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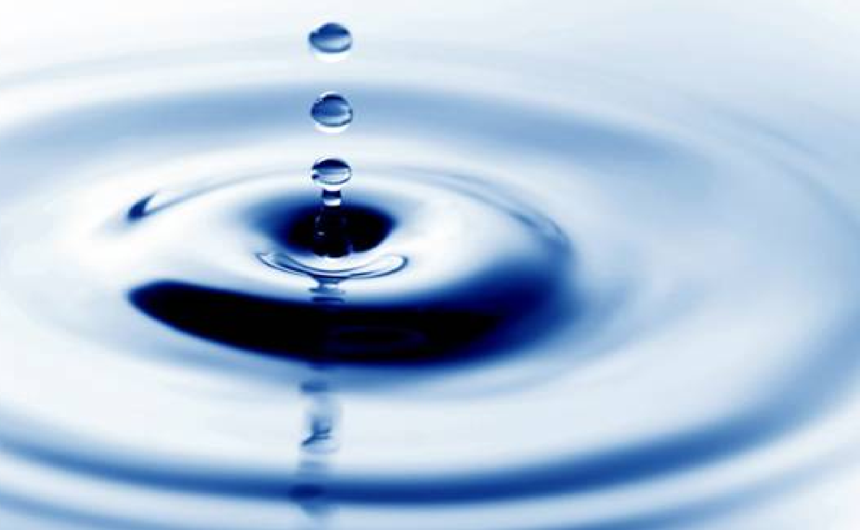
Technical Accounting Update



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Acronyms

Acronym	Full Form
ASC	Accounting Standards Codification
ASU	Accounting Standards Update
ED	Exposure Draft
FASB	Financial Accounting Standards Board
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
U.S. GAAP	Generally Accepted Accounting Principles in the United States

Agenda

- Revenue recognition
- Lease accounting
- Financial Instruments
- Other agenda items/future agenda

Revenue Recognition
ASU 2014-09

Revenue Recognition
Keys

FASB and IASB standards substantially converged

Scope

- Applies to an entity's **contracts** with **customers**
- Comprehensive guidance – replaces industry guidance
- Some transfers of nonfinancial assets (e.g., PP&E or intangible assets) that do not meet the definition of a business

Effective:

- 2017 for public companies/ 2018 for private companies
- No early adoption under US GAAP

Revenue Recognition
Overview

<u>Core principle</u>: Recognize revenue to depict the *transfer of promised goods or services to customers* in an amount that reflects *the consideration the entity expects to be entitled* in exchange for those goods or services

Unit of acct

- **Identify the contract with a customer (Step 1)**
- **Identify the performance obligations in the contract (Step 2)**

Measurement

- **Determine the transaction price (Step 3)**
- **Allocate the transaction price to performance obligations (Step 4)**

Recognition

- **Recognize revenue when (or as) the entity satisfies a performance obligation (Step 5)**

This revenue recognition model is based on a control approach which differs from the risks and rewards approach applied under current U.S. GAAP.

Revenue Recognition

Step 1 | Step 2 | Step 3 | Step 4 | Step 5

Step 1: Identifying the Contract

A legally enforceable contract (oral or implied) must meet all of the following requirements:

- The parties have approved the contract and are committed to perform
- The entity can identify each party's rights regarding goods or services
- The entity can identify the payment terms for the goods or services to be transferred
- The contract has commercial substance
- It is probable the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer

Collectibility threshold

A contract will not be in the scope if:

The contract is wholly unperformed ***AND*** Each party can unilaterally terminate the contract without compensation

Revenue Recognition

Step 2: Identifying Performance Obligations

The ASU defines a ***performance obligation*** as a promise to transfer to the customer a good or service (or a bundle of goods or services) that is ***distinct.***

What does distinct mean?

Identify all (explicit or implicit) promised goods and services in the contract

Are promised goods and services distinct from other goods and services in the contract?

CAPABLE OF BEING DISTINCT

Can the customer benefit from the good or service on its own or together with other readily available resources?

AND

DISTINCT IN CONTEXT OF CONTRACT

Is the good or service separately identifiable from other promises in the contract?

YES

Account for as a performance obligation

NO

Combine 2 or more promised goods or services & reevaluate

Revenue Recognition

Step 1 Step 2 Step 3 Step 4 Step 5

Step 3: Determining the Transaction Price

Principle: The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer (which excludes estimates of variable consideration that are constrained).

Transaction price shall include…

- Fixed consideration
- Variable consideration (estimated and potentially constrained)
- Noncash consideration
- Adjustments for significant financing component
- Adjustments for consideration payable to customer

Transaction price does NOT include…

- effects of customer credit risk

Need to consider whether adjustments are for concessions or credit risk

Revenue Recognition

Step 1 Step 2 Step 3 Step 4 Step 5

Step 4: Allocating the Transaction Price

- Allocate transaction price on a relative standalone selling price basis (estimate standalone selling price if not observable).
  - Expected cost-plus margin method, adjusted market assessment method, or residual method (only 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 and certain criteria are met.

What if don't have an observable price for the distinct elements?

Estimate them anyway!

Step 1 Step 2 Step 3 Step 4 Step 5

Revenue Recognition

Step 5: Recognizing Revenue

Evaluate if control of a good or service transfers over time, if not then control transfers at a point in time.

An entity satisfies a performance obligation over time if…

The customer receives and consumes the benefit as the entity performs. (e.g., cleaning service)

Performance creates or enhances a customer controlled asset. (e.g., home addition)

Performance does not create an asset with an alternative use and the entity has both an enforceable right to payment for performance completed to date and expects to fulfil contract as promised.

Revenue Recognition
Step 5: Recognizing Revenue (cont'd)

For performance obligations satisfied at a point in time, indicators that control transfers include, but are not limited to, the following:

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

Replaces completion of the earnings process

Revenue Recognition
Disclosures

Disclosures About Contracts with Customers

- Disaggregation of revenue
- Information about contract balances
- Remaining performance obligations
- Information about performance obligations

Disclosures about Significant Judgments and Estimates

- Description of significant judgments
- Transaction price, allocation methods and assumptions

Other Required Disclosures

- Policy decisions – time value of money & costs to obtain a contract
- Contract costs

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Revenue Recognition

Implementation Issues

Unit of account:	Determining “distinct”
Measurement:	Estimating stand-alone selling prices
	Allocating using portfolios
Recognition:	Determining point in time vs over time
	When does control pass
Presentation:	Gross vs. Net
	Interim disclosures

Joint Transition Resource Group to address issues
Will implementation be converged?

Lease Accounting

Leases Project

What's in and What's Out

Scope

- Generally similar to current U.S. GAAP
- Excludes leases to explore for/use nonregenerative resources, leases of biological assets, and leases of intangible assets

Short-term leases

- Lease term of 12 months or less (changed from ED)
- Elective in nature by underlying asset class
- Accounted for in a manner similar to today's operating leases

Small-Ticket Lease Considerations

- Applying lease accounting at a portfolio level ✓
- Explicit materiality requirement exception X
- Recognition and measurement exemption for small-ticket leases ?

Leases Project

Lessee Accounting - Initial Measurement

OVERVIEW:

- Most leases on balance sheet (similar to today's capital leases)
- Introduces the right-of-use (ROU) asset approach under which a lessee records in the balance sheet:
  - ROU asset – right to use the leased asset
  - Lease liability – obligation to make lease payments (PV of lease payments)

- Income Statement Treatment?
  - Type A – Finance lease – Amortization & interest expense
  - Type B – Operating lease – Straight line rent expense

Leases Project

Lessee Accounting– Subsequent Measurement

<u>ROU asset & Income Statement</u>

- Boards are not converged on the subsequent measurement:

<table>
<tr><th colspan="2">FASB Approach</th><th>IASB Approach</th></tr>
<tr><td colspan="2"><u>Dual-model approach </u>– a lessee would consider the guidance in IAS 17 when determining if a lease should be classified as Type A or Type B</td><td rowspan="3"><u>Single-model approach </u>– a lessee would account for all leases as a financed purchase of the ROU asset [Type A]</td></tr>
<tr><td>Type A Lease</td><td>Type B Lease</td></tr>
<tr><td>Consistent with today’s capital leases - expense will be front-loaded</td><td>Expense will be recorded on a straight-line basis</td></tr>
</table>

- Impairment: Refer to existing standards (ASC 360)

<u>Lease liability</u>

- Amortized cost: Use the effective interest method

Leases Project

Lessor Accounting Model

Will retain existing lessor accounting with minimal changes:

- Classification criteria would be consistent with IAS 17
  - Type A lease: generally consistent with today's sales-type/direct-finance leases
  - Type B lease: generally consistent with today's operating leases
- Differing views on recognizing dealer profit for sales-type leases:
  - FASB view: upfront recognition of manufacturer's profit would be precluded if control of asset is not transferred to lessee
  - IASB view: manufacturer's profit, if any, should be recognized upfront

Leases Project

Lease Classification

CLASSIFICATION CRITERIA

Would account for as a Type A lease when the lease…

- ✓ Transfers ownership by end of lease term;
- ✓ Includes a purchase option that the lessee is *reasonably certain* to exercise; or
- ✓ There is a transfer of substantially all of the risks and rewards of ownership of the asset

If it is not conclusive that all of the risks and rewards incidental to asset ownership are transferred, then the asset would be classified as a *Type B* lease.

Although the evaluation is similar to current U.S. GAAP, items to consider include:

- Land and other elements would evaluated separately unless the land element is clearly immaterial. This may result in more bifurcation of real estate leases than current U.S. GAAP.
- The bright-line rules in current U.S. GAAP would be eliminated.

Leases Project

Lease Term, Renewals, and Reassessment

Lease term

- Defined as…

  Noncancelable period + period(s) for which it is reasonably certain that the lessee will exercise renewal (or termination) options.*

- When determining which options to include, lessees and lessors would consider those for which lessee has an economic incentive to renew
- Reasonably certain is a high threshold substantially the same as reasonably assured in existing U.S. GAAP

Reassessment requirements

- Lessees would be required to reassess lease term upon the occurrence of a significant event or change in circumstances under the control of the lessee
- Lessors would <u>*not*</u> be required to reassess lease term

Leases Project

Lease Payments included in lease obligation

Fixed lease payments	• Include lease payments that are to be made over the lease term
Variable payments – only if…	• In-substance fixed payments • Payments based on index or rate (FASB decided that amounts are not subsequently updated)
Residual value guarantees	• Lessees would include the difference between expected and guaranteed residual value
Purchase/termination options	• Treated in a manner consistent with the accounting for renewal options

Leases Project

Lease Modifications

	Lessee	*Lessor*
Modifications resulting in a new lease	Recognize the lease modification as a new lease, separate from the original lease	
Modifications that do *not* result in a new lease	If the modification (1) expands the scope of the original lease or (2) results in a change to the lease consideration only, the lessee would use the updated lease payments and discount rate to revise the liability and ROU asset. If the modification reduces the scope of the original lease, the lessee would adjust the lease liability, a proportionate amount of the ROU asset, and recognize any difference as a gain/loss.	For a Type A lease, the lessor would use the guidance in ASC 310 to determine how to account for changes in the lease receivable. For a Type B lease, the lessor would account for the modified lease as a new lease.

Modifications result in a new lease when they (1) grant the lessee an additional ROU asset *and* (2) the additional ROU is at-market

Leases Project

Other Issues

- Lease definition/ Small ticket items
- Discount rate
- Lease and non-lease components
- Lease modifications
- Residual value guarantees
- Subleases
- Sale and leaseback transactions
- Presentation & disclosure
- Cost-benefit, transition & effective date
- Leveraged leases (FASB only)
- Private company and not-for-profit issues (FASB only)

Leases Project

Operational and Implementation Challenges

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

Financial Reporting

- Increased judgments
- Right-of-use assets will need to be evaluated for impairment
- Tax complexities
- Increased disclosures

Financial Instruments

Financial Instruments

Project Overview

High Level Overview:

- Impacts a broad range of instruments: Investments in debt and equity securities, loans, derivatives, trade A/R and A/P, debt liabilities and nonmarketable equity investments

- Comprised of three major components:
  1. Classification and Measurement
  2. Impairment
  3. Hedge Accounting

- Joint project but boards have taken different approaches and are on different timelines

Financial Instruments

Classification and Measurement - History

FASB

- Issued a proposed ASU (2/13).
- Proposed- Assets: similar to current classifications but based on (a) cash flow characteristics and
  (b) business model.

IASB

- Issued IFRS 9 (11/12).
- Assets: Classification (FVNI, FVOCI, Amortized Cost) based on (a) cash flow characteristics and
  (b) business model.

Objectives of Both Proposals

- Replace the various classification and measurement models under current guidance with a single approach.
- Increase convergence between the FASB and IASB models.

Financial Instruments

Classification and Measurement – Original Proposal

- Classify a financial asset into one of three categories:
  - amortized cost,
  - FV-OCI, or
  - FV-NI (default)

- Cash flow test (requirement for AC/FVOCI): **the contractual terms of the instrument give rise to cash flows that are solely payments of principal and interest [SPPI]**
  - If not SPPI = FVNI
  - Equity investments would generally be accounted for at FVNI

- Business Model: 3 distinct business models under which assets may be held and managed:

  Hold-to-collect (Amortized cost)

  Hold-and-sell (FVOCI)

  Neither of the above (FVNI)

Financial Instruments

Classification and Measurement – Recent Decisions

FASB	*IASB*

▪ Retained existing guidance in U.S. GAAP on classifying and measuring investments in debt securities and loans
▪ Possible amendments:
  ▪ Instrument-specific credit risk on financial liabilities for which a fair value option has been elected would be recognized in OCI rather than in NI
  ▪ All equity instruments at FVNI
▪ Finalize by end of 2014?
	▪ Is finalizing its amendments to IFRS 9 based on the SPPI contractual cash flow and business model tests.
	▪ Introduced FV-OCI category
	▪ The IASB expects to finalize this project in the second quarter of 2014.

Financial Instruments

Impairment

- **Explore alternative to incurred loss model:**
  - *July 2009 Financial Crisis Advisory Group Report*—Existing GAAP delays recognition of losses associated with financial instruments (incurred loss model).
  - Explore possibilities of incorporating more forward-looking information – **Expected Loss Models**.
- **Reduce complexity stemming from multiple models:**
- **Current response**

FASB model: Recognize all (lifetime) expected losses

IASB model: Recognize some (12 months) expected credit losses until significant threshold is met, then recognize lifetime expected credit losses.

Financial Instruments

Impairment – FASB's Proposed CECL Model

Single Impairment Model

- Generally applies to all financial instruments, except those measured at fair value through profit or loss
- Also applies to loan commitments, financial guarantees, lease receivables, and trade receivables

Information Set

- Includes historical loss experience, current conditions, **and** reasonable and supportable forecasts of future conditions.
- Must incorporate the time value of money and the risk of loss (best estimate not permitted)

Special Considerations

- Purchased credit-impaired assets would also apply the CECL model, but would be treated differently with respect to interest income recognition.

Financial Instruments

Impairment – CECL Model F/S Impact

Current Expected Credit Loss (CECL) Model

Recognition of expected credit losses

Balance Sheet

- At the date of origination/acquisition, an impairment allowance is recognized equal to the amount of current expected credit losses (i.e., the total amount of contractual cash flows not expected to be collected is recognized on "Day 1" through earnings).

Income Statement

- Other than for PCI assets (which uses a gross up approach), the initial recognition of the impairment allowance would be recognized through earnings.
- Subsequent changes in the impairment allowance (both positive and negative) would be recognized through earnings; **reversal of impairment is permitted**.

Write off

Direct Write-off

- When the entity has no reasonable expectation of future recovery.

Financial Instruments

Impairment – Other Considerations

Topic	Considerations
Measurement	• When determining the contractual cash flows and the life of the financial asset, an entity would consider prepayments, but generally not extensions, renewals, or modifications (unless it expects to complete a TDR). • Revert to historical loss average experience for future periods beyond which the entity is able to make reasonable and supportable forecasts. • The estimate should incorporate the time value of money. • An entity would be permitted to use a variety of methods to develop an estimate of current expected credit losses (DCF, loss-rate methods, provision matrix, etc.)
Recognition	• Although an entity's estimate must always reflect the risk of loss, an entity would not be required to recognize an allowance if the loss given default would be zero (e.g., due to collateral).
FV-OCI Assets	• The CECL model applies to FVOCI assets. However, for such assets, an entity need not record an allowance greater than the difference between the amortized cost of the asset and its fair value (i.e., fair value floor).

Financial Instruments

Other Impairment Issues:

- Possible changes to measurement principle
- Relevance of trouble-debt restructurings
- No non-accrual guidance
- Application to different sets of financial assets
- Scope related issues
- Disclosures

Other agenda items/ Future Agenda

Other Active FASB projects

Issued (or soon will be)

- Discontinued operations
- Development stage entities
- Repurchase agreements
- PCC standards
- EITF

Working on

- Disclosure framework
  - Board's decision process
  - Entity's decision process/ Standards
- Consolidation: Principle vs. Agent
- Goodwill for public companies
- Going concern
- Government assistance
- Statement of cash flows

What’s FASB’s future agenda?

Potential projects

Foundational
- Conceptual Framework

Recognition, Measurement, Presentation, Disclosure
- Financial statement presentation

Simplification
- Liabilities & Equities
- Hedge accounting
- Narrow Issues

International
- Advise IASB

Questions?