Key Elements and Considerations of FASB’s New Major Converged Financial Accounting and Reporting Standards

Deloitte & Touche LLP

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Panel discussion
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Moderator
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Professor, Saint John’s University and AERS Learning, Deloitte & Touche, LLP
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Financial Instruments

Projects Update
## Financial Instruments
### Key Milestones

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<th>Classification &amp; Measurement</th>
<th>Impairment</th>
<th>Hedging</th>
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<td>2009</td>
<td>IASB — Final: Assets under IFRS 9</td>
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<td>2010</td>
<td>IASB — Final: Liabilities under IFRS 9</td>
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<td></td>
<td>FASB — Comprehensive ED on all topics</td>
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<tr>
<td>2011</td>
<td></td>
<td>Joint SD</td>
<td></td>
</tr>
<tr>
<td>2012</td>
<td>IASB ED*</td>
<td>FASB ED</td>
<td>IASB RD**</td>
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<tr>
<td>2013</td>
<td>FASB ED</td>
<td>IASB ED</td>
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</table>

* Includes only limited amendments to IFRS 9 (2010).
** Relates to the IASB’s general hedge accounting model expected to be final in 2013 and does not include guidance related to macro hedge accounting.

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**Exposure Document (ED)**
**Review Draft (RD)**
**Supplementary Document (SD)**
Classification & Measurement
Classification & Measurement
Scope and Scope Exceptions

Scope includes all financial instruments (as that term is defined in the FASB ASC Master Glossary) unless explicitly excluded.

The following are examples of excluded financial instruments:

- Derivative instruments within the scope of ASC 815, *Derivatives and Hedging*
- Leases
- Financial guarantee contracts
- Financial instruments within the scope of ASC 944, *Financial Services — Insurance* (with certain exceptions)
Classification & Measurement

Overview

- Financial Assets
  - Cash Flow Characteristics
  - Business Model Assessment

- Financial Liabilities
  - Amortized Cost
  - Exceptions
Classification & Measurement
Financial Assets

Financial Assets

SPPI

Held to collect: Amortized cost

Hold & sell: FV-OCI

FV-NI (residual)

Not SPPI

FV-NI

SPPI = Solely payments of principal and interest
Classification & Measurement
Cash Flow Characteristics Assessment

*Principle*: Financial assets may be classified as something other than FV-NI if contractual terms give rise on specified dates to cash flows that are **solely payments of principal and interest** on the principal amount outstanding (SPPI)

- Principal is the amount transferred by the holder at initial recognition
- Interest is consideration for the **time value of money** and **credit risk** associated with the principal amount outstanding, which may include a premium for **liquidity risk**
- Prepayment provisions, extension options, contingent features, and contractual features that modify the economic relationship must be considered
Modified economic relationships between principal and interest may arise from terms that create:

- Leveraged interest rate (e.g., 1.5x LIBOR)
- Interest rate reset features (e.g., debt instrument paying three-month LIBOR resets every one-month)

For only these two features, an entity must assess the feature:

- Compare actual cash flows to “benchmark” cash flows
- Fails SPPI if variability in cash flows is more than insignificant

Beneficial interests

- Assess the terms of the beneficial interest (tranche) and pool
- The pool must have at least one instrument that meets SPPI and may include derivatives that reduce cash flow variability
- The tranche’s exposure to credit risk must be equal to or greater than the average credit risk exposure of the underlying pool
**Classification & Measurement**

**Business Model Assessment**

**Amortized Cost**
- Hold assets to collect contractual cash flows

**FV-OCI**
- **Both**
  - Hold assets to collect contractual cash flows
  - Sell assets

**FV-NI (Residual)**
- Assets that do not qualify for amortized cost or FV-OCI

**Considerations:**
- Assessment based on how the asset is managed together with other financial assets within a distinct business model
- An entity may have more than one business model
Classification & Measurement
Business Model Assessment (cont.)

Amortized cost classification

• Sales for reasons other than significant credit determinations should be very infrequent
• Sales of financial assets that occur close to maturity and proceeds from those sales that approximate the collection of the remaining contractual cash flows permitted
• Sales for other reasons may be expressly permitted (e.g., change in regulatory requirements)

FV-OCI classification

• Examples of strategies consistent with FV-OCI classification include liquidity management and interest rate risk/yield management

Reclassification

• Prospectively reclassify financial assets only when the business model changes (expected to be very infrequent)
**Classification & Measurement**

**Equity Investments**

**Marketable Equity Investments**
- Measured at FV-NI

**Non-Marketable Equity Investments**
- Measured at FV-NI (practicability exception permitted)
  - Cost less impairment plus upward or downward adjustments from observable price changes
  - New one-step impairment model

**Equity Method Investments**
- Generally unchanged, except for investments held-for-sale, which are at FV-NI
  - New one-step impairment model
Classification & Measurement
Financial Liabilities

Financial liabilities generally at amortized cost

- FV-NI required for:
  - Short sales
  - Financial liabilities that an entity has the ability and means to transact at fair value at inception

Nonrecourse financial liabilities

- Measured at the same basis and amount as the related financial assets
## Classification & Measurement

### Other Key Provisions

<table>
<thead>
<tr>
<th>Subject</th>
<th>Guidance</th>
</tr>
</thead>
</table>
| Initial measurement                          | - Transaction price — financial assets subsequently measured at amortized cost or FV-OCI  
   | - Fair value — financial assets subsequently measured at FV-NI             |
| FX denominated financial assets at FV-OCI    | - Changes in fair value attributable to foreign currency gain or loss recognized in net income  
   | - Fair-value based method for computing FX gain or loss                   |
| Deferred tax assets                          | - Valuation allowance on a deferred tax asset related to unrealized losses on a financial instrument classified at FV-OCI is assessed separately from the entity’s other deferred tax assets |
| Amortized cost financial assets subsequently identified for sale | - Continue to measure at amortized cost less credit losses; however, if fair value is below cost, impairment is equal to the difference between fair value and carrying (i.e., not credit loss)  
   | - Gains are recognized only when the sale is complete                      
   | - Presented as a separate line item on the balance sheet                   |
| Loan commitments, revolving line of credit, or a commercial letter of credit | - Assessed based on likelihood of exercise  
   | - Likelihood: not remote; classify commitment based on the classification of the underlying loan consistent with the contractual cash flow criterion and the business model assessment  
   | - Likelihood: remote; recognize commitment fee over the commitment period  |
## Subject Guidance

### Fair value option

- Four conditional fair value options:
  - Group of financial assets and financial liabilities for which an entity (1) manages the net exposure on a fair value basis and (2) provides information to management on that basis
  - A hybrid financial liability provided that neither of the following conditions exists (1) the embedded derivative(s) do not significantly modify the cash flows and (2) it is clear with little or no analysis when a similar hybrid instrument is first considered that separation of the embedded derivative(s) is prohibited
  - A financial asset that meets the contractual cash flow characteristics criterion and is managed within a FV-OCI business model
  - Nonfinancial hybrid liability provided that the hybrid nonfinancial liability contains an embedded derivative subject to bifurcation and separate accounting in accordance with ASC 815-15

### Presentation

- Parenthetical presentation on face of balance sheet (public entities only):
  - Fair value for assets and liabilities measured at amortized cost (not applicable to receivables and payables due within one year and core deposit liabilities)
  - Amortized cost for an entity’s own debt measured at FV-NI
- For financial liabilities at FV-NI under the fair value option, changes in fair value attributable to changes in the liability’s credit risk are presented in OCI and recycled to net income upon settlement

### Disclosures

- Detailed disclosure requirements
Classification & Measurement

Transition & Effective Date

Transition

• Cumulative-effect adjustment to the statement of financial position as of the beginning of the first reporting period in which the guidance is effective

Early adoption

• Prohibited, except for separate presentation requirements related to instrument-specific credit risk for financial liabilities measured at fair value because the fair value option was elected

Effective date

• TBD during redeliberations
Classification & Measurement
Impact on U.S. GAAP

• Embedded derivatives no longer bifurcated from hybrid financial assets
• Available-for-sale classification no longer available for equity investments
• New practicability exception for investments in nonmarketable equity securities (modified cost approach)
• Equity method investments at FV-NI if they are held for sale
• Loans held for sale no longer measured at lower of cost or fair value, but at FV-NI
• Securitization tranches with above average credit risk at FV-NI
• Foreign currency gains and losses on FV-OCI assets separately recognized in earnings
• Fair value option available only when specific eligibility criteria are met
• Own credit gains and losses on fair value option liabilities recognized in OCI
Classification & Measurement

Remaining Differences with IFRS

- Application guidance for amortized-cost classification differs
- FV-OCI is optional under the FASB model, but not under IFRSs
- Methods for computing foreign currency gains and losses on FV-OCI assets differ
- FASB has a practicability exception from FV-NI for nonmarketable equity investments
- FASB requires FV-NI for equity method investments held for sale
- IFRSs have an FV-OCI option for nontrading equity investments
- Different fair value option criteria
- Different reclassification dates upon business model change
- No recycling of own credit gains and losses under IASB model
Classification & Measurement
Classification & Measurement Comment Letter Trends

• Solely payments of principal & interest (SPPI)
  – Mixed views — some recommend removing completely; others recommend retaining, but suggest significant revisions to the implementation guidance
  – A majority of respondents suggest (1) removing the credit risk analysis for beneficial interests and (2) that the look-through concept would be impractical

• Business model test
  – People generally agree that business model should drive classification
  – The overwhelming majority of respondents commented that the permitted sales from the amortized cost (AC) classification are too stringent

• Fair value option (FVO)
  – Most banks recommended that the FASB expand the situations in which election of the FVO would be permitted
  – Either converge with IFRS 9 or make unconditional
Classification & Measurement

Next Steps

The boards plan to redeliberate the following topics during future joint meetings:

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<thead>
<tr>
<th>Topics to Be Redeliberated</th>
<th>Planned Meeting Date</th>
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<tbody>
<tr>
<td>Contractual cash flows characteristics assessment</td>
<td>September</td>
</tr>
<tr>
<td>Business model assessment</td>
<td>September</td>
</tr>
<tr>
<td>Fair value option</td>
<td>Fourth quarter</td>
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<tr>
<td>Other related matters</td>
<td>Fourth quarter</td>
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</table>

The boards will also separately deliberate other aspects of their respective proposals. The IASB plans to complete redeliberations by the end of 2013. The FASB currently projects that it will issue a final standard in the first half of 2014.
Impairment of Financial Instruments
Impairment of Financial Instruments
Drivers of Impairment Project

• Response to global financial crisis
  – Perception that existing incurred loss approach recognizes impairment losses “too little, too late”

• Opportunities to simplify existing guidance
  – Different impairment models for different types of financial assets
  – Complexity of some of the existing guidance

• Opportunities for international convergence
Impairment of Financial Instruments

Overview

• IASB — Proposed a “three-bucket” approach in March 2013
  – Comments were due July 5, 2013
  – Approach similar to the model developed jointly with the FASB before the FASB independently developed an alternative model beginning in June 2012

• FASB — Proposed a single, current expected credit losses (CECL) model in December 2012
  – Comments were due May 31, 2013
  – Intended to address concerns related to the “dual-measurement” approach in the jointly developed (and now the IASB’s) model and the operational challenges related to transfers from Bucket 1 to the other buckets
Impairment of Financial Instruments
IASB’s ED

<table>
<thead>
<tr>
<th>Bucket 1</th>
<th>Bucket 2</th>
<th>Bucket 3</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>RECOGNITION OF EXPECTED CREDIT LOSSES</strong></td>
<td><strong>Lifetime expected credit losses</strong></td>
<td><strong>Lifetime expected credit losses</strong></td>
</tr>
<tr>
<td>12-month expected losses</td>
<td>Financial assets for which there has been a significant deterioration in credit quality since initial recognition, except for assets that still have low credit risk as of the reporting date (e.g., investment grade)</td>
<td>Financial assets for which there is objective evidence of impairment</td>
</tr>
<tr>
<td>All financial assets at amortized cost or FV-OCI except:</td>
<td>• Purchased or originated credit-impaired assets</td>
<td>• Some trade/lease receivables</td>
</tr>
</tbody>
</table>

**INTEREST REVENUE**

| EIR on gross carrying amount | EIR on gross carrying amount | EIR on amortized cost |

- Lifetime expected credit losses are an expected present-value measure of credit losses that takes into account the potential for default at any point during the life of the financial asset.
- 12-month expected credit losses are the lifetime expected credit losses associated with the possibility of a default in the next 12 months (i.e., lifetime losses reduced by probability of occurrence).
Impairment of Financial Instruments
FASB’s Alternative — Current Expected Credit Loss Model

Measurement Objective

- **Single measurement method for all financial assets** regardless of their form and credit standing (no buckets, not limited to 12 months and no transfer notion)

- **Current expected credit losses recognized on day 1.** Those losses equal the current estimate of future contractual cash flows that management does not expect to collect

- Contemplates “all supportable internally and externally available information…, including past events, current conditions, and reasonable and supportable forecasts”
Impairment of Financial Instruments

Other Decisions

Estimate of expected losses
- Represents a range of possible outcomes
- Incorporates the time value of money

Interest income
- Decoupled from credit losses
- Troubled debt restructurings: keep original effective interest rate

Recording impairment
- Income statement reflects credit deterioration / improvement
- Record as an allowance, not as a basis adjustment
### Impairment of Financial Instruments

**Purchased Credit-Impaired Assets**

<table>
<thead>
<tr>
<th>FASB: Purchased Credit-Impaired (PCI) Assets</th>
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<tbody>
<tr>
<td>• Purchased assets that have experienced a significant deterioration in credit quality since origination</td>
</tr>
<tr>
<td>• The CECL model applies (i.e., one model for all financial assets)</td>
</tr>
<tr>
<td>• Initial allowance equal to amount of contractual cash flows that the entity does not expect to collect</td>
</tr>
<tr>
<td>• Interest income excludes the discount embedded in the purchase price attributable to expected credit losses (i.e., the nonaccretable yield)</td>
</tr>
<tr>
<td>• Positive changes in nonaccretable yield are recognized in earnings in the period of change</td>
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</table>

<table>
<thead>
<tr>
<th>IASB: Purchased Credit-Impaired (PCI) Assets</th>
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<tbody>
<tr>
<td>• Similar definition</td>
</tr>
<tr>
<td>• Always measured in Bucket 2/3</td>
</tr>
<tr>
<td>• Initial allowance is based on purchase price (not contractual cash flows)</td>
</tr>
<tr>
<td>• Similar interest income</td>
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</table>
Impairment of Financial Instruments

FV-OCI

• **FASB**
  - The CECL model applies, but there is a practical expedient
  - Entities need not recognize an allowance if:
    - fair value > carrying amount and
    - expected credit loss is insignificant

• **IASB**: no similar exception to the basic model
Impairment of Financial Instruments

Nonaccrual Principle (FASB Only)

Applies when the likelihood of collection of a financial asset’s principal and interest is not probable

If the full recovery of principal is not probable $\rightarrow$ cost recovery method

If the full recovery of principal is probable, but the full payment of interest is not $\rightarrow$ cash basis method
Impairment of Financial Instruments

Next Steps

• The boards heard a summary of comments received on their respective proposals on July 23, 2013. No decisions were made at this meeting

• Key themes in feedback related to the FASB’s proposals:
  – Significant majority of users responding to FASB’s proposals prefer recognizing all expected credit losses as proposed by the FASB
  – Most preparers prefer recognizing some expected credit losses

• Key themes in feedback related to the IASB’s proposals
  – Most accept the 12-month allowance in Bucket 1
  – The vast majority of respondents support the criteria for transferring to Buckets 2 or 3 (i.e., threshold for recognition of full lifetime expected losses

• Convergence is still a possibility but the likelihood is uncertain
Hedge Accounting
Hedge Accounting

Overview

• IASB expects to release new hedge accounting requirements in the third quarter of 2013
  – Expanded ability to designate hedges of nonfinancial risk components (e.g., crude oil component in jet fuel contract)
  – Simplified hedge effectiveness requirements
  – New hedge rebalancing requirements

• IASB tentatively decided to indefinitely delay the mandatory effective date of IFRS 9

• U.S. GAAP
  – FASB hedge accounting project on hold since 2010
  – ASU 2013-10, Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes, issued July 17, 2013
Revenue Recognition

Project Update
Revenue Recognition

Timeline

- 1999 (Dec)  SEC Staff Accounting Bulletin No. 101 issued
- 2000 +  Various EITF activity related to revenue recognition
- 2002 (Jan)  FASB discusses revenue recognition project
- 2002 (May)  Revenue recognition project added to FASB’s agenda
- 2008 (Dec)  FASB discussion paper issued
- 2010 (June)  Exposure draft on revenue recognition issued
- 2011 (Nov)  Revised exposure draft issued
- 2013 (2H)  Final standard on revenue recognition expected
- 2017  Effective date of final standard (2018 nonpublic)
Revenue Recognition

Overview

Core Principle: an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.
Revenue Recognition

Scope

• Applies to an entity’s contracts with customers
• Does not apply to:
  – Lease contracts
  – Insurance contracts
  – Certain financial instruments and other contractual rights or obligations
  – Guarantees (other than product warranties)
  – Nonmonetary exchanges whose purpose is to facilitate a sale to another party

**Customer**: a party that has contracted with an entity to obtain goods or services that are an output of the entity’s ordinary activities.
Revenue Recognition
Step 1: Identify the Contract

• A contract can be written, verbal, or implied by customary business practices (consider specific criteria)

• If each party can terminate a wholly unperformed contract without penalty, then a contract does not exist

• Combine contracts entered into at (or near) the same time with the same (or related) customer under certain circumstances

• Account for a contract modification as a separate contract if specific criteria are met
Revenue Recognition
Step 2: Identify the Performance Obligations

Identify all promised goods and services in the contract

Are there multiple goods or services promised in the contract?
Yes: Is the good or service capable of being distinct?
No: Treat as a performance obligation

Is the good or service distinct in the context of the contract?
Yes: Account for as a performance obligation
No: Combine promised goods and services until two or more are a distinct performance obligation

The final standard will include indicators for when a good or service is distinct in the context of the contract
Revenue Recognition
Step 3: Determine the Transaction Price

Transaction price shall include:
- Fixed consideration
- Variable consideration (consider constraint)
- Existence of a significant financing component
- Noncash consideration
- Consideration payable to customer

Transaction price does NOT include:
- Effects of customer credit risk

Transaction price: the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer.
Revenue Recognition
Step 3: Determine the Transaction Price (cont’d)

• Variable consideration is estimated and included in the transaction price only if the entity has a high level of certainty that including some (or all) of that amount would not result in a subsequent significant revenue reversal.

• Consider factors to determine if entity has high level of certainty to include an estimate of variable consideration:
  – Highly susceptible to factors outside the entity’s influence
  – Uncertainty not expected to be resolved for a long time
  – Entity’s experience is limited
  – Entity typically offers broad range of price concessions/payment terms
  – Large number of broad range possible outcomes

Final standard may provide certain limitations for including a minimum amount of variable revenue in the transaction price.
Revenue Recognition
Step 4: Allocate the Transaction Price

• Allocate transaction price on a relative standalone selling price basis (estimate if not observable)
  – Expected cost-plus margin, adjusted market assessment, or residual method (if price is highly variable or uncertain) are acceptable

• Allocate consideration (and changes) in the transaction price to all performance obligations (based on initial allocation) unless a portion of (or changes in) the transaction price relate entirely to one (or more) obligations, which is the case when:
  – Contingent terms relate specifically to a certain obligation, and
  – Amount allocated is consistent with allocation principle
Revenue Recognition

Step 5: Recognize Revenue

• Recognize revenue when (or as) entity satisfies a performance obligation by transferring good or service to a customer (transfer occurs when customer obtains control)

• An entity satisfies a performance obligation over time if:
  – customer receives and consumes the benefit as the entity performs
  – performance creates or enhances a customer controlled asset
  – performance does not create an asset with an alternate use and entity has both an enforceable right to payment for performance completed to date and expects to fulfill contract as promised
Revenue Recognition
Step 5: Recognize Revenue (cont’d)

• Measure progress toward completion using input or output methods
• If control does not transfer over time, it transfers at a point in time
• Indicators of the point in time that control transfers:
  – The entity has a present right to payment
  – The customer has legal title
  – The entity has transferred physical possession
  – The customer has risks and rewards of ownership
  – The customer has accepted the asset
Revenue Recognition
Other Provisions

Costs to obtain a contract
• Capitalize costs of obtaining a contract if they are incremental and expected to be recovered

Costs to fulfill a contract
• Recognize assets in accordance with other Topics (inventory, PP&E, software, etc.), otherwise capitalize costs that:
  – relate directly to the contract (or specific anticipated contract);
  – generate/enhance a resource that will be used to satisfy obligations in the future; and
  – are expected to be recovered

Assets amortized on a systematic basis consistent with the transfer of the related goods or services
Revenue Recognition

Disclosures — Annual

- Disaggregation of revenue
- Information about contract balances
- Contract costs
- Information about performance obligations
- Description of significant judgments
- Policy decisions – TVM & costs to obtain a contract
- Transaction price, allocation methods and assumptions
- Remaining performance obligations
Revenue Recognition
Effective Date

FASB only

• Public entities:
  – Annual reporting periods beginning after December 15, 2016, including interim reporting periods therein
  – Early application not permitted

• Nonpublic entities:
  – Three optional effective dates:
    o Same as public entities (interim and annual)
    o Same initial year of adoption as public entities (Q4) interim periods in subsequent year
    o One year deferral from effective date of public entities
## Revenue Recognition

### Transition

- Apply retrospectively by applying ASC 250 (with certain optional practical expedients), OR
- **Modified approach**
  - Apply revenue standard to contracts not completed as of adoption of standard and record cumulative catch-up
  - Do not apply standard to completed contracts

<table>
<thead>
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<th>January 1, 2017 Initial Application Year</th>
<th>2017 Current Year</th>
<th>2016 Prior Year 1</th>
<th>2015 Prior Year 2</th>
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<tr>
<td>New contracts</td>
<td>New standard</td>
<td></td>
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<tr>
<td>Existing contracts</td>
<td>New standard + cumulative catch-up</td>
<td>Legacy GAAP</td>
<td>Legacy GAAP</td>
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<tr>
<td>Completed contracts</td>
<td></td>
<td>Legacy GAAP</td>
<td>Legacy GAAP</td>
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Leases

Project Update
Main takeaway — lessees must account for all leases, except certain short-term leases, on the face of the balance sheet

Scope
- Similar to current U.S. GAAP
- Greater pressure on definition of lease (versus service)

Balance Sheet
- Except for short-term leases, lessees must account for all leases on balance sheet; no grandfathering
- Potentially significant impact on leverage ratios

Income Statement
- Income statement impact will depend on whether the lessee consumes more than an insignificant portion of the leased asset’s economic benefits (property vs. other than property)

Other Impact Areas
- Need to capture and process relevant data; internal controls
- Increased disclosures
Leases
Short-term Leases

• Maximum possible lease term, including options to renew, of 12 months or less
  – Consider all renewal options that are enforceable
  – Renewal options that require agreement from both the lessee and lessor to exercise may not be enforceable
    o If unenforceable, only consider the noncancellable period plus any notice period

• Current operating lease treatment for lessee and lessor

• Elective in nature by underlying asset class

Month-to-month leases — would not qualify as short-term if the lessee has the unilateral right to continue using the leased asset indefinitely (i.e., implicit renewal options)
Leases
Definition of a Lease

A contract in which the right to use a specified asset (the underlying asset) is conveyed, for a period of time, in exchange for consideration

- Identified asset
  - Explicitly or implicitly specified
  - Substitution rights must be considered
- Control
  - “Ability to direct the use” and “derive the benefit from use”
    - Rights to substantially all economic benefits from use over the lease term
    - Taking all of the output will no longer be determinative
Leases
Lease Term

Noncancellable period + period(s) for which the lessee has a significant economic incentive to exercise renewal options or not to exercise termination options

**Contract Factors**
- The terms included in the lease agreement

**Asset Factors**
- Significant leasehold improvements

**Entity Factors**
- The importance of the asset to the entity’s operations, historical practice of the entity, and management intent

**Market Factors**
- Market rentals for comparable assets
Leases
Lease Payments

Fixed lease payments

• Include lease payments that are to be made over the lease term
  – For example, payments required in a period that follows a termination option are used to measure lease assets and liabilities if it is determined that the lessee has a significant economic incentive to not exercise the termination option

Variable lease payments — only included if:

• In-substance fixed payments
• Payments based on index or rate (e.g., CPI, LIBOR)
Leases
Operational and Implementation Challenges

Financial Reporting
- Increased judgments
- Impairment of right-of-use assets
- Tax complexities
- Increased disclosures

Systems
- New systems requirements
- Identification lease arrangements and capturing relevant data
- Changes to internal controls

Business Changes
- Compliance with debt covenants
- Educating analysts
- Lease vs. buy decisions
Lessee Accounting
# Lessee Accounting

## Measurement

<table>
<thead>
<tr>
<th>Initial measurement</th>
<th>Right-of-use asset</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Present value (PV) of lease payments + lessee’s initial direct costs</td>
</tr>
<tr>
<td></td>
<td>Initial direct costs: Incremental costs directly attributable to negotiating and arranging a lease</td>
</tr>
<tr>
<td></td>
<td>Recognize lease incentives as a reduction in the right-of-use asset</td>
</tr>
<tr>
<td></td>
<td>Lease liability</td>
</tr>
<tr>
<td></td>
<td>PV of lease payments</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Subsequent measurement</th>
<th>Right-of-use asset</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Amortized cost: method of amortization depends on nature of underlying asset (see the following slide)</td>
</tr>
<tr>
<td></td>
<td>Impairment: refer to existing standards (ASC 360)</td>
</tr>
<tr>
<td></td>
<td>Lease liability</td>
</tr>
<tr>
<td></td>
<td>Amortized cost: use the effective interest method</td>
</tr>
</tbody>
</table>
**Lessee Accounting**

**Measurement (cont.)**

<table>
<thead>
<tr>
<th><strong>Other Than Property</strong></th>
<th><strong>Property</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>A lease of other than property shall be classified as a Type A (financing approach for lessees), unless*:</td>
<td>A lease of property shall be classified as a Type B lease (straight-line approach for lessees) unless:</td>
</tr>
<tr>
<td>1) “the lease term is an insignificant part of total economic life of the underlying asset”; or</td>
<td>1) “the lease term is for the major part of the remaining economic life of the underlying asset”; or</td>
</tr>
<tr>
<td>2) “the present value of the lease payments is insignificant relative to the fair value of the underlying asset.”</td>
<td>2) “the present value of the lease payments accounts for substantially all of the fair value of the underlying asset”; or</td>
</tr>
<tr>
<td>3) “[the] lessee has a significant economic incentive to exercise an option to purchase the underlying asset, the lease would be classified as a Type A asset regardless of whether it meets the exceptions.”</td>
<td>3) “[the] lessee has a significant economic incentive to exercise an option to purchase the underlying asset.”</td>
</tr>
</tbody>
</table>

*If a lessee has a significant economic incentive to exercise an option to purchase the underlying asset, the lease would be classified as a Type A asset regardless of whether it meets the exceptions.
Constituents’ concern about income statement effect being inconsistent with lease economics.
Lessee Accounting
Illustrative Example

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

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

<table>
<thead>
<tr>
<th>Year</th>
<th>Both Methods</th>
<th>Financing Approach</th>
<th>Straight-Line Expense Approach</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Lease Liability</td>
<td>Interest Expense &lt;X&gt;</td>
<td>Amortization Expense &lt;Y&gt;</td>
</tr>
<tr>
<td>0</td>
<td>$38,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>31,038</td>
<td>$3,038</td>
<td>$12,666</td>
</tr>
<tr>
<td>2</td>
<td>18,520</td>
<td>2,481</td>
<td>12,667</td>
</tr>
<tr>
<td>3</td>
<td>-</td>
<td>1,481</td>
<td>12,667</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>$7,000</td>
<td>$38,000</td>
</tr>
</tbody>
</table>
Lessor Accounting
### Lessor Accounting

#### Measurement

| Receivable and residual (Type A) | • Derecognize  
|                                 |   - Underlying asset  
| • Recognize                     |   • Lease receivable  
|                                 |   • Residual asset  
|                                 |   • Initial profit, if any  
|                                 |   • Defer profit relating to the residual asset (netted with residual asset) |
| Operating lease (Type B)        | • Continue to recognize the underlying asset and recognize lease income over the lease term |
Lessor Accounting
Illustrative Example

A lessor leases an asset to a lessee. The leased asset has a carrying amount of $20,000 and a fair value of $24,000 at lease commencement. The terms of the lease are as follows:

<table>
<thead>
<tr>
<th>Terms</th>
<th>Value/Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease term</td>
<td>5 years</td>
</tr>
<tr>
<td>Annual lease payments</td>
<td>$4,500, due at the end of each year</td>
</tr>
<tr>
<td>Estimated useful life of underlying asset</td>
<td>9 years</td>
</tr>
<tr>
<td>Rate the lessor charges the lessee (implicit rate in the lease)</td>
<td>6.2%</td>
</tr>
<tr>
<td>Present value of lease receivable at lease commencement</td>
<td>$18,829</td>
</tr>
<tr>
<td>Estimated residual value at the end of the lease term</td>
<td>$ 7,000</td>
</tr>
</tbody>
</table>
Lessor Accounting
Illustrative Example (cont’d)

Under the receivable and residual model, the lessor will record the following entry on the lease commencement date:

<table>
<thead>
<tr>
<th>Journal Entry</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease receivable</td>
<td>$18,829</td>
<td></td>
</tr>
<tr>
<td>Net residual asset</td>
<td></td>
<td>$4,309</td>
</tr>
<tr>
<td>Underlying asset</td>
<td></td>
<td>$20,000</td>
</tr>
<tr>
<td>Profit</td>
<td></td>
<td>3,138</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year</th>
<th>Lease Receivable</th>
<th>Gross Residual</th>
<th>Deferred Profit</th>
<th>Net Residual Asset</th>
<th>Profit</th>
<th>Interest Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>$18,829</td>
<td>$5,171</td>
<td>$(862)</td>
<td>$4,309</td>
<td>$3,138</td>
<td>$</td>
</tr>
<tr>
<td>1</td>
<td>15,506</td>
<td>5,493</td>
<td>(862)</td>
<td>4,631</td>
<td>–</td>
<td>1,499</td>
</tr>
<tr>
<td>2</td>
<td>11,974</td>
<td>5,837</td>
<td>(862)</td>
<td>4,975</td>
<td>–</td>
<td>1,312</td>
</tr>
<tr>
<td>3</td>
<td>8,222</td>
<td>6,201</td>
<td>(862)</td>
<td>5,339</td>
<td>–</td>
<td>1,112</td>
</tr>
<tr>
<td>4</td>
<td>4,235</td>
<td>6,588</td>
<td>(862)</td>
<td>5,726</td>
<td>–</td>
<td>901</td>
</tr>
<tr>
<td>5</td>
<td>–</td>
<td>7,000</td>
<td>(862)</td>
<td>6,138</td>
<td>–</td>
<td>676</td>
</tr>
<tr>
<td>Total</td>
<td>$3,138</td>
<td></td>
<td></td>
<td>$5,500</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The year-0 profit of $3,138 represents profit recognized at lease commencement when the leased asset is transferred to the lessee. It is calculated as (1) the difference between the fair value and the carrying amount of the leased asset at inception ($24,000 – $20,000 = $4,000) multiplied by (2) the lease receivable divided by the fair value of the leased asset at lease commencement ($18,829 ÷ $24,000 = 78%). In all other periods, profit equals periodic interest income on the lease receivable plus periodic accretion of the gross residual asset.

The residual asset initially equals $4,309 [(carrying amount of underlying asset – (carrying amount of underlying asset × (lease receivable ÷ fair value of underlying asset))] [(20,000 – (20,000 × [18,829 ÷ 24,000]))].
Other Projects and Standards
Comprehensive Income
Comprehensive Income

ASU 2011-05 Overview

• Required that comprehensive income be reported in either:
  – A continuous statement of comprehensive income
  – Two separate, but consecutive statements

• The ASU 2011-05 did not change the items that must be reported in other comprehensive income (OCI)
Comprehensive Income
ASU 2011-05 Overview (cont.)

- ASU 2011-05 required the presentation of reclassification adjustments by component in both the statement where net income is presented and the statement where comprehensive income is presented
  - Prior to ASU 2011-05, entities had an option under ASC 220 to present reclassification adjustments out of OCI in either (a) the statement in which OCI is reported or (b) the footnotes to the financial statements

- However, during initial implementation, constituents raised several concerns over this new requirement:
  - Availability of information required at necessary level of detail
  - Potential cluttering effect to financial statements
  - Level of detail required for interim reporting purposes
  - How to apply the provisions to reclassifications out of accumulated other comprehensive income (AOCI) that are initially recorded on the balance sheet
Comprehensive Income
ASU 2011-12 Overview

- Deferred the requirement to present reclassification adjustments out of AOCI by component in both the statement in which net income is presented and the statement in which OCI is presented (for both interim and annual financial statements)
Comprehensive Income
FASB Redeliberations

• During June 2012, the FASB decided that the presentation requirements deferred in ASU 2011-12 would not be reinstated due to the excessive costs to preparers and the potential cluttering effect on the statement(s) where comprehensive income is reported.

• As an alternative, the Board decided that user’s needs for information about items reclassified from AOCI and their corresponding impact on net income could be aided, with little cost to preparers, by requiring an entity to provide:
  – Enhanced ASC 220-10-45-14A disclosures to explain the effect of reclassification adjustments on the changes of OCI by component.
  – Disclose in a separate table, by component, significant items reclassified out of AOCI and corresponding information about the income statement line item(s) affected by the reclassification adjustment.
Comprehensive Income
ASU 2013-02

Intent
• Improve the transparency of changes in Accumulated Other Comprehensive Income (AOCI) and the impact on net income

Does not amend
• Any existing requirements for reporting net income or OCI in the financial statements

Required disclosures
• Entities to provide information about:
  1. Changes in AOCI balances by component
  2. Income statement effects of significant items reclassified out of AOCI

Effective for fiscal years, and interim periods within those years, beginning after December 15, 2012, for public entities (one year deferral for nonpublic entities)
Comprehensive Income
ASU 2013-02 (cont.)

Changes in AOCI by component

- Disclose changes in AOCI by component and separately present:
  - Current period reclassification adjustments, and
  - Other amounts of OCI for the period

<table>
<thead>
<tr>
<th>Entity XYZ</th>
<th>Notes to Financial Statements</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Changes in Accumulated Other Comprehensive Income by Component&lt;sup&gt;a&lt;/sup&gt;</td>
</tr>
<tr>
<td></td>
<td>For the Period Ended December 31, 201X</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Gains and Losses on Cash Flow Hedges</th>
<th>Unrealized Gains and Losses on Available-for-Sale Securities</th>
<th>Defined Benefit Pension Items</th>
<th>Foreign Currency Items</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning balance</td>
<td>$(1,200)</td>
<td>$1,000</td>
<td>$(8,800)</td>
<td>$1,300</td>
<td>$(7,700)</td>
</tr>
<tr>
<td>Other comprehensive income before reclassifications</td>
<td>3,000</td>
<td>2,500</td>
<td>$(3,000)</td>
<td>1,000</td>
<td>3,500</td>
</tr>
<tr>
<td>Amounts reclassified from accumulated other comprehensive income&lt;sup&gt;b&lt;/sup&gt;</td>
<td>$(750)</td>
<td>(1,500)</td>
<td>4,500</td>
<td>–</td>
<td>2,250</td>
</tr>
<tr>
<td>Net current-period other comprehensive income</td>
<td>2,250</td>
<td>1,000</td>
<td>1,500</td>
<td>1,000</td>
<td>5,750</td>
</tr>
<tr>
<td>Ending balance</td>
<td>$1,050</td>
<td>$2,000</td>
<td>$(7,300)</td>
<td>$2,300</td>
<td>$(1,950)</td>
</tr>
</tbody>
</table>

<sup>a</sup> All amounts are net of tax. Amounts in parentheses indicate debits.

<sup>b</sup> See the separate table in ASC 220-10-55-17E for details about these reclassifications.
Comprehensive Income
ASU 2013-02 (cont.)

Significant items reclassified out of AOCI

Present information in one location, in either of the following ways:

- Face of statement where net income is presented (if eligible):
  - Include before-tax significant reclassification amount parenthetically on the line item affected
  - Present aggregate income tax amount parenthetically on income tax line

- Separate disclosure in the notes to the financial statements:
  - Disclose the amount reclassified and line item affected
  - Reference significant partial reclassifications to respective footnote for additional information
## Comprehensive Income

**ASU 2013-02 Example**

### Entity XYZ

**Statement of Income**

For the Period Ended December 31, 201X

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues (includes $2,500 accumulated other comprehensive income reclassifications for net gains on cash flow hedges)</td>
<td>$122,500</td>
</tr>
<tr>
<td>Expenses (includes ($2,000) accumulated other comprehensive income reclassifications for net losses on cash flow hedges)</td>
<td>$(32,000)</td>
</tr>
<tr>
<td>Interest Income (expense) (includes $1,000 accumulated other comprehensive income reclassifications for net gain on cash flow hedges)</td>
<td>$5,000</td>
</tr>
<tr>
<td>Gain on the sale of securities (includes ($500) accumulated other comprehensive income reclassifications for net losses on cash flow hedges)</td>
<td>$4,000</td>
</tr>
<tr>
<td>Income from operations before tax</td>
<td>$99,500</td>
</tr>
<tr>
<td>Income tax expense (includes ($250) income tax expense from reclassification items)</td>
<td>$(24,875)</td>
</tr>
<tr>
<td><strong>Net Income</strong></td>
<td>$74,625</td>
</tr>
</tbody>
</table>

$,2,500 - 2,000 + 1,000 – 500 – 250 = 750
## Comprehensive Income

**ASU 2013-02 Example (cont’d)**

<table>
<thead>
<tr>
<th>Details about AOCI Components</th>
<th>Amount Reclassified from AOCI</th>
<th>Affected Line Item in the Statement Where Net Income Is Presented</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gains and losses on cash flow hedges</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest rate contracts</td>
<td>$1,000</td>
<td>Interest income/(expense)</td>
</tr>
<tr>
<td>Credit derivatives</td>
<td>$(500)</td>
<td>Other income/(expense)</td>
</tr>
<tr>
<td>Foreign exchange contracts</td>
<td>$2,500</td>
<td>Sales/revenue</td>
</tr>
<tr>
<td>Commodity contracts</td>
<td>$(2,000)</td>
<td>Costs of sales</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Total before tax</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Tax (expense)/benefit</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Net of tax (b)</td>
</tr>
<tr>
<td></td>
<td><strong>$750</strong></td>
<td></td>
</tr>
</tbody>
</table>

(a) Amounts in parenthesis indicate debits to profit/loss.

(b) Amount agrees with "Amounts reclassified from AOCI" line for each respective component displayed in the Changes in AOCI by Component disclosure.
Comprehensive Income
ASU 2013-02 Implementation Considerations

- Interaction between SEC interim reporting guidance and the ASU
- Cross referencing to partial reclassification adjustments in interim reports
- Relationship between presenting a single line of OCI in interim reports and disclosure requirements in the ASU
- Format of disclosures
- Income tax considerations
Liquidation Basis of Accounting
Liquidation Basis of Accounting

Background

- On April 22, 2013, the FASB issued ASU 2013-07, *Liquidation Basis of Accounting*

- Provides guidance on when and how to apply the liquidation basis of accounting and required disclosures

- Before ASU, limited guidance on this topic under U.S. GAAP
Liquidation Basis of Accounting

Scope

- Applies to all entities (public and nonpublic), except investment companies regulated under the Investment Company Act of 1940

- Scope exception cannot be applied by analogy to other entities
Liquidation Basis of Accounting

Recognition

• Adopt the liquidation basis of accounting when liquidation is imminent unless liquidation follows a plan specified in entity’s governing documents

• Liquidation plan does not follow plan specified in entity’s governing documents if entity must dispose assets for value other than fair value

• Liquidation is imminent when:
  – A plan of liquidation is approved by those with the power to do so and remote likelihood it will be blocked
  – Liquidation is imposed by other forces and remote likelihood entity will return from liquidation
## Liquidation Basis of Accounting

### Initial Recognition/Measurement — Assets & Liabilities

#### Assets
- Recognize assets expected to be sold in liquidation, not previously recognized (e.g., trademarks)
- Measure to reflect actual amount of cash the entity expects to collect during liquidation
- Fair value measurement may be acceptable

#### Liabilities
- Recognize and measure in accordance with respective existing U.S. GAAP
- Adjust inputs used to measure liabilities to reflect liquidation
- Do not adjust amount for anticipated legal release

Remeasure liabilities (if required by relevant U.S. GAAP), assets, and other items expected to be sold in liquidation to actual or estimated carrying amount at each subsequent reporting period.
Liquidation Basis of Accounting
Initial Recognition/Measurement — Costs

**Estimated costs to dispose**
- Accrue estimated costs to dispose of assets, including other items expected to sell
- Present total estimated costs to dispose in aggregate separately from measurement of assets

**Ongoing income & expense**
- Accrue other costs and income expected to be incurred during liquidation period if and when reasonable basis for estimation exists

Remeasure disposal cost accruals or other ongoing income and expenses at each subsequent reporting period to reflect actual or estimated change in carrying value
## Liquidation Basis of Accounting

### Disclosures

<table>
<thead>
<tr>
<th>Required Disclosures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Facts and circumstances surrounding adoption of liquidation basis of accounting and determination of liquidation being imminent</td>
</tr>
<tr>
<td>Description of entity’s liquidation plan, including, the manner by which it expects to sell assets or settle liabilities and expected completion date</td>
</tr>
<tr>
<td>Methods and significant assumptions used to measure assets and liabilities, including subsequent changes</td>
</tr>
<tr>
<td>Types and amount of costs and income accrued and period over which they are expected to be incurred or earned</td>
</tr>
</tbody>
</table>
Liquidation Basis of Accounting

Presentation

• Liquidation basis financial statements include (at a minimum):
  − Statement of net assets in liquidation
  − Statement of changes in net assets in liquidation

• Entity would not be required to present “information about any of its activities” before adopting the liquidation basis

• Must comply with disclosure requirements under the standard as well as those under other U.S. GAAP that would be relevant to the liquidation
Liquidation Basis of Accounting

Effective Date

- Annual reporting periods beginning after December 15, 2013, and interim reporting periods therein. Adopt prospectively from date liquidation is imminent. Early adoption permitted
- Entity already reporting on liquidation basis upon effective date under another standard does not apply this guidance
- All other entities that report liquidation basis upon effective date record cumulative catch up for any differences
Going Concern
Objective: To provide guidance about how an entity should assess its ability to continue as a going concern and the nature and extent of related disclosures.

- FASB released exposure draft for comment
- Modified objective to early warning disclosures
- Incorporated into Liquidity and interest rate risk disclosures project
- Revisit the question of whether management should be required to assess whether there is doubt about an entity’s ability to continue as a going concern
- Separated into its own project (separate from liquidation basis)
- Proposed ASU published June 26, 2013
Going Concern

Key Provisions

• **Management** will be required to perform the going concern assessment at each reporting period (including interim periods)
  – Currently no requirements in U.S. GAAP, so practice is driven from auditors application of auditing standards
  – Extends responsibility to management

• **Time horizon** of going concern assessment
  – *At least 12 months* after F/S date, beyond 12 months “known or probable” events *not to exceed 24 months* after the F/S date
  – Time horizon exceeds that in current auditing literature (which is not to exceed 12 months)
Going Concern
Disclosure Thresholds

More Likely Than Not Threshold

Substantial Doubt Threshold (Public Entities Only)

Liquidation Imminent

Going Concern Disclosures Required

Liquidation Basis of Accounting Required
## Going Concern
### Required Disclosures

<table>
<thead>
<tr>
<th>Conditions and events that give rise to the entity’s potential inability to meet its obligations</th>
<th>Possible effects of those conditions and events</th>
<th>Management’s evaluation of the significance of those conditions and events and any mitigating factors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Management’s plans to address the entity’s potential inability to meet its obligations</td>
<td>Substantial doubt (public entities only)</td>
<td>Mitigating conditions and events</td>
</tr>
</tbody>
</table>