide feedback on the proposed amendments to the FASB. Multinational companies should note that the FASB’s proposed hedging model is likely to differ significantly from the IASB’s IFRS 9 hedging model.

To follow the status of the FASB’s hedging project, see the project page on Deloitte’s US GAAP Plus Web site.
FASB’s Simplification Initiative

Goodwill and Identifiable Intangible Assets for Public Business Entities and Not-for-Profit Entities

Background
In November 2013, the FASB endorsed a decision by the PCC to allow nonpublic business entities to amortize goodwill and perform a simplified goodwill impairment test. In addition, in 2014 the FASB endorsed the PCC’s alternative that gives private companies an exemption from having to recognize certain intangible assets for (1) assets acquired in a business combination or (2) investments accounted for under the equity method or upon the adoption of fresh-start accounting. The Board received feedback on the PCC’s decision indicating that many public business entities and not-for-profit entities had similar concerns about the cost and complexity of applying these requirements. In response, the Board added a project on goodwill and a separate project on intangible assets to its agenda in 2014.

Current Status and Next Steps
The goodwill project is currently in the initial deliberations phase. At its meeting on October 28, 2015, the FASB tentatively decided to split the project into two phases. The first phase would focus on simplifying the goodwill impairment test. In the second phase, the Board would work with the IASB to address stakeholder concerns related to the subsequent accounting for goodwill.

At the October meeting, the Board discussed how to simplify the goodwill impairment test and tentatively decided to remove step 2, thus eliminating the requirement to complete a hypothetical purchase-price allocation. The FASB also tentatively decided not to give entities the option to perform step 2 and to instead require them to adopt the simplified impairment test prospectively. An exposure draft related to the first phase of the project is expected to be released in the first half of 2016. The comment period would be 60 days.

The identifiable intangible assets project is currently in the initial deliberations phase. The FASB will continue its research related to this project in conjunction with the IASB.

Employee Share-Based Payments
In June 2015, the FASB issued a proposed ASU on share-based payments as part of its simplification initiative. The proposed ASU would affect several aspects of the accounting for employee share-based payment transactions for both public and nonpublic entities, including the accounting for income taxes, forfeitures, minimum statutory withholding requirements, classification in the statement of cash flows, and classification of awards with repurchase features. In addition, the proposed ASU contains two practical expedients for nonpublic entities under which such entities can use the simplified method to estimate the expected term of an award and make a one-time election to switch from fair value measurement to intrinsic value measurement for liability-classified awards.

The FASB received over 60 comment letters on the proposal (which were due by August 14, 2015) from various respondents, including preparers, professional and trade organizations, and accounting firms. While respondents were generally supportive of the proposed changes, a number of them were concerned with a key provision related to accounting for excess tax benefits and deficiencies. Specifically, the ASU proposes to eliminate the APIC pool and require entities to record all excess tax benefits and deficiencies to the income statement. While respondents generally agreed with the Board’s proposal to eliminate the APIC pool, many would prefer to record all excess tax benefits and deficiencies directly to equity.

For additional information about the proposed ASU, see Deloitte’s June 12, 2015, Heads Up.

See the PCC’s overview of decisions reached on PCC Issue No. 14-01.
Balance Sheet Classification of Debt

Background
As part of its simplification initiative, the FASB has tentatively decided to replace its current, fact-specific debt classification guidance with a cohesive principle that would be applied in the determination of whether debt liabilities should be classified as current or noncurrent in a classified statement of financial position. All debt arrangements (i.e., those that “provide a lender a contractual right to receive money and a borrower a contractual obligation to pay money on demand or on fixed or determinable dates”) would be within the scope of the tentative decisions.

Thinking It Through
The scope of this project also includes convertible debt instruments, even though they may be settled in shares upon conversion, and mandatorily redeemable financial instruments that are classified as liabilities, even if they were issued in the form of an entity's equity shares.

Tentative Decisions

Debt Classification Principle
The Board has tentatively decided that “an entity should classify a debt as noncurrent if one or both of the following criteria are met as of the balance sheet date:

1. The liability is contractually due to be settled more than 12 months (or operating cycle, if longer) after the balance sheet date
2. The entity has a contractual right to defer settlement of the liability for at least 12 months (or operating cycle, if longer) after the balance sheet date.”

Thinking It Through
Under existing U.S. GAAP, an entity in some cases considers transactions entered into after the balance sheet date, but before the financial statements are issued, in classifying debt as current or noncurrent. For example, an entity may exclude short-term obligations from current liabilities in certain circumstances if it has issued long-term obligations or equity securities to refinance a short-term obligation on a long-term basis after the balance sheet date but before the financial statements are issued. Under the Board’s tentative decision, the classification would instead be made on the basis of the entity’s rights and obligations as of the balance sheet date. The proposed classification principles would more closely align U.S. GAAP with IFRSs (i.e., paragraph 69 of IAS 1).

Although the classification of debt generally would be based on the facts and circumstances as of the balance sheet date, the Board tentatively decided to make an exception in certain circumstances when the entity receives a waiver of a debt covenant violation. When an entity violates a debt covenant on or before the balance sheet date, and the long-term debt becomes a short-term obligation, the entity would not automatically be required to classify the debt as current. If the lender grants the entity a waiver of the covenant before the entity’s financial statements are issued, the entity would classify the debt as noncurrent and present the debt separately on the face of the balance sheet. The purpose of such presentation would be to notify financial statement users that this debt is classified as noncurrent even though the entity violated one or more covenants as of the balance sheet date. The exception would not apply to waivers that involve a debt modification or extinguishment under ASC 470-50.

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10 See the handout for the FASB’s July 29, 2015, meeting.
11 Quoted text is from the FASB’s summary of tentative Board decisions reached at its January 28, 2015, meeting.
For an entity’s application of the waiver exception, the Board tentatively decided to retain existing U.S. GAAP guidance12 under which (1) the waiver of the current violation must be greater than 12 months from the balance sheet date and (2) it is not probable that the borrower will be unable to comply with the covenant by the covenant compliance dates within the next 12 months.

**Subjective Acceleration Clauses**

Subjective acceleration clauses are clauses under which the lender may accelerate the maturity date of the debt as a result of conditions that are not objectively determinable (e.g., if the debtor fails to maintain satisfactory operations or if a material adverse change occurs). The FASB tentatively decided that subjective acceleration clauses should affect the classification of debt only when such clauses are triggered.

**Thinking It Through**

Under current U.S. GAAP, long-term obligations subject to a subjective acceleration clause in certain circumstances (e.g., if the borrower is experiencing recurring losses or liquidity problems) are classified as current even if the lender has not invoked the clause. On the basis of the Board’s tentative decision, however, it appears that a subjective acceleration clause would only affect the classification of debt when the entity’s debt payment has been accelerated.

**Disclosures and Transition**

The FASB has tentatively decided to (1) incorporate into U.S. GAAP the disclosure requirements related to debt covenant violations that currently exist in SEC guidance13 and (2) require the disclosures for both public and nonpublic business entities. The Board has also decided to require entities to disclose the nature and existence of significant subjective acceleration clauses and debt covenants.

The guidance would apply on a prospective basis to all debt that exists as of the effective date. On transition, an entity would be required to disclose:

- The nature of and reason for the change in accounting principle.
- The effect of the change on affected financial statement line items in the current period.

The effective date will be determined after stakeholder feedback is received.

**Next Steps**

The FASB expects to issue a proposed ASU with a 60-day comment period in the first quarter of 2016.

**Equity Method Simplification**

In June 2015, the FASB issued a proposed ASU on equity method accounting as part of its simplification initiative. The proposal is intended to eliminate the requirements for an investor to (1) account for basis differences related to its equity method investees and (2) retroactively account for an investment that becomes newly qualified for use of the equity method because of an increase in ownership interest or degree of influence.

On the basis of the feedback received on its proposed ASU, the FASB directed the staff to perform additional research on whether to eliminate the requirement to account for the basis differences. However, the FASB decided to further clarify and finalize its proposed guidance related to eliminating the retroactive accounting for an investment that becomes newly qualified for use of the equity method of accounting upon an increase in ownership interest or degree of influence. The FASB clarified that unrealized holding gains or losses in accumulated other comprehensive income related to an AFS security

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12 See ASC 470-10-45-1(b).
13 See SEC Regulation S-X, Rule 4-08 (ASC 235-10-S99-1(c)).
that becomes eligible for the equity method should be recognized in earnings as of the date on which the investment qualifies for the equity method.

The FASB directed the staff to draft a final standard for issuance, which is expected in the first quarter of 2016. The guidance in the ASU will be applied prospectively to increases in the level of ownership interest or degree of influence occurring after the final ASU’s effective date. No transition disclosures will be required. For all entities, the final standard will be effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. In addition, all entities will be permitted to early adopt the guidance upon issuance of the final standard.
Other Topics
Disclosure Framework

Background
In July 2012, the FASB issued a discussion paper as part of its project to develop a framework to make financial statement disclosures “more effective, coordinated, and less redundant.” The paper identifies aspects of the notes to the financial statements that need improvement and explores possible ways to improve them. The FASB subsequently decided to distinguish between the “Board’s decision process” and the “entity’s decision process” for evaluating disclosure requirements.

FASB’s Decision Process
In March 2014, the FASB released for public comment a proposed concepts statement that would add a new chapter to the Board’s conceptual framework for financial reporting. The proposal outlines a decision process to be used by the Board and its staff for determining what disclosures should be required in notes to financial statements. The FASB’s objective in issuing the proposal is to improve the effectiveness of such disclosures by ensuring that reporting entities clearly communicate the information that is most important to users of financial statements. See Deloitte’s March 6, 2014, Heads Up for additional information.

Entity’s Decision Process
In September 2015, the FASB issued a proposed ASU that would amend the Codification to indicate that the omission of disclosures about immaterial information is not an accounting error. The proposal, which is part of the FASB’s disclosure effectiveness initiative, notes that materiality is a legal concept applied to assess quantitative and qualitative disclosures individually and in the aggregate in the context of the financial statements taken as a whole. See Deloitte’s September 28, 2015, Heads Up for additional information.

Comments on the proposed ASU were due by December 8, 2015. See Deloitte’s comment letter on the proposal.

Topic-Specific Disclosure Reviews
In addition to proposing amendments to guidance, the FASB staff is analyzing ways to “further promote [entities’] appropriate use of discretion” in determining proper financial statement disclosures. The Board is applying the concepts in both the entity’s and the Board’s decision process in considering “section-specific modifications.” In the second half of 2015, the FASB reached tentative decisions about disclosure requirements in the following Codification topics:

- ASC 820 (fair value measurement).
- ASC 740 (income taxes).
- ASC 715-20 (defined benefit plans).
- ASC 330 (inventory).

Proposed changes to the disclosure requirements for fair value measurement and income taxes are discussed below.
**Fair Value Measurement**

**Objective for Disclosures**

In December 2015, the FASB issued for public comment a proposed ASU that would amend the requirements in ASC 820 for disclosing fair value measurements. The proposed ASU would add the following objective to ASC 820 to encourage preparers to use discretion in complying with the disclosure requirements:

> The objective of the disclosure requirements in this Subtopic is to provide users of financial statements with information about all of the following:
> a. The valuation techniques and inputs that a reporting entity uses to arrive at its measures of fair value, including judgments and assumptions that the entity makes
> b. The effects of changes in fair value on the amounts reported in financial statements
> c. The uncertainty in the fair value measurement of Level 3 assets and liabilities as of the reporting date
> d. How fair value measurements change from period to period.

In addition, the proposed ASU would make changes (eliminations, modifications, and additions) to the fair value disclosure requirements in ASC 820, as discussed below.

**Eliminated and Modified Disclosure Requirements**

**Policy on Timing of Transfers Between Levels and Transfers Between Levels 1 and 2**

The proposed ASU would remove the requirement in ASC 820-10-50-2C for an entity to disclose its policy on the timing of transfers between levels of the fair value hierarchy. An entity would still be required to have a consistent policy on timing of such transfers. The requirement to separately disclose the amounts transferred between Level 1 and Level 2 and the corresponding reason for doing so would also be removed.

**Level 3 Fair Value Measurements**

The disclosure requirements for Level 3 fair value measurements would be amended as follows:

- **Valuation process** — The proposed ASU would remove requirements in ASC 820-10-50-2(f) (and related implementation guidance in ASC 820-10-55-105) for an entity to disclose its valuation processes for Level 3 fair value measurements.

  **Thinking It Through**

  Removing the disclosure requirement in ASC 820-10-50-2(f) will result in divergence between U.S. GAAP and IFRSs. The requirement was added to the FASB’s and IASB’s jointly issued standard on the basis of a recommendation by the IASB’s expert panel. The panel explained that the disclosure would help users understand the quality of the entity’s fair value estimates and give investors more confidence in management’s estimate. The FASB has proposed to remove the requirement because it would conflict with the Board’s proposed concepts statement. The Board indicated that disclosure of internal control procedures is outside the purpose of the notes to the financial statements and is not required under other topics in U.S. GAAP. Removing this requirement does not change management’s responsibility for internal controls over the valuation process and related auditor testing. Further, it should not affect investor confidence in the quality of the fair value estimate given the regulatory environment in the United States (e.g., SEC and PCAOB) as well as the intense scrutiny in this area. The Board also noted that investors are typically familiar with the overall valuation process.

- **Measurement uncertainty** — The proposal would retain the requirement in ASC 820-10-50-2(g) to provide a narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs. However, the Board plans to clarify that this disclosure is intended to communicate information about the uncertainty in measurement as of the reporting date and not to provide information about sensitivity to future changes in fair value.
• **Quantitative information about unobservable inputs** — The proposed ASU would require disclosure of the range and weighted average of the unobservable inputs to comply with the requirement in ASC 820-10-50-2(bbb) (as shown by example in the implementation guidance in ASC 820-10-55-103). Disclosing the period used to develop significant unobservable inputs based on historical data would also be required.

• **Level 3 rollforward** — The proposal would retain the Level 3 rollforward requirement for public business entities. For entities that are not public business entities, the Board tentatively decided to modify the Level 3 rollforward guidance and remove the requirement to disclose the change in unrealized appreciation or depreciation related to investments held as of the balance sheet date under ASC 820-10-50-2(d). Instead, disclosures would be required about transfers into and out of Level 3 and purchases of Level 3 investments. The Board indicated that entities are already required to disclose the ending balance in the fair value hierarchy table, and they could disclose transfers into (and out of) and purchases of Level 3 investments in a sentence rather than in a full rollforward as required today. A defined benefit plan sponsor would also remove the reconciliation of beginning and ending balances for plan investments categorized as Level 3 within the fair value hierarchy (i.e., the Level 3 rollforward) and would only be required to disclose transfers into and out of Level 3 and purchases of Level 3 assets in its defined benefit plan footnote (for more information about the FASB’s project on reviewing defined benefit plan disclosures, see the project page on Deloitte’s US GAAP Plus Web site).

**Thinking It Through**

The Board discussed the results of user outreach on the Level 3 rollforward and noted that some financial statement users believe that the rollforward is useful because it helps them understand management’s decisions, especially for different economic cycles. The full rollforward was generally deemed less useful for users of private-company financial statements. Transfers into and out of Level 3 were generally considered to be the most useful aspect of the rollforward.

**NAV Disclosures of Estimates of Timing of Future Events**

The following disclosures currently required under ASC 820-10-50-6A(b) and ASC 820-10-50-6A(e) would apply only when they have been communicated to the reporting entity by the investee or are otherwise made publicly available (even if not specifically communicated to the investor):

• “For each class of investment that includes investments that can never be redeemed with the investees, but the reporting entity receives distributions through the liquidation of the underlying assets of the investees, the reporting entity’s estimate of the period of time over which the underlying assets are expected to be liquidated by the investees.”

• “[W]hen the restriction from redemption might lapse.”

**Thinking It Through**

The objective of this change is to prevent an investor from having to make its own estimate when it does not have knowledge of the timing from the investee or other public source. In addition, ASU 2015-07 removed the requirement for entities to categorize within the levels of the fair value hierarchy all investments they have measured under the NAV practical expedient.

**New Disclosure Requirements — Unrealized Gains and Losses**

Public business entities would disclose fair value changes for assets and liabilities held as of the balance sheet date disaggregated by fair value hierarchy level (i.e., Levels 1, 2, and 3) for (1) net income before taxes and (2) comprehensive income. This is currently only required for the Level 3 amounts within net income under ASC 820-10-50-2(c) and (d). This requirement would not apply to entities that are not public business entities in accordance with the private-company decision-making framework.
Transition and Next Steps

Modifications to disclosures about changes in unrealized gains and losses and the changes in the quantitative information about unobservable inputs (see discussion above) would be applied prospectively beginning in the period of adoption. Entities would apply all other changes in disclosures retrospectively to all periods presented.

The FASB did not propose an effective date for the final standard. Rather, the Board indicated that it plans to determine such date after considering stakeholders’ feedback on the proposed guidance. Comments on the proposal are due by February 29, 2016. For more information about the proposed ASU, see Deloitte’s December 8, 2015, Heads Up.

Income Taxes

At its meeting on January 7, 2015, the FASB staff outlined potential revisions to the disclosure requirements in ASC 740 that would enhance a financial statement user’s understanding of foreign taxes. The Board’s efforts are largely driven by findings in the post-implementation review of Statement 109 that users want more information that will allow them to analyze (1) “the cash effects associated with income taxes, particularly current period taxes paid by jurisdiction (e.g., U.S. and foreign), and estimate future tax payments” and (2) “earnings determined to be indefinitely reinvested in foreign subsidiaries.”

At its October 21, 2015, meeting, the FASB discussed income tax disclosure requirements related to income taxes paid, deferred income taxes, valuation allowances, and rate reconciliation and reached the following tentative decisions, which would apply to both public and nonpublic entities:

- **Income taxes paid** — The Board would add requirements for a reporting entity to disclose (1) when a change in tax law has been enacted and it is probable that the change will affect the reporting entity in a future period and (2) the disaggregation of the income taxes paid between foreign and domestic jurisdictions.

- **Deferred income taxes** — An entity would be required to disclose the balance sheet line item(s) in which deferred taxes are presented (i.e., a mapping of total deferred taxes to the balance sheet line items in which they are reported).

- **Valuation allowances** — An entity would need to explain the “nature and amounts of the valuation allowance recorded and released during the reporting period.”

- **Rate reconciliation** — The Board tentatively decided that:
  - Nonpublic entities would be required to present a rate reconciliation in the notes to the financial statements, as ASC 740-10-50-12 currently requires for public entities.
  - A disaggregation of a component of the rate reconciliation would be required if the individual component is greater than or equal to 5 percent of the tax at the statutory rate in a manner consistent with SEC Regulation S-X.
  - An entity would be required to disclose a qualitative description of the items that have caused a significant year-over-year change to the effective tax rate.

In addition, the Board tentatively decided to require disclosures about the (1) gross amounts and expiration dates of carryforwards recorded on a tax return, (2) tax-effected amounts and expiration dates of carryforwards that give rise to a deferred tax asset, and (3) total amount of unrecognized tax benefits that offset deferred tax assets related to carryforwards.

The Board directed its staff to begin drafting a proposed ASU for public comment that would take into account all the tentative decisions reached to date regarding income tax disclosure requirements. Such decisions include the Board’s previous tentative decisions made about disclosure requirements related to indefinitely reinvested foreign earnings and unrecognized tax benefits.

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1 Quoted text is from the FASB’s summary of tentative Board decisions reached at its October 21, 2015, meeting.
Undistributed Foreign Earnings

On February 11, 2015, the FASB tentatively decided that entities should:

- Disclose information separately about the domestic and foreign components of income before income taxes. Further, entities should separately disclose income before income taxes of individual countries that are significant relative to total income before income taxes.2
- Disclose the domestic tax expense recognized in the period related to foreign earnings.
- Disclose unremitted foreign earnings that, during the current period, are no longer asserted to be indefinitely reinvested and an explanation of the circumstances that caused the entity to no longer assert that the earnings are indefinitely reinvested. These disclosures should be provided in the aggregate and for each country for which the amount no longer asserted to be indefinitely reinvested is significant in relation to the aggregate amount.
- Separately disclose the accumulated amount of indefinitely reinvested foreign earnings for any country that is at least 10 percent of the aggregate amount.

Unrecognized Tax Benefits

At its meeting on August 26, 2015, the FASB tentatively decided to:

- Add a disclosure requirement in the tabular reconciliation to disaggregate settlements between cash and noncash (e.g., settlement by using existing net operating loss or tax credit carryforwards).
- Add a disclosure requirement to provide a breakdown of the amount of total unrecognized tax benefits shown in the tabular reconciliation by the respective balance-sheet lines on which such unrecognized tax benefits are recorded.
- Eliminate the requirement in ASC 740-10-50-15(d) for entities to provide details of positions for which it is reasonably possible that the total amount of unrecognized tax benefits will significantly increase or decrease in the next 12 months.

Since the two new proposed disclosure requirements for unrecognized tax benefits are related to the tabular reconciliation, they will only apply to public entities.

The Board directed its staff to prepare examples of the proposed additional disclosures.

Interim Reporting

To date, the FASB has discussed five interim reporting concepts under its proposed concepts statement. The Board generally agreed that interim financial statements should describe “differences in recognition, measurement, and presentation of line items” and should explain “how the interim period relates to the entire year.”3 Two of the interim reporting concepts pertained to disclosing changes from the latest annual financial statements, and two pertained to disclosing items that are not peripheral or are “especially important.”

To determine the meaning of “especially important,” the Board will assess the interim disclosure requirements being proposed in the Board’s project on reviewing fair value measurement disclosures as well as the interim disclosure requirements related to revenue in ASC 270-10-50-1A. On the basis of this process, the FASB can assess whether entities should disclose an item or amount that has not changed but is especially important.

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2 In ASC 740, income before income taxes is also referred to as pretax financial income.
3 Quoted text is from a handout for the Board’s January 7, 2015, meeting.
Statement of Cash Flows: Classification of Certain Cash Receipts and Cash Payments (EITF Issue 15-F)

To reduce diversity in the application ASC 230, the FASB added nine subissues related to EITF Issue 15-F to the EITF’s agenda in 2015:

<table>
<thead>
<tr>
<th>Cash Flow Classification Issue</th>
<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Debt Prepayment or Extinguishment Costs</strong></td>
<td>Consensus-for-exposure</td>
</tr>
<tr>
<td>Cash payments for debt prepayment or extinguishment costs would be classified as cash outflows in financing activities.</td>
<td></td>
</tr>
<tr>
<td><strong>Settlement of Zero-Coupon Bonds</strong></td>
<td>Consensus-for-exposure</td>
</tr>
<tr>
<td>At settlement, the cash outflows of a zero-coupon bond would be classified in operating and financing activities. The cash payment of the accreted interest would be classified in operating activities, while the cash payment attributable to the original proceeds (i.e., the principal) would be classified in financing activities.</td>
<td></td>
</tr>
<tr>
<td><strong>Restricted Cash</strong></td>
<td>Tentative decisions</td>
</tr>
<tr>
<td>Changes in restricted cash that affect an entity’s cash and cash equivalent balance would be classified as investing activities (i.e., on the basis of the nature of the cash flow). The remaining restricted cash-related issues will be discussed at a future meeting.</td>
<td></td>
</tr>
<tr>
<td><strong>Contingent Consideration Payments Made After a Business Combination</strong></td>
<td>Consensus-for-exposure</td>
</tr>
<tr>
<td>Contingent consideration payments that were not made on the acquisition date or soon before or after the business combination would be classified in operating and financing activities. Cash payments up to the fair value amount of the contingent consideration liability, including any measurement-period adjustments, that are recognized as of the acquisition date would be classified in financing activities, while any excess cash payments would be classified in operating activities.</td>
<td></td>
</tr>
<tr>
<td><strong>Proceeds From the Settlement of Insurance Claims</strong></td>
<td>Consensus-for-exposure</td>
</tr>
<tr>
<td>The cash proceeds from the settlement of insurance claims would be based on the nature of the insurance coverage (i.e., nature of the loss), including lump-sum payments for which the nature of the loss can be reasonably estimated.</td>
<td></td>
</tr>
<tr>
<td><strong>Proceeds From the Settlement of Corporate-Owned Life Insurance (COLI) Policies</strong></td>
<td>Consensus-for-exposure</td>
</tr>
<tr>
<td>Cash proceeds from the settlement of COLI polices would be classified in investing activities. However, an entity would be permitted, but not required, to align the classification of premium payments on COLI policies with the classification of COLI proceeds.</td>
<td></td>
</tr>
<tr>
<td><strong>Distributions Received From Equity Method Investees</strong></td>
<td>Consensus-for-exposure</td>
</tr>
<tr>
<td>Distributions received by an equity method investee would be classified in operating and investing activities by applying the cumulative earnings approach.</td>
<td></td>
</tr>
<tr>
<td><strong>Beneficial Interests in Securitization Transactions</strong></td>
<td>Consensus-for-exposure</td>
</tr>
<tr>
<td>The transferor’s beneficial interests received as proceeds from the securitization of an entity’s assets would be disclosed as a noncash activity. Subsequent cash receipts on beneficial interests from the securitization of an entity’s trade receivables would be classified in investing activities.</td>
<td></td>
</tr>
<tr>
<td><strong>Application of the Predominance Principle</strong></td>
<td>Consensus-for-exposure</td>
</tr>
<tr>
<td>The Task Force decided to retain and clarify the predominance principle in ASC 230.</td>
<td></td>
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</tbody>
</table>

The EITF has reached a consensus-for-exposure on all of the subissues except for Issue 3 (on restricted cash) and has decided that the guidance related to those eight subissues would be applied retrospectively to all periods presented. The Task Force has also decided to incorporate an impracticability principle into the guidance.

Because Task Force members’ views differ on the guidance related to restricted cash, the EITF has directed the staff to perform further research. The Task Force is expected to continue discussing restricted cash and the effective date for the guidance at a future meeting. For more information, including tentative decisions reached by the EITF as of the date of this publication, see Deloitte’s November 2015 EITF Snapshot.

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4 The impracticability principle would be applied in a manner similar to ASC 250-10-45-9.
SEC Update

Background
The SEC continues to focus on rulemaking, particularly in connection with its efforts to complete mandated actions under the Dodd-Frank Act. Key SEC rulemaking activities and other developments that have occurred since the last edition of this publication are discussed below.

SEC Issues Final Rule on Pay Ratio Disclosure
In August 2015, the SEC issued a final rule that requires a registrant to calculate and disclose (1) the median of the annual total compensation of all of its employees (excluding its principal executive officer (PEO)), (2) the PEO’s annual total compensation, and (3) the ratio of (1) to (2). Starting with its first full fiscal year beginning on or after January 1, 2017, the registrant will include the disclosures in filings in which executive compensation information is required, such as proxy and information statements, registration statements, and annual reports. Emerging growth companies, smaller reporting companies, foreign private issuers, registered investment companies, and filers under the U.S.-Canadian Multijurisdictional Disclosure System are exempt from the rule’s requirements.

Thinking It Through
The rulemaking associated with the new requirements has been controversial, as demonstrated by the SEC’s receipt of over 287,400 comment letters on the original rule proposal and the Commission’s 3–2 vote on the final rule. To address concerns expressed by commenters about the costs of complying with the requirements, the rule provides certain accommodations.

We expect that during the first year or two after adoption, some registrants may change their method of computing the pay ratio as they find more efficient and accurate ways to identify the median employee and to calculate annual total compensation. Once registrants find a method that works for them, however, they are advised to stick with it. Some shareholders, analysts, or other parties may view frequent method changes as a red flag, thereby drawing unwarranted attention to a registrant’s pay ratio disclosure.

The final rule became effective on October 19, 2015.

For more information, see the press release on the SEC’s Web site.

SEC Proposes New Clawback Requirements
In July 2015, the SEC issued a proposed rule that would require companies to adopt “clawback” polices on executive compensation. Specifically, the proposal, which was released in response to a mandate in Section 954 of the Dodd-Frank Act, “would direct the national securities exchanges and national securities associations to establish listing standards that would require each issuer to develop and implement a policy providing for the recovery, under certain circumstances, of incentive-based compensation based on financial information required to be reported under the securities laws that is received by current or former executive officers, and require the disclosure of the policy.” This proposal marks the completion of the SEC’s issuance of proposed executive compensation rules under the Dodd-Frank Act.
Thinking It Through

In light of the proposed accelerated timeframe for adopting the mandatory compensation recovery policy and the fact that the recovery policy could apply to unearned and unvested awards of incentive-based compensation granted before the effective date of the new listing rules (if earned or vested after the effective date), an affected registrant should:

- Monitor the timing of both the issuance of the final SEC rule and the adoption of the changes’ new listing rules. This is because the registrant would have a limited amount of time (60 days as proposed) in which to amend its existing recovery policy or adopt a new policy once the listing rules have been approved.
- Establish a cross-functional team from its human resources and legal departments to:
  - Review the registrant’s existing recovery policy and begin considering changes that may be necessary to comply with the SEC’s final rule.
  - Review executive officers’ employment and/or letter agreements to (1) determine whether there is any potential conflict between the terms of the agreements and the proposed SEC rule and (2) consider whether the company needs to amend those agreements.
  - Review the form of the registrant’s stock award agreements, the terms of its annual bonus plan, and its long-term incentive plan to determine whether they permit the recovery of excess incentive-based compensation and whether they should be updated.

Comments on the proposed rule were due by September 14, 2015.

For more information, see the press release on the SEC’s Web site.

SEC Issues Proposed Rule on Pay Versus Performance

In April 2015, the SEC issued a proposed rule that would require public companies — except foreign private issuers, registered investment companies, and emerging growth companies — to disclose “the relationship between executive compensation actually paid and the financial performance of the registrant” in proxy or information statements in which executive compensation disclosures are required. In a public statement, SEC Chairman Mary Jo White indicated that she believes that the proposed disclosure requirements would “assist shareholders in assessing a company’s executive compensation practices and policies [and] inform [them] when voting in an election of directors and in connection with a shareholder’s advisory vote on executive compensation.”

Many registrants may find it challenging to determine (1) where to present this disclosure and (2) how to integrate it into the other extensive compensation disclosures already required by the SEC rules. The proposal acknowledges that placement of the disclosure in the compensation discussion and analysis (CD&A) section of a filing would suggest that the relationship of pay to total shareholder return was a factor in establishing compensation, which may not be the case. Therefore, under the proposed rule, registrants retain the flexibility to place the required disclosure wherever they believe it is most appropriate in the proxy. In addition, registrants may continue to compute and present other performance measures, such as realizable compensation (as defined), that will allow them to “tell their own story” elsewhere in the CD&A.

Comments on the proposed rule were due by July 6, 2015.

For more information, see the press release on the SEC’s Web site.
SEC Issues Final Rule to Ease Smaller Companies’ Access to Capital

In March 2015, the SEC issued a final rule that amends and expands Regulation A, which exempts certain offerings from registration under the Securities Act. The rule implements a mandate in Section 401 of the JOBS Act to ease smaller companies’ access to capital.

Under Regulation A before the amendments, a company could offer up to $5 million of securities in a 12-month period and no more than $1.5 million of those securities could be offered by the company’s securityholders. Under the new rule, a company can offer and sell up to $50 million of securities in a 12-month period if it meets specified eligibility, disclosure, and reporting requirements. The rule creates the following two tiers of offerings under Regulation A:

- “Tier 1: annual offering limit of $20 million, including no more than $6 million on behalf of selling securityholders that are affiliates of the issuer.”
- “Tier 2: annual offering limit of $50 million, including no more than $15 million on behalf of selling securityholders that are affiliates of the issuer.”

The final rule establishes offering and reporting requirements for issuers under both tiers; however, such requirements are more extensive for Tier 2 issuers, which must provide audited financial statements in their offering documents and file annual, semiannual, and current reports with the SEC. The rule also preserves, “with some modifications, existing provisions regarding issuer eligibility, offering circular contents, testing the waters, and ‘bad actor’ disqualification.”

The final rule became effective on June 19, 2015.

For more information, see the press release on the SEC’s Web site.

SEC Staff Issues Guidance on Amendments to Regulation A

In June 2015, the SEC staff issued guidance on its March 2015 amendments to Regulation A. The amendments, which were issued to implement Section 401 of the JOBS Act, exempt certain offerings from registration under the Securities Act.

Specifically, the amendments provide relief for entities that offer and sell up to $50 million of securities in a 12-month period if they meet specified eligibility, disclosure, and reporting requirements. The amendments became effective on June 19, 2015.

The SEC staff also recently issued and revised a number of C&DIs to provide additional guidance on Regulation A. Specifically, the staff added questions 182.01 through 182.11 to the Securities Act Rules section and withdrew questions 128.01 and 128.03 from the Securities Act Forms section.
Appendixes
Appendix A — Glossary of Standards and Other Literature

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

**AICPA TIS**
2220.25, “Impact of ‘Near Term’ on Classification Within Fair Value Hierarchy”

**FASB ASC References**
For titles of FASB Accounting Standards Codification references, see Deloitte’s “Titles of Topics and Subtopics in the FASB Accounting Standards Codification.”

**FASB Accounting Standards Updates and Other FASB Literature**
See the FASB’s Web site for the titles of:

- Accounting Standards Updates.
- Proposed Accounting Standards Updates (exposure drafts and public comment documents).
- Pre-Codification literature (Statements, Staff Positions, EITF Issues, and Topics).
- Concepts Statements.

**PCAOB Literature**
PCAOB AU Section 341, *The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern*

**Private Company Council Literature**
PCC Issue No. 14-01, *Definition of a Public Business Entity*

**SEC Final Rules**
33-9877, *Pay Ratio Disclosure*
33-9741, *Amendments to Regulation A*

**SEC and CFTC Interpretive Release**
34-74936, *Forward Contracts With Embedded Volumetric Optionality*

**SEC Proposed Rules**
34-74835, *Pay Versus Performance*
34-74581, *Exemption for Certain Exchange Members*
33-9922, *Comment Period for Investment Company Reporting Modernization Release*
33-9861, *Listing Standards for Recovery of Erroneously Awarded Compensation*
33-9776, *Investment Company Reporting Modernization*
IA-4091, *Amendments to Form ADV and Investment Advisers Act Rules*
SEC Staff Accounting Bulletins
SAB Topic 13, “Revenue Recognition”

SEC Office of Compliance Inspections and Examinations
Examination Priorities for 2015

SEC Guidance
Amendments to Regulation A: A Small Entity Compliance Guide

International Standards
See Deloitte’s IAS Plus Web site for the titles of:

- International Financial Reporting Standards.
- International Accounting Standards.
- Exposure documents.
### Appendix B — Abbreviations

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABS</td>
<td>asset-backed security</td>
</tr>
<tr>
<td>AFS</td>
<td>available for sale</td>
</tr>
<tr>
<td>AICPA</td>
<td>American Institute of Certified Public Accountants</td>
</tr>
<tr>
<td>APIC</td>
<td>additional paid-in capital</td>
</tr>
<tr>
<td>ASC</td>
<td>FASB Accounting Standards Codification</td>
</tr>
<tr>
<td>ASU</td>
<td>FASB Accounting Standards Update</td>
</tr>
<tr>
<td>C&amp;DI</td>
<td>SEC Compliance and Disclosure Interpretation</td>
</tr>
<tr>
<td>CD&amp;A</td>
<td>compensation discussion and analysis</td>
</tr>
<tr>
<td>CECL</td>
<td>current expected credit loss</td>
</tr>
<tr>
<td>CFTC</td>
<td>U.S. Commodity Futures Trading Commission</td>
</tr>
<tr>
<td>ED</td>
<td>exposure draft</td>
</tr>
<tr>
<td>EITF</td>
<td>Emerging Issues Task Force</td>
</tr>
<tr>
<td>ETF</td>
<td>exchange-traded fund</td>
</tr>
<tr>
<td>FASB</td>
<td>Financial Accounting Standards Board</td>
</tr>
<tr>
<td>FVTNI</td>
<td>fair value through net income</td>
</tr>
<tr>
<td>GP</td>
<td>general partner</td>
</tr>
<tr>
<td>IAS</td>
<td>International Accounting Standard</td>
</tr>
<tr>
<td>IASB</td>
<td>International Accounting Standards Board</td>
</tr>
<tr>
<td>IFRS</td>
<td>International Financial Reporting Standard</td>
</tr>
<tr>
<td>IM</td>
<td>investment management</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>IPO</td>
<td>initial public offering</td>
</tr>
<tr>
<td>LP</td>
<td>limited partner</td>
</tr>
<tr>
<td>NAV</td>
<td>net asset value</td>
</tr>
<tr>
<td>OCI</td>
<td>other comprehensive income</td>
</tr>
<tr>
<td>PCAOB</td>
<td>Public Company Accounting Oversight Board</td>
</tr>
<tr>
<td>PCC</td>
<td>Private Company Council</td>
</tr>
<tr>
<td>PCI</td>
<td>purchased credit-impaired</td>
</tr>
<tr>
<td>PEO</td>
<td>principal executive officer</td>
</tr>
<tr>
<td>REIT</td>
<td>real estate investment trust</td>
</tr>
<tr>
<td>ROU</td>
<td>right of use</td>
</tr>
<tr>
<td>SAB</td>
<td>SEC Staff Accounting Bulletin</td>
</tr>
<tr>
<td>SEC</td>
<td>Securities and Exchange Commission</td>
</tr>
<tr>
<td>SIFMA</td>
<td>Securities Industry and Financial Markets Association</td>
</tr>
<tr>
<td>TIS</td>
<td>Technical Inquiry Service</td>
</tr>
<tr>
<td>TRG</td>
<td>FASB-IASB joint revenue recognition transition resource group</td>
</tr>
<tr>
<td>U.S. GAAP</td>
<td>United States Generally Accepted Accounting Principles</td>
</tr>
<tr>
<td>VIE</td>
<td>variable interest entity</td>
</tr>
</tbody>
</table>

The following is a list of short references for the Acts mentioned in this publication:

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Act</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dodd-Frank Act</td>
<td>The Dodd-Frank Wall Street Reform and Consumer Protection Act</td>
</tr>
<tr>
<td>JOBS Act</td>
<td>Jumpstart Our Business Startups Act</td>
</tr>
<tr>
<td>Securities Act</td>
<td>Securities Act of 1933</td>
</tr>
</tbody>
</table>
Appendix C — Other Resources

Deloitte Publications

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