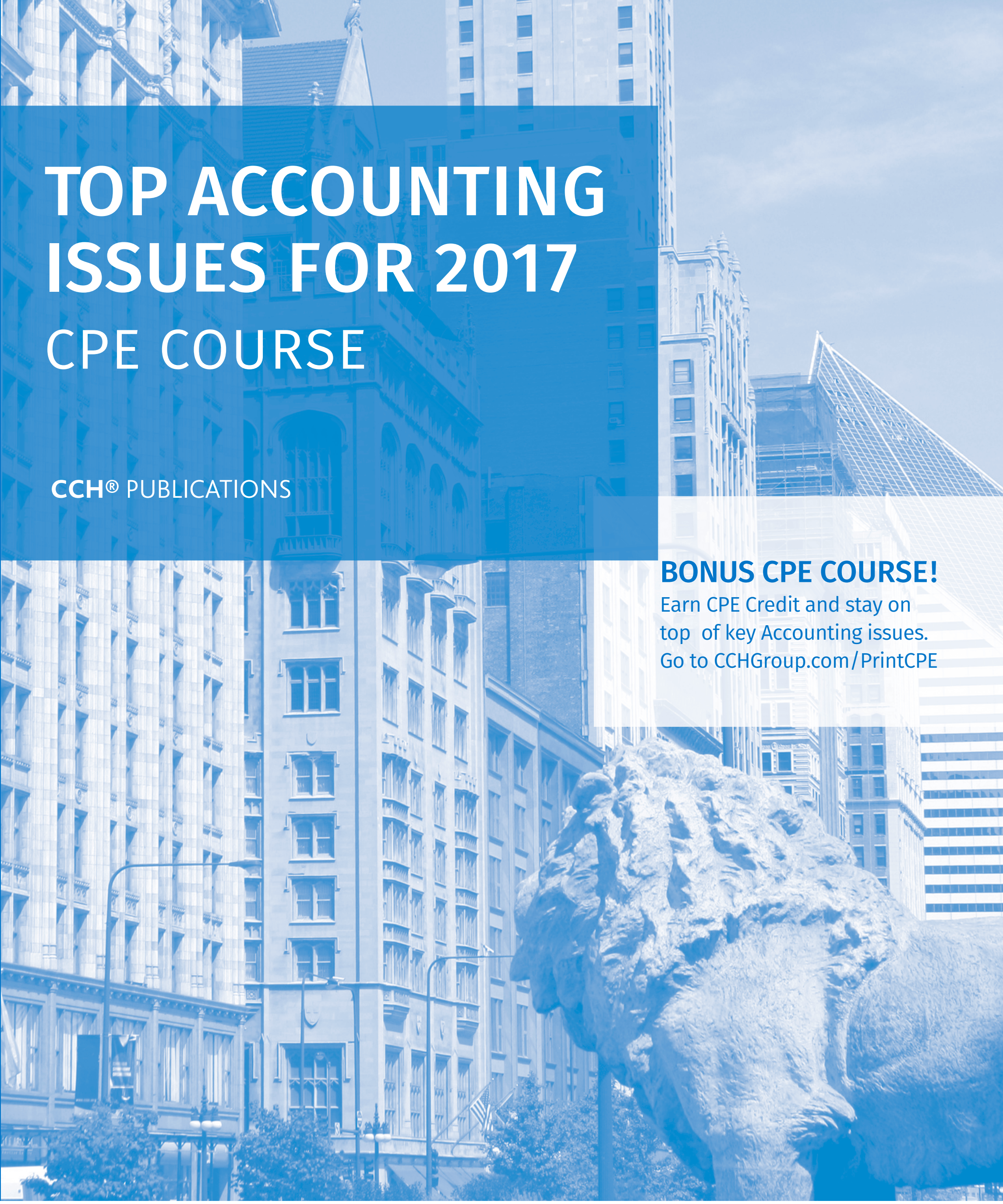

# TOP ACCOUNTING ISSUES FOR 2017

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# Top Accounting Issues for 2017 | CPE Course

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# Introduction

*Top Accounting Issues for 2017 CPE Course* helps CPAs stay abreast of the most significant new accounting standards and important projects. It does so by identifying the events of the past year that have developed into hot issues and reviewing the opportunities and pitfalls presented by these changes. The topics reviewed in this course were selected because of their impact on financial reporting and because of the role they play in understanding the accounting landscape in the year ahead.

Module 1 of this course reviews ongoing issues.

Chapter 1 discusses the changes to lease accounting that are the result of ASU 2016-02 and the effects those changes may have.

Chapter 2 provides an overview of the accounting and reporting amendments with respect to Accounting Standards Update 2015-11 released by the FASB in July 2015. This ASU is part of the FASB's Simplification Initiative and applies to entities that measure their inventory using either the first-in first-out (FIFO) or average cost methods. The ASU did not make changes to inventories measured using either last-in first-out (LIFO) or the retail inventory method.

Chapter 3 provides an overview of the accounting and reporting requirements with respect to deferred income taxes and net operating losses. This includes a discussion of valuation accounts, future income considerations, as well as differences between various types of carryforwards. This chapter also discusses the key requirements codified within ASC 740 from FIN 48 and certain changes prescribed by ASU 2015-17. Finally, the chapter concludes with a discussion related to corporate tax rates across different countries in the world.

Module 2 of this course reviews financial statement reporting.

Chapter 4 examines studies and recommendations that will hopefully lead to a comprehensive business reporting model that is valuable from the investor's perspective.

Chapter 5 provides an overview of the consolidation guidance prescribed within ASC 810 along with the significant amendments to the guidance from ASU 2015-02. This includes an in-depth analysis of five specific areas where ASU 2015-02 made specific amendments to the consolidations guidance along with illustrative examples.

Module 3 of this course reviews other current developments.

Chapter 6 provides an overview of the accounting and reporting requirements with respect to costs incurred related to terrorism and natural disasters. This includes a discussion of the disclosure requirements, the treatment of insurance recoveries, as well as the related income statement presentation and certain tax consequences.

Chapter 7 reviews some recent ASUs related to going concern assessment by management, debt issuance costs, internal-use software, and identifiable intangible assets in a private company business combination.

Chapter 8 provides an overview of information and statistics that suggest that company defined benefit pension plans are on the decline. This includes an analysis of the significant unfunded liabilities with respect to various pension plans, both from the governmental and nongovernmental standpoint. This chapter also discusses how pension plans can influence their total pension liability based on changes in assumptions used in the pension liability calculation.

**Study Questions.** Throughout the course you will find Study Questions to help you test your knowledge, and comments that are vital to understanding a particular strategy or idea. Answers to the Study Questions with feedback on both correct and incorrect responses are provided in a special section beginning at ¶ 10,100.

**Index.** To assist you in your later reference and research, a detailed topical index has been included for this course.

**Final Exam.** This course is divided into three Modules. Take your time and review all course Modules. When you feel confident that you thoroughly understand the material, turn to the Final Exam. Complete one, or all, Module Final Exams for continuing professional education credit.

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**August 2016**

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## COURSE OBJECTIVES

This course provides an overview of important accounting developments. At the completion of this course, the reader will be able to:

- Identify the changes that will be made under the new lease standard
- Recognize how existing leases will be handled when the new statement becomes effective
- Identify the measurement basis used to measure FIFO and LIFO inventories under ASU 2015-11
- Recognize how to account for a recovery of an inventory write-down in subsequent periods
- Identify the GAAP rules for measuring and recording a deferred tax asset and related valuation account
- Recognize and differentiate between the various types of carryforwards
- Identify key requirements codified within ASC 740 from FASB Interpretation No. 48
- Recognize the key changes prescribed by ASU 2015-17
- Identify some of the 12 recommended principles for the Comprehensive Business Reporting Model
- Recognize some of the key ratios used to analyze working capital
- Identify some of the symptoms of inefficiently managed working capital
- Recognize a key aspect of a VIE
- Recall situations in which use of combined statements is useful and not useful

- Recognize a key change to the consolidation model made by ASU 2015-02 with respect to a general partner of a limited partnership
- Identify some of the rights a noncontrolling limited partner might have in a limited partnership
- Identify the accounting and disclosure requirements related to certain risks and uncertainties and those related to terrorism and natural disasters
- Recognize how certain insurance recoveries should be accounted for in an entity's financial statements
- Explain changes made to going concern assessment by ASU 2014-15
- Identify one of the criteria that must be met to treat a hosting arrangement as internal-use software
- Identify how to account for intangible assets under ASU 2014-18's accounting alternative
- Recognize statistics related to unfunded liabilities prevalent across defined pension plans
- Recognize key requirements prescribed by GASB Statement No. 68
- Differentiate between the various color zones used to assess pension plan health

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One **complimentary copy** of this course is provided with certain copies of Wolters Kluwer publications. Additional copies of this course may be downloaded from **CCHGroup.com/PrintCPE** or ordered by calling 1-800-248-3248 (ask for product 10024493-0004).

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# Contents

# MODULE 1: ONGOING ISSUES—CHAPTER 1: Changes to Lease Accounting

## ¶ 101 WELCOME

This chapter discusses the changes to lease accounting that are the result of ASU 2016-02 and the effects those changes may have.

## ¶ 102 LEARNING OBJECTIVES

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Upon completion of this chapter, you will be able to:

- Identify the changes that will be made under the new lease standard
- Recall how lessees will account for leases under the new standard
- Identify the items that are considered part of the lease payment under the new standard
- Recall how the lessee calculates the liability for a lease under the new standard
- Recognize how existing leases will be handled when the new statement becomes effective
- Determine the effect the new standard may have on future lease terms
- Recognize how the new standard may affect book/tax differences, EBITA, and debt-equity ratios

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## ¶ 103 INTRODUCTION

The FASB approved a final statement on lease accounting that was issued in February 2016. The statement results in the culmination of a decade's work to dramatically transform how companies account for leases.

In particular, most leases will be capitalized resulting in billions of dollars of assets and liabilities being recorded on company balance sheets.

Although the lease accounting project has gone through numerous changes, the fundamental concept that leases be capitalized did not change in the final document.

## ¶ 104 BACKGROUND

Under current GAAP, ASC 840, *Leases*, divides leases into two categories: operating and capital leases. Capital leases are capitalized while operating leases are not. In order for a lease to qualify as a capital lease, one of four criteria must be met:

- The present value of the minimum lease payments must equal or exceed 90 percent or more of the fair value of the asset.
- The lease term must be at least 75 percent of the remaining useful life of the leased asset.
- There is a bargain purchase at the end of the lease.
- There is a transfer of ownership.

In practice, it has been common for lessees to structure leases to ensure they do not qualify as capital leases, thereby removing both the leased asset and obligation from the lessee's balance sheet. This approach has been typically used by restaurants, retailers, and other multiple-store facilities.

**EXAMPLE:** Lease 1: The present value of minimum lease payments is 89 percent of the fair value of the asset and the lease term is 74 percent of the remaining useful life of the asset.

Lease 2: The present value of minimum lease payments is 90 percent of the fair value of the asset or the lease term is 75 percent of the remaining useful life of the asset.

Lease 1 is an operating lease not capitalized, while Lease 2 is a capital lease under which both the asset and lease obligation are capitalized.

## ¶ 105 THE SEC PUSHES TOWARD CHANGES IN LEASE ACCOUNTING

In its report entitled "Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance-Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuer," the SEC targeted lease accounting as one of the areas that resulted in significant liabilities being off-balance-sheet.

According to the SEC Report that focused on U.S. public companies and a U.S. Chamber of Commerce Report:

- Sixty-three percent of companies record operating leases while 22 percent record capital leases.
- U.S. companies have approximately $1.5 trillion in operating lease obligations that are off-balance-sheet.
- European companies have a total of approximately $928 billion in off-balance-sheet operating lease obligations.
- Seventy-three percent of all leases held by U.S. public companies ($1.1 trillion) involve the leasing of real estate. (CFO.com)

In its Report, the SEC noted that because of ASC 840's bright-line tests (90 percent, 75 percent, etc.), small differences in economics can completely change the accounting (capital versus operating) for leases.

Keeping leases off the balance sheet while still retaining tax benefits has been an industry unto itself. So-called synthetic leases have been commonly used to maximize the tax benefits of a lease while not capitalizing the lease for GAAP purposes. In addition, lease accounting abuses have been the focus of restatements with approximately 270 companies, mostly restaurants and retailers, restating or adjusting their lease accounting in the wake of Section 404 implementation under Sarbanes-Oxley.

Retailers have the largest amount of operating lease obligations outstanding that are not recorded on their balance sheets, as noted in the following table:

**Operating Leases Obligations Outstanding—Major Retailers**

| Retailer | Lease Obligations (in millions) |
|---|---|
| Office Depot Inc. | $1,104 |
| Walgreens Co. | 27,434 |
| CVS | 38,917 |
| Whole Foods | 6,322 |
| Sears | 7,608 |

**Source:** Annual Reports

The above table shows the amount of off-balance-sheet lease obligations for some of the largest U.S. retailers. These numbers are significant and bring to the forefront the pervasive impact the new lease standard will have on the larger retailers.

## ¶ 106 FASB-IASB LEASE PROJECT

Since the Sarbanes-Oxley Act became effective, the FASB has focused on standards that enhance transparency of transactions and that eliminate off-balance-sheet transactions, the most recent of which was the issuance of ASC 810, *Consolidation of Variable Interest Entities*. The FASB added to its agenda a joint project with the IASB that would replace existing lease accounting rules found in ASC 840 and its counterpart in Europe, IASB No. 17. The FASB and IASB started deliberations on the project in 2007, and issued a discussion memorandum in 2009, followed by the issuance of an exposure draft in 2010 entitled, *Leases (Topic 840)*.

The 2010 exposure draft was met with numerous criticisms that compelled the FASB to issue a second, replacement exposure draft on May 16, 2013 entitled *Leases (Topic 842), a revision of the 2010 proposed FASB Accounting Standards Update, Leases (Topic 840)*. Following are some of the changes that the FASB and IASB have included in their new lease model as outlined in the May 2013 Exposure Draft.

## ¶ 107 BASIC CONCEPTS OF ASU 2016-02 LEASES (TOPIC 842)

The core principle of the requirements found in ASU 2016-02 is that an entity should use the *right-of-use model* to account for leases which will require the entity to recognize assets and liabilities arising from a lease. Thus, most existing operating leases will be brought onto the balance sheet.

In accordance with the right-of-use model, a lessee will recognize assets and liabilities for any leases that have a maximum possible lease term of more than 12 months. Leases with terms of 12 months or less will have the option of remaining as operating leases.

Following the study questions is a summary of the key elements of the new lease standard.

### STUDY QUESTIONS

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**1.** Under existing GAAP (*Leases (ASC 840)*), in order for a lease to qualify as a capital lease, which one of the following conditions must be satisfied?

- **a.** The future value of the minimum lease payments must be equal to or exceed 10 percent or more of the fair value of the asset.
- **b.** The lease term must be no more than 50 percent of the remaining useful life of the leased asset.
- **c.** There must be a bargain purchase at the end of the lease.
- **d.** There must not be a transfer of ownership.

**2.** Which of the following models does the new lease standard use?

- **a.** Right-of-use model
- **b.** Operating lease model
- **c.** Capital lease model
- **d.** True lease model

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# ¶ 108 LESSEE

At the commencement date, a lessee will measure both of the following:

- A lease liability (liability to make lease payments)
- A right-of-use asset (right to use the leased asset for the lease term)

## Lease Liability

The lease liability will be recorded at the present value of the lease payments over the lease term, discounted using the *rate the lessor charges the lessee* (the lessor's imputed rate) based on information available at the commencement date. If the lessor's imputed rate cannot be readily determined, the lessee will use its *incremental borrowing rate*.

Nonpublic entities will be permitted to use a *risk-free discount rate*, determined using a period comparable to that of the lease term, as an accounting policy election for all leases. The risk-free discount rate will be a U.S. Treasury instrument rate for the same term as the lease.

## Right-of-Use Asset

At the commencement date, the cost of the right-of-use asset will consist of all of the following:

- The amount of the initial measurement of the lease liability
- Any lease payments made to the lessor at or before the commencement date, less any lease incentives received from the lessor
- Any *initial direct costs* incurred by the lessee

At the commencement date, initial direct costs will be included as part of the cost of the lease asset capitalized and may include:

- Commissions
- Legal fees
- Evaluating the prospective lessee's financial condition
- Evaluating and recording guarantees, collateral, and other security contracts
- Negotiating lease terms and conditions
- Preparing and processing lease documents
- Payments made to existing tenants to obtain the lease

The following items are examples of costs that will *not* be initial direct costs:

- General overheads (e.g., depreciation, occupancy and equipment costs, unsuccessful origination efforts, and idle time)
- Costs related to activities performed by the lessor for advertising, soliciting potential lessees, servicing existing leases, or other ancillary activities

## Lease Payments

At the commencement date, lease payments included in the lease liability will consist of the following payments related to the use of the underlying asset during the lease term that are not yet paid:

- Fixed payments, less any lease incentives receivable from the lessor
- Variable lease payments that depend on an index or a rate (such as the Consumer Price Index or a market interest rate), initially measured using the index or rate at the commencement date
- Amounts expected to be payable by the lessee under residual value guarantees
- The exercise price of a purchase option if the lessee is reasonably certain to exercise that option
- Payments for penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease

Variable lease payments will be included in lease payments used to calculate the lease liability if the lease payments will depend on an index or rate, such as a CPI index. Each year, the lessee will adjust the lease obligation to reflect the present value of the remaining lease payments using latest index in effect at the end of that year.

Lease payments based on performance (such as a percentage of sales, with no minimum) will not be reflected in the lease payments in computing the lease obligation. Instead, such payments will be recorded annually as actual sales are generated.

## Lease Term

An entity will determine the lease term as the *noncancellable period of the lease*, together with *both* of the following:

- Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option
- Periods covered by an option to terminate the lease if the lessee is reasonably certain *not* to exercise that option.

Factors will be considered together, and the existence of any one factor will not necessarily signify that a lessee is reasonably certain to exercise, or not to exercise, the option. Examples of factors to consider will include, but will not be limited to, any of the following:

- Contractual terms and conditions for the optional periods compared with current market rates
- Significant leasehold improvements that are expected to have significant economic value for the lessee when the option to extend or terminate the lease or to purchase the asset becomes exercisable
- Costs relating to the termination of the lease and the signing of a new lease, such as negotiation costs, relocation costs, costs of identifying another underlying asset suitable for the lessee's operations, or costs associated with returning the underlying asset in a contractually specified condition or to a contractually specified location
- The importance of that underlying asset to the lessee's operations, considering, for example, whether the underlying asset is a specialized asset and the location of the underlying asset

**EXAMPLE:** A retail lessee, a liquor store, has a five-year lease with two, five-year options. It will be very difficult for the lessee to move the liquor store due to neighborhood opposition. Thus, the store location is very important to the lessee and the lessee most likely is reasonably certain to exercise the options so that the lease term is probably 15 years.

An entity will reassess the lease term only if either of the following occurs:

- There is a *change in relevant factors* that will result in the lessee no longer being reasonably certain to exercise an option to extend the lease or not to exercise an option to terminate the lease.

  **NOTE:** A change in market-based factors (such as market rates to lease a comparable asset) shall not, in isolation, trigger reassessment of the lease term.

- The lessee does either of the following:

  - Elects to exercise an option even though the entity had previously determined that the lessee was not reasonably certain to do so

  - Does not elect to exercise an option even though the entity had previously determined that the lessee was reasonably certain to do so

## Classification of Leases

ASU 2016-02 establishes two types of leases:

*Type A lease*: Lease in which lessee expects to consume *more than an insignificant portion* of the economic benefits (life) of the asset:

- Will apply to most leases of assets other than property (e.g., equipment, aircraft, cars, trucks)
- Will recognize a right-of-use asset and a lease liability, initially measured at the present value of lease payments
- Will recognize the unwinding of the discount on the lease liability as interest separately from the amortization of the right-of-use asset
- Total expense will be accelerated and shown in two expense components:
- Interest expense (accelerated)
- Amortization expense (straight-line)

*Type B lease*: Lease in which the lessee expects to consume only an insignificant portion of the economic benefits (life) of the asset:

- Will apply to most leases of property (i.e., land and/or a building or part of a building)
- Will recognize a right-of-use asset and a lease liability, initially measured at the present value of lease payments (same as Type A lease)
- Will recognize a single lease expense, combining the unwinding of the discount on the lease liability (interest) with the amortization of the right-of-use asset, on a straight-line basis.
- Total expense will be recorded on a straight-line basis throughout the lease term.

The following chart compares the new standard with existing GAAP for leases.

**Comparison of Existing GAAP Versus New GAAP for Leases Lessee Side**

| Description | Current GAAP for Operating Leases | New GAAP |
|---|---|---|
| Lease type | Leases are classified as operating or capital leases (financing arrangements) based on satisfying one of four criteria:<br>• 75% rule<br>• 90% rule<br>• Bargain purchase<br>• Transfer of ownership | All leases classified as financing arrangements (as if asset purchases)<br>Right-of-use asset and lease liability recorded at present value of payments over the lease term |

| Comparison of Existing GAAP Versus New GAAP for Leases Lessee Side | | |
|---|---|---|
| **Description** | **Current GAAP for Operating Leases** | **New GAAP** |
| Lease term | Non-cancellable periods<br>Option periods generally not included in lease term | Non-cancellable period together with any options to extend or terminate the lease when it is reasonably certain that the lessee will exercise an option to extend the lease |
| Contingent/variable rents | Contingent rents excluded from lease payments. When paid, they are period costs. | Variable rents included in lease payments in certain instances |
| Income statement | Operating leases: lease expense straight-line basis<br>Capital leases: depreciation and interest expense | Two Approaches:<br>*TYPE A LEASE*: Interest and amortization expense recorded—Accelerated expense<br>*TYPE B LEASE:* Lease expense recorded as combination of interest and amortization—straight-line expense |
| Assessment | Terms are not re-assessed | Leases reassessed in certain instances |

## STUDY QUESTION

**3.** Facts: A company is a lessee of a lease with a lease term of 12 months. How may the lessee account for this lease under the new lease standard?

- **a.** The company is required to record a lease asset and liability.
- **b.** The company is required to record the lease as an operating lease.
- **c.** The company has the option to record the lease asset and liability, or record the lease as an operating lease.
- **d.** The new standard does not address lease terms of 12 months or less.

## ¶ 109 SHORT-TERM LEASES

A lessee will not be required to recognize lease assets or lease liabilities for short-term leases. A short-term lease is defined as follows:

> A lease that, at the date of commencement of the lease, has a maximum possible term, including any options to renew, of 12 months or less.

For short-term leases, the lessee will recognize lease payments as rent expense in the income statement on a straight-line basis over the lease term, unless another systematic and rational basis is more representative of the time pattern in which use is derived from the underlying asset.

**NOTE:** The new standard will treat short-term leases (12 months or less) as operating leases by not requiring the lessee to record the lease asset and liability. Instead, rent expense will be recorded on a straight-line basis as incurred, although the new standard permits an entity to use another approach (other than a straight-line method) to record rent expense if that alternative is more representative of the time pattern in which the lessee uses the lease asset.

A lessee will be permitted (but is not required) to record a lease asset and liability for a short-term lease. Lessors will be permitted to elect to account for all short-term leases by not recognizing lease assets or lease liabilities and by recognizing lease payments received in rental income on a straight-line basis over the lease term, or another systematic and rational basis that is more representative of the time pattern in which use is derived from the underlying asset.

## ¶ 110 DISCLOSURES

Both lessees and lessors will provide disclosures to meet the objective of enabling users of financial statements to understand the amount, timing, and uncertainty of cash flows arising from leases.

## ¶ 111 EFFECTIVE DATE AND TRANSITION

ASU 2016-02 is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years, for any of the following:

- A public business entity
- A not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market
- An employee benefit plan that files financial statements with the U.S. Securities and Exchange Commission (SEC).

For all other entities, the amendments in this ASU are effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Early application is permitted for all entities.

Existing leases will not be grandfathered thereby requiring existing operating leases to be brought onto the balance sheet. All existing outstanding leases will be recognized and measured at the date of initial application using a simplified retrospective approach. On transition, a lessee and a lessor will recognize and measure leases at the beginning of the earliest period presented using either a modified retrospective approach or a full retrospective approach.

## ¶ 112 IMPACT OF CHANGES TO LEASE ACCOUNTING

The lease accounting changes could be devastating to many companies and may result in many more leases being capitalized which will impact all financial statements. Retailers, in particular, will be affected the most. If leases of retailers, for example, are capitalized, the impact on financial statements will be significant, as noted below:

- Lessee's balance sheets will be grossed up for the recognized lease assets and the lease obligations for all lease obligations.

  **NOTE:** Including contingent lease payments and renewal options may result in overstated liabilities given the fact that contingent payments must be included in the lease payments and renewal options must be considered in determining the lease term.

- For Type A leases, lessee's income statements will be adversely affected with higher lease expense in the earlier years of new leases. On average, a 10-year lease will incur approximately 15-20 percent higher annual lease expense in the earlier years, if capitalized, as compared with an operating lease. That higher lease amount will reverse in the later years.
- For Type A leases, on the statement of cash flows, there will be a positive shift in cash flow to cash from operations from cash from financing activities. A portion of rent expense previously deducted in arriving at cash from operations will now be deducted as principal payments in cash from financing activities. Thus,

companies will have higher cash from operating activities and lower cash from financing activities.

- In most cases, annual lease expense for GAAP (interest and amortization) will not match lease expense for income tax purposes thereby resulting in deferred income taxes.

Changes to both the balance sheets and income statements of companies will have rippling effects on other elements of the lessee companies. On the positive side, a lessee's earnings before interest, taxes, depreciation and amortization (EBITDA) may actually improve as there is a shift from rent expense under operating leases to interest and amortization expense under the new standard.

- Both interest and amortization expense is not deducted in arriving at EBITDA while rent expense is.
- Changes in EBIDTA may affect existing agreements related to compensation, earn outs, bonuses, and commissions.

On the negative side, for Type A and B leases, lessee debt-equity ratios will be affected with entities carrying significantly higher lease obligation debt than under existing GAAP. Higher debt-equity ratios could put certain loan agreements into default. Moreover, net income will be lower in the earlier years of the lease term due to higher interest and amortization expense replacing rental expense.

## How significant will the change to the new lease standard be for U.S. companies?

As previously noted, there are approximately $1.5 trillion of operating lease obligations that are not recorded on public company balance sheets. That $1.5 trillion is magnified by the many nonpublic companies that have unpublished operating lease obligations that are unrecorded. The author estimates that unrecorded lease obligations of nonpublic operating leases is at least another $1.3 trillion bringing to estimated total unrecorded lease obligations at approximately $2.8 trillion.

Consider the following estimated impacts of shifting those operating leases to capitalized right-of-use leases (Report issued by Change & Adams Consulting, commissioned by the U.S. Chamber of Commerce, and others (2012)):

- Earnings of retailers will decline significantly. One recent study suggested that there will be a median drop in EPS of 5.3 percent and a median decline in return on assets of 1.7 percent.
- Public companies could face $10.2 billion of added annual interest costs.
- There could be a loss of U.S. jobs in the range of 190,000 to 3.3 million.
- Cost of compliance with the new standard could lower U.S. GDP by $27.5 billion a year.
- Lessors could lose approximately $14.8 billion in the value in their commercial real estate.
- Balance sheets could be loaded with significant lease obligations that would impact debt-equity ratios ( Bear Stearns research study).

  - Aggregate debt of nonfinancial S&P 500 companies could increase by 17 percent if all leases were capitalized.

  - Return on assets could decline as total assets (the denominator) could increase by approximately 10 percent.

- The S&P 500 could record an estimate of $549 billion of additional liabilities under the new lease standard on existing operating leases (Leases Landing on Balance Sheet (Credit Suisse)).

- U. S. companies, as a whole (public and nonpublic), could record approximately $7.8 trillion of additional liabilities if operating leases are capitalized (Author's estimate: $1.5 trillion for public companies and $6.3 trillion for nonpublic companies).

According to a Credit Suisse study, (Leases Landing on Balance Sheet (Credit Suisse)), there are 494 of the S&P 500 companies that are obligated to make $634 billion of total future minimum lease payments under operating leases. On a present value basis, including contingent rents, the $634 billion translates into an additional liability under the new standard of $549 billion. Of the $549 billion of additional liabilities, 15 percent of that total relates to retail companies on the S&P 500.

In some cases, the effect of capitalizing lease obligations under the new lease standard is that the additional liability exceeds stockholders' equity.

Consider the following table:

**Impact of Capitalizing Leases—Selected Retailers Based on Annual Reports**

| Retailer | Operating lease obligations | PV converter 5 years 4% (a) | Additional liability under new lease standard | Stockholders' equity | **% equity** |
|---|---|---|---|---|---|
| Office Depot Inc. | $ 2 B | .822 | $1.6 B | $661M | **248%** |
| Walgreens Co. | 35 B | .822 | 28.8 B | 18 B | **160%** |
| CVS | 28 B | .822 | 23.0 B | 38 B | **61%** |
| Whole Foods | 6.8 B | .822 | 5.6 B | 3.8 B | **147%** |
| Sears | 4.5 B | .822 | 3.7 B | 3.1 B | **119%** |

**Source:** Annual Reports, as obtained by the author.
(a) Assumes the weighted-average remaining lease term is five years, and the incremental borrowing rate is four percent

The previous table identifies the sizeable problem that exists for many U.S. retailers which is that there are huge off-balance-sheet operating lease liabilities as a percentage of company market capitalization. Under the proposed lease standard, these obligations would be recorded, thereby having a devastating impact on those retailers' balance sheets. For example, look at Office Depot and its $1.6 billion lease liability that would represent 248% of its stockholders' equity of $661 million.

## How will the new lease standard impact how leases are structured?

Companies are going to consider the balance sheet impact when structuring leases and in deciding whether to lease or buy the underlying asset. There are several likely actions that will come from the new standard:

**Lease-versus-buy decision impacted:** By implementing the new standard, the GAAP differences between leasing and owning an asset will be reduced. Having to capitalize all leases may have a significant effect on the lease versus purchase decision, particularly with respect to real estate. Tenants, in particular those in single-tenant buildings with long-term leases, may choose to purchase a building instead of leasing it:

- A similar amount of debt will be included on the tenant's balance sheet under a long-term lease as compared with a purchase.
- GAAP depreciation under a purchase may actually be lower than amortization under a lease because the amortization life under the lease (generally the lease term) is likely to be shorter than the useful life under a purchase.

**EXAMPLE:** Assume there is a 10-year building lease with two, five-year lease options, resulting in a maximum lease term of 20 years. Assume further that the useful life of the building is 30 years for depreciation purposes. If the entity leases the real estate, the right-of-use asset will be amortized over a maximum of 20 years. If, instead, the entity were to purchase the real estate, the building will be depreciated over the useful life of 30 years.

**NOTE:** In some instances, lessees may choose to purchase the leased asset rather than lease it, if the accounting is the same. In particular, the purchase scenario may be more appealing for longer-term leases that have significant debt obligations on the lessee balance sheets. Lessees with shorter-term leases will not be burdened with the extensive debt obligations and, therefore, may choose not to purchase the underlying lease asset.

**Lease terms are likely to shorten:** For many companies who do not wish to purchase the underlying leased asset, lease terms may shorten to reduce the amount of the lease obligation (and related asset) that is recorded at the lease inception. The new lease standard will affect not only the landlords and tenants, but also brokers, as there will be much greater emphasis placed on executing leases for shorter periods of times thereby increasing the paperwork over a period of time and the commissions earned.

**Deferred tax assets will be created:** Because many operating leases will now be capitalized for GAAP but not for tax purposes, total GAAP expense (interest and amortization) will be greater than lease expense for tax purposes, resulting in deferred tax assets for the future tax benefits that will be realized when the temporary difference reverses in later years.

Under existing GAAP, most, but not all, operating leases are treated as operating leases for tax purposes. Therefore, rarely are operating leases capitalized for tax purposes. Now the game is about to change if operating leases are capitalized as right-of-use assets under GAAP, while they continue to be treated as operating leases for tax purposes. As we have seen in the previous examples, most leases capitalized under the new standard will result in the creation of a deferred tax asset.

## STUDY QUESTIONS

**4.** Which of the following will be a probable effect of the new lease standard?

- **a.** The lessee's income statement will have lower total lease expense in the earlier years of new leases.
- **b.** There will be a negative shift in cash from operations from cash from financing activities in the statement of cash flows.
- **c.** In most cases, total expense for GAAP will be the same as total expense for income tax purposes.
- **d.** The lessee's EBITDA may increase as there is a shift from rent expense to interest and amortization expense.

**5.** One change that may occur as a result of the new lease standard being implemented is:

- **a.** Companies that typically purchase a single-tenant building may choose to lease instead of buy.
- **b.** Tenants in multi-tenant buildings will likely sign longer-term leases.
- **c.** Tenants in single-tenant buildings with long-term leases may choose to buy.
- **d.** There is likely to be no change.

**6.** Annual GAAP depreciation expense for a purchase of a leased asset may be ______________ assuming there is a Type A lease.

**a.** Higher than annual amortization expense under a lease

**b.** Lower than annual amortization expense under a lease

**c.** The same as annual amortization expense under a lease

**d.** Either higher or lower than amortization expense under a lease, depending on whether options are part of the lease term

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## Dealing with Financial Covenants

The new lease standard will cast a wide web across the accounting profession. By capitalizing leases that were previously off-balance-sheet as operating leases, there may be consequences.

**EXAMPLES:**

- *Impact on state apportionment computations*: Many states compute the apportionment of income assigned to that state using a property factor based on real and tangible personal property held in that particular state.

  **NOTE:** When it comes to rent expense, most states capitalize the rents using a factor such as eight times rent expense. Although each state has its own set of rules, the implementation of the new standard may have a sizeable positive or negative impact on state tax apportionment based on shifting rent expense to capitalized assets.

- *Impact on tax planning*: Capitalizing leases might have a positive effect in tax planning.

  **NOTE:** One example is where there is a C corporation with accumulated earnings and exposure to an accumulated earnings tax (AET). The additional lease obligation liability will certainly help justify that the accumulation of earnings is not subject to the AET.

- *Impact on total asset and liability thresholds:* Companies should also be aware that not only will the new standard increase liabilities, but will also increase total assets.

  **NOTE:** In some states, there are total asset thresholds that drive higher taxes and reporting requirements.

A critical impact of the new standard will be that certain loan covenants may be adversely impaired, thereby forcing companies into violations of their loans.

Consider the following ratios:

| Ratio | Likely impact of new lease standard |
|---|---|
| EBITDA: | |
| *Earnings before interest, taxes, depreciation and amortization* | *Type A Leases:* Favorable impact due to shift from rental expense to interest and amortization expense, both of which are added back in computing EBITDA *Type B Leases:* May be favorable impact depending on whether "lease expense" is added back to compute EBITDA |
| Interest coverage ratio: $\frac{\textit{Earnings before interest and taxes}}{\textit{Interest expense}}$ | May be negatively impacted from lower ratio |
| Debt-equity ratio: $\frac{\textit{Total liabilities}}{\textit{Stockholders' equity}}$ | Negative impact from higher ratio |

There will be a favorable impact on EBITDA for Type A leases by implementing the new standard. Rent expense recorded for operating leases under existing GAAP will be reduced while interest expense and amortization expense will increase once the leases are capitalized.

However, the issue is what happens to EBITDA for Type B leases. Under the proposal, interest and amortization are combined as one line item on the income statement entitled "lease expense." The question is whether that line item is added back in arriving at EBITDA. Perhaps it should be added back because it represents interest and amortization despite the lease expense label.

As to the interest coverage ratio, the impact on the ratio depends on the whether there is a Type A or B lease. For a Type A lease, earnings before interest and taxes will likely be higher as rent expense is removed and replaced with interest and amortization expense. For Type A leases, the denominator increases significantly due to the higher interest expense. On balance, the slightly higher earnings before interest and taxes divided by a higher interest expense in the denominator yields a lower interest coverage ratio.

For a Type B lease, the impact on the ratio is unclear. Although interest expense, along with amortization expense, will be embedded in the caption line item "lease expense," most analysts will likely carve out the interest and amortization components and adjust the interest coverage ratio by the interest portion.

Perhaps the most significant impact of capitalizing leases under the new lease standard will be its effect on the debt-equity ratio. With sizeable liabilities being recorded, this ratio will likely turn quite negative and severely impact company balance sheets. In some cases, the debt-equity ratio will result in violation of existing loan covenants, thereby requiring a company to renegotiate the covenants with its lenders or at least notify lenders in advance of the likely lack of compliance with loan covenants.

## What about the impact on smaller nonpublic entities?

One leasing organization noted that more than 90 percent of all leases involve assets worth less than $5 million and have terms of two to five years (Equipment Leasing and Financing Association (ELFA) "Companies: New Lease Rule Means Labor Pains" (CFO.com)). That means that smaller companies have a significant amount of leases, most of which are currently being accounted for as operating leases.

Unless these smaller, nonpublic entities choose to use the income tax basis for their financial statements, under GAAP, these companies will be required to capitalize their operating leases.

## What about related party leases?

Some, but not all, related party leases result in the lessee (parent equivalent) consolidating the lessor (subsidiary equivalent) under the consolidation of variable interest entity rules (ASC 810). The common example of a related-party lease is where an operating company lessee leases real estate from its related party lessor. In general, under ASC 810, if there is a related party lessee and lessor, consolidation is required if:

- The real estate lessor is a variable interest entity (VIE) (e.g., it is not self-sustaining), and,
- The lessee operating company and/or the common shareholder provide financial support to the real estate lessor in the form of loans, guarantees of bank loans, above-market lease payments, etc.

If these two conditions are met, it is likely that the real estate lessor must be consolidated in with the operating company lessee's financial statements. If there is consolidation, capitalizing the lease under the new standard will be moot because the asset, liability, and lease payments will be eliminated in the consolidation.

In 2014, the Private Company Council (PCC) issued ASU 2014-07 which provides private (nonpublic) entities an election not to apply the consolidation of VIE rules to a related-party lease arrangement. When implemented, the ASU should provide most private companies with relief from the VIE rules for related party leases. Thus, most private (nonpublic) entities involved in related-party leases will not be consolidating the lessor into the lessee.

When it comes to a related-party lease in which there is no consolidation, the parties will have to account for that lease as a right-of-use lease asset and obligation, just like any other lease transaction. Consequently, under the new standard, the operating company lessee will be required to record a right-of-use asset and lease obligation based on the present value of the lease payments.

Many related parties either do not have formal leases or the leases are short-term. If the operating company lessee is going to have to record a significant asset and liability, it may make sense to have a related-party lease that has a lease term of 12 months or less or is a tenant-at-will arrangement.

With respect to a related party lease that is 12 months or less, the new standard will permit (but not require) use of the short-term lease rules as follows:

- A lessee will treat the short-term lease as an operating lease with no recognition of the lease asset or lease liability. The rental payments will be recognized as rent expense on a straight-line basis.
- On the lessor side, the lessor will record rental income on a straight-line basis and not record the lease asset and liability.
- Either the lessee or lessor could elect to record the lease asset and liability using the new standard rules.

With many related-party leases, the operating company lessee may issue financial statements while the real estate lessor does not. Therefore, how the lessee accounts for the transaction under GAAP may be more important than the lessor's accounting for the transaction.

**EXAMPLE:** Company X is a real estate lessor LLC that leases an office building to a related-party operating Company Y. X and Y are related by a common owner. The companies sign an annual 12-month lease with no renewals, and no obligations that extend beyond the twelve months. Monthly rents are $10,000. Y issues financial statements to its bank while X does not issue financial statements. Y chooses ASU 2014-07's election not to consolidate X into Y's financial statements.

Because the entities have a short-term lease of 12 months or less, Y, as lessee, will qualify for the short-term lease rules. Therefore, Y *will not* record a lease asset and liability and, instead, will record the monthly rent payments and rent expense on a straight-line basis over the short-term lease period. Alternatively, Y could elect to treat the short-term lease as a standard lease by recording both the lease asset and liability.

As to the lessor, it will also not record the lease asset and liability and, instead, will record rental income on a straight-line basis over the 12-month period.

**OBSERVATION:** Many nonpublic entities may take steps to avoid the new standard's arduous rules. One approach will likely be to make sure the related-party leases have terms that are 12 months or less so that the lease can be treated as an operating lease and not capitalized. Another approach will be to issue income tax basis financial statements.

# MODULE 1: ONGOING ISSUES—CHAPTER 2: Simplifying Inventory Measurement

## ¶ 201 WELCOME

This chapter provides an overview of the accounting and reporting amendments with respect to Accounting Standards Update 2015-11 released by the FASB in July 2015. This ASU is part of the FASB's Simplification Initiative and applies to entities that measure their inventory using either the first-in first-out (FIFO) or average cost methods. The ASU did not make changes to inventories measured using either last-in first-out (LIFO) or the retail inventory method.

## ¶ 202 LEARNING OBJECTIVES

Upon completion of this chapter, you will be able to:

- Identify the measurement basis used to measure FIFO and LIFO inventories under ASU 2015-11
- Recognize how to account for a recovery of an inventory write-down in subsequent periods
- Identify the method to be used to implement ASU 2015-11 for inventory

## ¶ 203 INTRODUCTION

The FASB received comments from users that the current guidance on the measurement of inventory is unnecessarily complex because there are three potential outcomes to determine the market used in the lower of cost or market comparison. As a result, ASU 2015-11 was issued in order to simplify the measurement of inventory. This ASU, effective for fiscal years beginning after December 15, 2016, and interim periods within those annual periods (one year later for nonpublic entities), is part of the FASB's Simplification Initiative. The objective of the Simplification Initiative is to identify, evaluate, and improve areas of U.S. GAAP for which cost and complexity can be reduced, while maintaining or improving the usefulness of the information provided to users of financial statements.

ASC 330 ("Inventory") presently requires an entity to measure inventory at the lower of cost or market. Currently within ASC 330, market could be any one of three outcomes: replacement cost, net realizable value, or net realizable value less normal profit margin. The determination of the market is subject to a range. The upper amount of the range (the ceiling) is net realizable value (selling price less costs to dispose (sell), transportation, and costs of completion). The floor is net realizable value less the normal profit margin.

Replacement cost is market subject to a ceiling and floor computed as follows:

| | |
|---|---|
| Selling price | $XX |
| Costs of completion, disposal, and transportation | (XX) |
| NET REALIZABLE VALUE- MARKET CEILING | XX |
| Normal profit margin | (XX) |
| MARKET FLOOR | $XX |

In computing market, replacement cost is compared to the range noted above in order to determine the market price used in the lower of cost or market assessment. If replacement cost is within the ceiling and floor range, replacement cost is considered market and compared with cost to determine lower of cost or market. However, if replacement cost is greater than the ceiling, the ceiling is considered the market price and is used in the comparison. Finally, if replacement cost is lower than the floor, the floor is considered the market. Refer to the following example for an illustration of this method of determining the market.

**EXAMPLE:**

| | **Item 1** | **Item 2** |
|---|---|---|
| Cost | $40 | $60 |
| Replacement Cost | 50 | 70 |
| Ceiling | 55 | 55 |
| Floor | 45 | 45 |
| Market | | |
| Replacement Cost | $50 | |
| Ceiling | | $55 |
| **Lower of Cost or Market** | **$40** | **$55** |

## ¶ 204 CHANGES RESULTING FROM THE ASU

While the FASB decided to simplify the model to reduce costs and increase comparability for inventory measured at FIFO or average cost, the FASB chose to exclude from the new rules inventory measured using LIFO or the retail inventory method. As a result, for FIFO and average cost inventory cost is compared with net realizable value. For LIFO and average cost, the existing lower of cost or market approach was retained (i.e. three potential outcomes).

The amendments in the ASU make U.S. inventory valuations more closely aligned with the measurement of inventory in International Financial Reporting Standards (IFRS). Other than the change in the measurement guidance from the lower of cost or market to the lower of cost and net realizable value for inventory within the scope of the ASU, there are no other substantive changes made by the ASU to the measurement of inventory.

## STUDY QUESTIONS

**1.** Company Z uses LIFO for its inventory valuation and measures its inventory at lower of cost or market. Because Company Z uses the LIFO inventory valuation method, market is defined as which of the following?

- **a.** Fair value
- **b.** Replacement cost with ceiling and floor limits
- **c.** Net realizable value
- **d.** Normal profit

**2.** When calculating net realizable value, estimated selling price is adjusted for which of the following?

- **a.** Less normal profit
- **b.** Less costs of completion
- **c.** Less fixed costs
- **d.** Plus discounts and allowances

# ¶ 205 SUBSEQUENT MEASUREMENT

The method used for the subsequent measurement of inventory depends on the cost method being used by the entity. As a result, the subsequent measurement of inventory is different for the each of the following:

- Inventory measured using LIFO or the retail inventory method
- Inventory measured using any method other than LIFO or the retail inventory method

When evidence exists that the net realizable value of inventory is lower than its cost, the difference is recognized as a loss in earnings in the period in which it occurs. This loss can be driven by damage, physical deterioration, obsolescence, changes in price levels, or other causes.

## FIFO or the Retail Inventory Method

For inventory measured using LIFO or the retail inventory method, an entity should continue to measure the inventory at the lower of cost or market. A departure from the cost basis of pricing inventory measured using LIFO or the retail inventory method is required when the utility of the goods is no longer as great as their cost.

## Applicable to All Inventory Valuation Methods

If inventory has been the hedged item in a fair value hedge, the inventory's cost basis for purposes of subsequent measurement is required to reflect the effect of the adjustments of its carrying amount made in accordance with ASC 815-25-35-1(b).

> **COMMENT:** ASC 815-25-35-1(b) states that the gain or loss (based on the change in fair value) on a hedged item attributable to the hedged risk shall adjust the carrying amount of the hedged item and is recognized currently in earnings.

Once inventory has been written down to either cost or its net realizable value, the written down amount becomes the new cost and cannot be reversed under U.S. GAAP. This is contrary to IFRS which permits the write-down to be reversed up to the original cost. The SEC Staff Accounting Bulletin (SAB) Topic 5. BB-Inventory Valuation Allowance (ASC 330-10-S99-2) addresses the issue of restoration of write-downs under the previous lower of cost or market rules. The conclusion still applies to the new lower of cost and net realizable value requirements in ASU 2015-11.

> **Question:** Does the write-down of inventory to the lower of cost or market, as required by FASB ASC Topic 330, create a new cost basis for the inventory, or may a subsequent change in facts and circumstances allow for restoration of inventory value, not to exceed original historical cost?
>
> **Interpretative Response:** Based on FASB ASC paragraph 330-10-35-14, a write-down of inventory to the lower of cost or market at the close of a fiscal year creates a new basis that subsequently cannot be marked up based on changes in underlying facts and circumstances.

Depending on the character and composition of the inventory, the lower of cost or market inventory measurement can be applied using any of the following three approaches. The appropriateness of the various approaches is based on which one most clearly reflects periodic income. The measurement can be applied:

- Directly to each individual item
- To the total inventory
- To the total of the components of each major category of inventory

In principle, the purpose of reducing the carrying amount of inventory is to reflect fairly the income of the period. The most common practice is to apply the applicable subsequent measurement guidance separately to each item of the inventory. However, if there is only one end-product category, the application of the applicable subsequent measurement guidance to inventory in its entirety may have the greatest significance for accounting purposes. Similarly, where more than one major product or operational category exists, the application of the applicable subsequent measurement guidance to the total of the items included in such major categories may result in the most useful determination of income. It is also important to note that Internal Revenue Code (Code) requires that the lower of cost or market test be performed on an individual-item basis and not for the inventory as a whole.

Additionally, it is important to understand the accounting requirements for market declines in interim periods. In this situation, if near-term price recovery is uncertain, a decline in the market value (for inventory measured using LIFO or the retail inventory method) or net realizable value (for all other inventory) of inventory below cost during an interim period should be accounted for consistently with annual periods.

**EXAMPLE:** Company X is a distributor of wholesale products which are complete and ready to sell. However, the selling prices of certain items within its inventory have declined due to competition. The costs to dispose (sell) and transport as a percentage of gross sales are as follows:

| | |
|---|---|
| Commissions | 8% |
| Freight out | 4% |
| Sales discounts and allowances | 3% |
| | 15% |

The company had no write-down of inventory in the prior year, 2016. At December 31, 2017, inventory information for its five products (A, B, C, D and E) is as follows:

| **Product** | **A** | **B** | **C** | **D** | **E** |
|---|---|---|---|---|---|
| Cost- FIFO | $110 | $155 | $165 | $140 | $70 |
| NRV: | | | | | |
| Estimated selling price | $140 | 160 | 180 | 120 | 100 |
| Cost to dispose and transportation (15%) | (21) | (24) | (27) | (18) | (15) |
| Net realizable value | $119 | $136 | $153 | $102 | $85 |

**Computation of Lower of Cost and Net Realizable Value**
**December 31, 2017**

| **Product** | **Quantity (a)** | **Unit cost (b)** | **NRV (c)** | **Total cost (a) x (b)** | **Total at NRV (a) x (c)** | **Lower of cost and NRV** |
|---|---|---|---|---|---|---|
| A | 1,000 | $110 | $119 | $110,000 | $119,000 | $110,000 |
| B | 2,000 | 155 | 136 | 310,000 | 272,000 | 272,000 |
| C | 3,000 | 165 | 153 | 495,000 | 459,000 | 459,000 |
| D | 4,000 | 140 | 102 | 560,000 | 408,000 | 408,000 |
| E | 2,000 | 70 | 85 | 140,000 | 170,000 | 140,000 |
| | | | | $1,615,000 | $1,428,000 | $1,389,000 |

If the company computes the lower of cost and net realizable value on an individual product basis, the write-down is calculated as follows:

| | |
|---|---|
| Inventory at cost | $1,615,000 |
| Inventory at NRV | 1,389,000 |
| Write-down | $(226,000) |

| | | |
|---|---|---|
| Entry at December 31, 2017: | | |
| Cost of goods sold- inventory write-down | 226,000 | |
| Allowance for inventory write-down | | 226,000 |

Note that the entry could also be recorded as a credit directly to inventory without the use of an inventory allowance account.

Alternatively, if the company computes lower of cost and net realizable value based on the total inventory (i.e. not on an individual product basis), the write-down is calculated as follows:

| | |
|---|---|
| Inventory at cost | $1,615,000 |
| Inventory at NRV | 1,428,000 |
| Write-down | $(187,000) |

| | | |
|---|---|---|
| Entry at December 31, 2017: | | |
| Cost of goods sold- inventory write-down | 187,000 | |
| Allowance for inventory write-down | | 187,000 |

## STUDY QUESTION

**3.** If Company M uses the FIFO method of inventory valuation and has adopted the amendments of ASU 2015-11, then the company should always measure its inventory as which of the following?

**a.** Net realizable value

**b.** Lower of cost and net realizable value

**c.** Replacement cost

**d.** Lower of cost or fair value

## Challenge for Manufacturers

A manufacturer has a challenge in applying the ASU if it uses FIFO or average cost to value its inventory. Because the computation is based on the lower of cost and net realizable value, the only way to perform the test is to do so in total for the entire inventory, either by segment or in total. Performing a lower of cost and net realizable value on an individual-item basis is not possible if there are raw materials. The prime reason is because replacement cost is no longer used in the computation. As a result, an entity must compute net realizable value. Because raw materials become part of finished goods, net realizable value must be computed based on the final finished goods product, and cannot be performed on raw materials, by itself.

**EXAMPLE:** Company X is a manufacturer which has the following inventory at December 31, 2017:

| | |
|---|---|
| Raw materials (RM) | $5,000,000 |
| Work in process (WIP) | 1,000,000 |
| Finished goods (FG) | 4,000,000 |
| | $10,000,000 |

Costs to dispose (sell) and transportation as a percentage of gross sales, are as follows:

| | |
|---|---|
| Commissions | 8% |
| Freight out | 4% |
| Sales discounts and allowances | 3% |
| | 15% |

Additionally, costs of completion are as follows:

- Direct labor to convert WIP inventory to FG inventory: $200,000
- Direct labor to convert RM to FG inventory: 80% of materials cost
- Fixed and variable overhead: Allocated based on 50% of materials and labor in finished goods inventory

Company X's computation of lower of cost and net realizable value is as follows:

| | | |
|---|---|---|
| Estimated sales of all inventory upon conversion to finished goods (given) | | $22,000,000 |
| Costs to dispose (sell) and transportation (15% x $22,000,000) | | (3,300,000) |
| Costs to complete: Conversion of RM and WIP to FG: | | |
| Direct labor to convert WIP to FG (see a) | 200,000 | |
| Direct labor to convert RM to FG (see b) | 4,000,000 | |
| Fixed overhead – to convert RM and WIP to finished goods (see c) | 5,100,000 | |
| Total costs to convert RM and WIP to FG | | (9,300,000) |
| Net realizable value | | $9,400,000 |
| Inventory at cost | | $10,000,000 |
| **Lower of cost and net realizable value** | | **$9,400,000** |

(a): Additional labor required to complete the WIP inventory to finished goods is $200,000.

(b): Information given is that direct labor in the finished product is 80% of materials cost: RM cost $5,000,000 x 80% = $4,000,000.

(c): Fixed and variable overhead is 50% of direct labor and materials in finished goods inventory.
Fixed and variable overhead is allocated to RM and WIP upon completion as finished goods:
RM cost $5,000,000 + direct labor $4,000,000 = $9,000,000 x 50% = $4,500,000
WIP: $1,000,000 + direct labor $200,000 = $1,200,000 x 50% = $600,000
Total fixed overhead to complete inventory: $4,500,000 + $600,000 = $5,100,000.

The entry to adjust the inventory to the lower of cost and net realizable value is as follows:

| | |
|---|---|
| Inventory at cost | $10,000,000 |
| Inventory at NRV | 9,400,000 |
| Write-down | $(600,000) |

| Entry at December 31, 2017: | | |
|---|---|---|
| Cost of goods sold- inventory write-down | 600,000 | |
| Allowance for inventory write-down | | 600,000 |

As shown in the example above, a manufacturer must test lower of cost and net realizable value in the aggregate for all inventory, including raw materials. The reason is because the test must be based on net realizable value and no longer involves use of replacement cost.

When raw materials inventory exists, that inventory must be included in an overall test that includes finished goods and work-in-process inventory. That test is performed by working backwards from final estimated sales at the finished goods level, reduced by costs to complete, dispose (sell) and transport, to arrive at net realizable value. Although it is relatively easy to compute net realizable value if only finished goods and work-in-process inventory exists, it is far more difficult for raw materials inventory. As a result, the question is whether an entity must consider lower of cost and net realizable value with respect to raw materials inventory if that inventory is not material to the overall inventory.

There may be instances in which a test of raw materials for lower of cost or net realizable value may not be required when those materials will be ultimately part of finished goods inventory. This could be the case with either of the following:

- Materials cost is not significant to the total product and/or not significant in comparison to the inventory as a whole, or
- Evidence indicates that there is no write-down of work-in-process and finished goods inventory to lower of cost and net realizable value.

If raw materials inventory is not a significant component of the ending finished goods product, an entity should be able to test lower of cost and net realizable value for finished goods and work-in-process inventory only, and exclude any raw material inventory in that test. The assumption is that if raw materials inventory is not significant, any possible write-down would not be significant as a result.

What if raw materials inventory is significant though? In this instance, ASC 330-10-35-10 provides limited guidance as follows:

> *"When no loss of income is expected to take place as a result of a reduction of cost prices of certain goods because others forming components of the same general categories of finished products have a market value (for inventory measured using LIFO or the retail inventory method) or net realizable value (for all other inventory) equally in excess of cost, such components need not be adjusted . . . ."*

Although the above citation is not precisely on point with raw materials inventory, the substance of the message is essentially the same. If raw material inventory is a significant component of finished goods and work-in-process inventory, it would appear that an entity could avoid testing that raw material inventory as part of an overall lower of cost and net realizable value if evidence exists that the finished goods and work-in-process inventory has no write-down when tested. After all, the raw materials inventory ultimately becomes part of the work-in-process and finished goods inventory. If an entity first tests work-in-process and finished goods inventory for lower of cost and net realizable value and there is no write-down, that would suggest that a component of that inventory (materials cost) should have no impairment, as well.

**COMMENT:** The previous example illustrated a test of lower of cost or net realizable value for a manufacturer. In looking at that test, extensive work is required to gather information when raw materials inventory exists and is included in the test. For example, costs to complete the raw materials inventory (e.g., convert the raw materials to finished goods inventory) must be calculated. Those costs to complete include direct labor and fixed and variable overhead. Eliminating raw materials inventory from that test altogether saves considerable time. As a result, the author believes that with respect to a manufacturer, an entity should do the following:

1. Perform a test of lower of cost and net realizable value on finished goods and work-in-process inventory, without consideration of raw materials inventory.
2. If the test above shows no write-down of finished goods and work-in-process inventory, there should be no need to include raw materials inventory in the lower of cost and net realizable value test.

The theory behind this approach is that raw materials inventory ultimately becomes part of work- in-process and finished goods inventory. If there is no indication of an impairment of work-in-process and finished goods inventory (e.g., cost exceeds net realizable value), that should indicate that the raw materials component also has no impairment.

## STUDY QUESTION

**4.** Which of the following identifies the primary challenge for a manufacturer in implementing the amendments of the ASU if it uses the FIFO or average cost to value its inventory and it uses raw materials in manufacturing its finished goods?

**a.** The only way to perform the test is to do so in total for the entire inventory.

**b.** The test must be performed on an individual item basis.

**c.** Replacement cost cannot be readily determined.

**d.** Net realizable value must be computed based on work in process.

## ASU 2015-11 Versus IRS Rules

Code Sec. 1.471-4 *Inventories at Cost or Market, whichever is Lower*, permits, but does not require, an entity to use lower of cost or market for its inventory valuation. Lower of cost or market is not permitted for LIFO inventory valuations, but is permitted for all other methods such as FIFO, average cost, etc. In comparing the new ASU 2015-11 to the Code, there are a few key variations:

- ASU 2015-11 now uses lower of cost and net realizable value, while the Code continues to use lower of cost or market.
- The Code requires its lower of cost or market test be performed on an *individual-item basis*, and not for the inventory in total, compared to ASU 2015-11 which allows various approaches for the comparison.

In particular, Code Sec. 471.4 defines *market* as:

> "the aggregate of the *current bid prices* prevailing at the date of the inventory . . . "

In applying the lower of cost or market method, the IRS regulations require that an entity:

> "compare the market value of *each item on hand* on the inventory date with its cost and use the lower value as its inventory value . . . "

Therefore, with the changes made by ASU 2015-11, there are certainly differences in the way in which lower of cost and net realizable value (for GAAP) and lower of cost or market (for tax purposes) are computed, thereby likely to result in book-tax differences, if material.

## Application of Lower of Cost and Net Realizable Value to LIFO and the Retail Method

As previously noted, the FASB decided to exclude from the ASU's scope, inventory measured using LIFO or the retail inventory method. As a result, the subsequent measurement guidance remains unchanged for inventory measured using these methods. Those inventory methods continue to use the lower of cost or market approach.

The question is why didn't the FASB extend the lower of cost and net realizable value measurement to LIFO and retail methods? The FASB notes that some third-party users had concerns about applying the ASU to LIFO and retail method for the following reasons:

- The amendments would result in potentially significant costs, particularly upon transition, and would not simplify the subsequent measurement of inventory nor result in significantly more useful information for users of financial statements.
- The amendments also might not simplify the accounting for those entities because of the inherent complexities involved in estimating cost under LIFO and the retail inventory method and the related complexities involved in estimating impairment.
- Under existing GAAP, inventory is not comparable across entities that use different inventory methods. Therefore, the FASB concluded that making subsequent measurement consistent across all methods would not improve comparability in any meaningful way.
- Some respondents did not want to eliminate the current use of replacement cost in LIFO inventory valuations because they thought it was useful.
- Under the ASU, at the beginning of the year of adoption of the ASU, any previous write-downs from lower of cost or market are treated as part of the inventory cost. That means that if the new ASU rules were applied to LIFO, any previous write-downs would have to be allocated to LIFO layers to create the opening cost in the year the ASU is implemented. Such an allocation would add complexity to the LIFO valuation.
- Eliminating use of the existing floor (net realizable value less normal profit) would remove an existing practice used to value some retail inventories.

**COMMENT:** Under some approaches to applying the retail inventory method, the cost of inventory is estimated by multiplying the retail price of inventory by a margin that excludes the effect of permanent markdowns, which is similar to valuing inventory using net realizable value less normal profit margin (commonly referred to as the "floor" in practice). The floor is one of the measures that is eliminated by the ASU. Some users were concerned that this approach to applying the retail inventory method would no longer be permitted.

The changes the FASB originally proposed for inventory accounting applied to all companies, regardless of how they measured inventory. However, some large retailers, including Target and Wal-Mart, complained that the proposal didn't take into account the nuances of calculating inventory under the LIFO or retail inventory methods. Thus, the FASB decided to exclude LIFO and the retail inventory methods from the scope of ASU 2015-11.

## Will ASU 2015-11 Achieve its Objectives?

There are questions as to whether the ASU will actually simplify the existing lower of cost or market model for inventory. On the positive side, advocates for the ASU's changes suggest the following:

- For FIFO and average cost inventory, the ASU does in fact eliminate the three-outcome approach to determine market: replacement cost, net realizable value (ceiling) and net realizable value less normal profit (floor).
- The new model avoids having to determine a floor based on a normal profit margin.
- The new model simplifies the test for a non-manufacturer who now only has to compute net realizable value instead of a replacement cost and normal profit.

Critics, however, suggest the following as a result of the amendments from the ASU:

- The ASU fails to change the model for LIFO and retail method inventory thereby providing two different approaches: one for FIFO and average cost, while another for LIFO and retail method.
- The split approach is not consistent with IFRS, which applies the net realizable value approach to all inventory.
- The model relies on net realizable value, which is based on sales in the normal course of business. There may be products that do not have active markets that require unreliable estimates of sales.
- The new model places great reliance on selling price, which is subject to internal manipulation and subjectivity, particularly if an item is sold within an inactive market.

# ¶ 206 DISCLOSURES

ASU 2015-11 and ASC 330 requires the following disclosures:

- Any losses from measuring inventory at lower of cost and net realizable value (for FIFO or average cost) or lower of cost or market (for LIFO and retail methods) should be disclosed in the financial statements.
- An entity is required to disclose the nature of and reason for the change in accounting principle in the first interim and annual period of adoption of ASU 2015-11.
- An entity should continue to disclose the inventory valuation method in its summary of significant accounting policies.

**EXAMPLE:** Assume an entity adopts the ASU for calendar year 2017. The company uses the lower of cost and net realizable value which results in a write-down in the amount of $100,000 (no write-down in 2016). An example of the disclosure is included below.

**NOTE X: Inventory**

Effective in 2017, the Company adopted Accounting Standards Update (ASU) 2015-11, *Inventory (Topic 330)-Simplifying the Measurement of Inventory* to simplify the measurement of its inventory. In accordance with ASU 2015-11, the Company is required to measure its inventory at the lower of cost and net realizable value. The December 31, 2016 inventory was measured at the lower of cost or market and has not been re-measured to reflect the change made by ASU 2015-11.

**NOTE XX: Summary of Significant Accounting Policies**

**Inventory:**

For the year 2017, the Company values its inventories at lower of cost and net realizable value, using the first-in, first-out (FIFO) method. Net realizable value is defined as the estimated selling prices of the inventory in the ordinary course of business, less reasonably predictable costs of completion, disposal and transportation. For the year ended 2016, the Company valued its inventories at lower of cost or market, using the FIFO method. In 2017, the company recorded a loss in the amount of $100,000 due to a write-down of its inventory to lower of cost and net realizable value.

## ¶ 207 IMPLEMENTATION OF ASU 2015-11

An entity is required to apply the amendments in the ASU prospectively to the measurement of inventory after the date of adoption. Earlier application is permitted as of the beginning of an interim or annual reporting period.

If an entity has written down inventory below its cost before the adoption of the ASU, and it was measured using any method other than LIFO or the retail inventory method, that reduced amount is considered the cost upon adoption. It is also important to note that an entity is required only to disclose the nature of and reason for the change in accounting principle in the first interim and annual period of adoption.

**EXAMPLE:** Company X is a nonpublic entity that adopts ASU 2015-11 for calendar year 2017. At December 31, 2016, the inventory was as follows:

| | |
|---|---|
| Inventory at cost | $10,000,000 |
| Allowance – lower of cost or market | (500,000) |
| Inventory- LCM | $9,500,000 |

In the year of adoption (2017) any previous write-downs of inventory become part of the beginning inventory cost. In this example, Company X makes the following entry on January 1, 2017 to reflect the inventory adjustment:

| | | |
|---|---|---|
| Allowance- lower of cost or market | 500,000 | |
| Inventory | | 500,000 |

After the entry, the beginning inventory on January 1, 2017 is as follows:

| | |
|---|---|
| Inventory at cost | $9,500,000 |
| Allowance – lower of cost or market | ( 0) |
| Inventory- LCM | $9,500,000 |

As a result, the previous write-down of $500,000 becomes part of the beginning cost.

At December 31, 2017, Company X values its inventory under ASU 2015-11 at lower of cost and net realizable value as follows:

| | |
|---|---|
| Inventory at cost | $11,000,000 |
| Inventory at net realizable value | 11,700,000 |
| Allowance required for write-down | $( 0) |

There is no write-down entry in 2017 (first year of adoption of ASU 2015-11) as net realizable value ($11,700,000) exceeds cost ($11,000,000).

## STUDY QUESTION

**5.** Which of the following is a reason why the FASB elected ***not*** to apply the ASU 2015-11 amendments to entities that use the LIFO inventory valuation method?

- **a.** The amendments would require an elimination of the LIFO reserve.
- **b.** The amendments would provide a new requirement to use replacement cost.
- **c.** The amendments would result in significant costs.
- **d.** The amendments would provide a new requirement to use normal profit.

# MODULE 1: ONGOING ISSUES—CHAPTER 3: Deferred Income Taxes and Net Operating Losses

## ¶ 301 WELCOME

This chapter provides an overview of the accounting and reporting requirements with respect to deferred income taxes and net operating losses. This includes a discussion of valuation accounts, future income considerations, as well as differences between various types of carryforwards. This chapter also discusses the key requirements codified within ASC 740 from FIN 48 and certain changes prescribed by ASU 2015-17. Finally, the chapter concludes with a discussion related to corporate tax rates across different countries in the world.

## ¶ 302 LEARNING OBJECTIVES

Upon completion of this chapter, you will be able to:

- Identify the GAAP rules for measuring and recording a deferred tax asset and related valuation account
- Differentiate between both positive and negative evidence used to assess the appropriateness of a deferred tax asset valuation account
- Recognize and differentiate between the various types of carryforwards
- Identify key requirements codified within ASC 740 from FASB Interpretation No. 48
- Recognize the key changes prescribed by ASU 2015-17
- Identify certain tax-planning strategies
- Differentiate between corporate tax rates across different countries in the world

## ¶ 303 ASC 740 – THE BASICS

ASC 740 is the GAAP authority for the accounting for income taxes. Total income taxes consist of the current portion and the deferred portion. The current portion is recognized based on the estimated taxes payable or refundable on tax returns for the current year as a tax liability or asset. The deferred portion, on the other hand, is recognized as a deferred tax liability or asset for the estimated future tax effects attributable to temporary differences and carryforwards.

In addition, temporary differences are the difference between the book and tax basis of an asset or liability that will result in taxable or deductible amounts in future years when the reported amount is recovered or settled. And finally, deferred tax assets and liabilities are computed based on enacted tax rates expected to apply to taxable income in the periods in which the deferred tax liability or asset is expected to be settled or realized. Refer to the following example for an overview of these overall principles.

**EXAMPLE 1:** Company X is a C corporation is a first year entity and has the following M-1 reconciliation:

| | |
|---|---|
| Pretax book income | $5,000,000 |
| M-1: | |
| Depreciation | (1,000,000) |
| Taxable income | 4,000,000 |
| | 35% |
| Current federal income tax | $1,400,000 |
| Accumulated depreciation: 12-31-20X1: | |
| Book | $2,000,000 |
| Tax | 3,000,000 |
| Temporary difference | 1,000,000 |
| Tax rate | 35% |
| Deferred tax liability | $350,000 |

| | | |
|---|---|---|
| Entry: | | |
| Income tax expense-current | 1,400,000 | |
| Income tax expense-deferred | 350,000 | |
| Accrued FIT | | 1,400,000 |
| Deferred FIT | | 350,000 |

**EXAMPLE 2:** Company Z has the following information for year ended 2015:

| | |
|---|---|
| 2015 tax net operating loss | $(1,000,000) |
| Temporary difference: | |
| Accumulated depreciation at 12-31-15: | |
| Book | $2,000,000 |
| Tax | 3,500,000 |
| Temporary difference | $1,500,000 |

The $1 million 2015 net operating loss is available for carryforward to 2035 (20 years). The company had federal tax losses in the two carryback years (2013 and 2014) which were carried back to earlier years to obtain a federal tax refund. There is no portion of the 2015 NOL available for carryback. The temporary difference related to accumulated depreciation (AD) will reverse in years 2016 through 2025. There are no other temporary differences and no state income taxes.

A deferred income tax asset and liability was recorded with balances at 12-31-15 as follows:

| | |
|---|---|
| Deferred income tax asset (federal): | |
| 2013 federal tax net operating loss $1,000,000 x 35% | $350,000 |
| [NOL expires in 2035, 20 years] | |
| Deferred income tax liability: | |
| Temporary difference: AD $1,500,000 x 35% | $(525,000) |

Putting aside the political aspects of corporate tax rates, the question is, what happens to deferred income tax balances if corporate rates decline from 35 percent to 28 percent? In February 2015, the Georgia Tech Financial Analysis Lab issued a study entitled, *The Effects of Tax Reform on Deferred Taxes: The Winners and Losers.* In the study, the authors examined 809 U.S. companies and the impact of U.S. corporate income tax reform on deferred taxes and which companies and industries will gain and lose if tax reform were to come to fruition. The focus of the study was to address the adjustment, if any, which would occur to deferred tax assets and liabilities if tax rates were to be reduced from 35 percent to 28 percent.

Deferred tax assets and liabilities are recorded at the marginal tax rate expected to be in effect when the temporary differences that create the deferred taxes reverse in future years. A change in the corporate rate to 28 percent would result in a reduction in both deferred tax assets and liabilities, resulting in a change in assets, liabilities and stockholders' equity in most companies. For a sample of 809 U.S. companies with revenue greater than $500 million with reported deferred tax balances, the authors of the study present the financial statement effects of lowering the corporate income tax rate from 35 percent to 28 percent. The results of the study reveal the following:

- If rates were to decline from 35 percent to 28 percent, the 809 sampled companies would receive an overall net increase in stockholders' equity of $104 billion broken out as follows:

  - 548 of the companies sampled with deferred tax liabilities would receive a $142 billion reduction in liabilities and increase in stockholders' equity. In addition, liabilities would decline by 2 percent, stockholders' equity would increase by 3.3 percent, and financial leverage (liabilities to equity ratio) would decline by 5.5 percent.

  - 261 of the companies would see a decline of $38 billion in deferred tax assets and decrease in stockholders' equity. In addition, assets would decline by .4 percent, stockholders' equity would decrease by 1.2 percent, and financial leverage would increase by 1.2 percent.

- Winners would include utilities and energy sectors, electric, gas and water utilities, oil and gas exploration, and transportation, including railroad companies.

- Losers would include the following:

  - Mortgage, finance and banking sectors
  - Financial companies
  - Commercial banks
  - Consumer finance companies
  - Leisure equipment
  - Durables
  - Pharmaceuticals
  - Biotechnology
  - Auto components
  - Computer hardware and software

- Companies that are net losers from tax reform (e.g., deferred tax assets and stockholders' equity would decline) could violate existing loan covenants.

- Entities with the largest reduction in liabilities (winners) include the following:

**Biggest Winners from Reduction in Corporate Rates to 28%**

| Company | Reduction in deferred tax liabilities | % reduction in total liabilities | Increase in stockholders' equity |
|---|---|---|---|
| Comcast | $(6.3) billion | (5.9)% | 12.5% |
| Time Warner | (2.3) billion | (5.7)% | 33.9% |
| Hilton International | (967) million | (4.4)% | 22.2% |
| Hertz | (584) million | (2.7)% | 21.1% |
| N star | (303) million | (6.8)% | 12.2% |

| Biggest Winners from Reduction in Corporate Rates to 28% | | | |
|---|---|---|---|
| **Company** | **Reduction in deferred tax liabilities** | **% reduction in total liabilities** | **Increase in stockholders' equity** |
| Median- all sampled | | (2.0)% | 3.3% |
| **Source:** Georgia Tech Financial Analysis Lab study, *The Effects of Tax Reform on Deferred Taxes: The Winners and Losers.* | | | |

| Biggest Losers from Reduction in Corporate Rates to 28% | | | |
|---|---|---|---|
| **Company** | **Reduction in deferred tax Assets** | **% reduction in total assets** | **Decrease in stockholders' equity** |
| Fannie Mae | $9.5 billion | (.3)% | (99.7)% |
| Orbitz | 32 million | (2.9)% | (77)% |
| Federal Home Loan Mtg | 4.5 billion | (.2)% | (35.4)% |
| Delta | 1.3 billion | (2.6)% | (11.6)% |
| Citigroup | 10.6 billion | (.6)% | (5.2)% |
| Median all sampled | | (.4)% | (1.2)% |
| **Source:** Georgia Tech Financial Analysis Lab study, *The Effects of Tax Reform on Deferred Taxes: The Winners and Losers.* | | | |

So if the corporate tax rate were to decline from 35 percent to 28 percent, where would the adjustment of the deferred tax asset or liability be presented on financial statements?

ASC 740-10-45-15 states "when deferred tax accounts are adjusted as required by paragraph 740-10-35-4 for the effect of a change in tax laws or rates, the effect shall be included in income from continuing operations for the period that includes the enactment date." Therefore, if the corporate tax rate is reduced to 28 percent, the deferred tax asset and/or liability would be adjusted to the lower rate with the offsetting entry to income tax expense. Consider the following example:

Company Z has the following information for year ended 2016:

| | |
|---|---|
| 2016 tax net operating loss | $(1,000,000) |
| Temporary difference: | |
| Accumulated depreciation at 12-31-16: | |
| Book | $2,000,000 |
| Tax | 3,500,000 |
| Temporary difference | $1,500,000 |

The $1 million 2016 net operating loss is available for carryforward to 2036 (20 years). The temporary difference related to accumulated depreciation (AD) will reverse in years 2017 through 2026. There are no other temporary differences and no state income taxes. A deferred income tax asset and liability was recorded with balances at 12-31-16 as follows:

| | |
|---|---|
| Deferred income tax asset (federal): | |
| 2016 federal tax net operating loss $1,000,000 x 35% | $350,000 |
| [NOL expires in 2036, 20 years] | |
| Deferred income tax liability: | |
| Temporary difference: AD $1,500,000 x 35% | $(525,000) |

Effective January 1, 2017, the U.S. corporate tax rate is reduced from 35 percent to 28 percent. As a result, effective January 1, 2017, the deferred tax asset and liability are recomputed at the new 28 percent rate as follows:

| | | |
|---|---|---|
| Deferred tax asset: | | |
| Originally computed: | 1,000,000 × 35% | $350,000 |
| Revised | 1,000,000 × 28% | 280,000 |
| Adjustment | | $70,000 |

| | Originally computed | Revised |
|---|---|---|
| Deferred tax liability: | 35% | 28% |
| Temporary difference: | | |
| Accumulated depreciation at 12-31-16: | | |
| Book | $2,000,000 | $2,000,000 |
| Tax | 3,500,000 | 3,500,000 |
| Temporary difference | 1,500,000 | 1,500,000 |
| | 35% | 28% |
| | $525,000 | $420,000 |
| Adjustment | $105,000 | |

| | | |
|---|---|---|
| Entry: (January 1, 2017) | | |
| Deferred tax liability | 105,000 | |
| Deferred tax asset | | 70,000 |
| Income tax expense- deferred | | (1) 35,000 |
| (1) shown as a separate component of income tax expense | | |

In 2017, the $35,000 deferred tax adjustment is shown as a separate component of income tax expense as follows:

**NOTE X:** Income Taxes:

A summary of the current and deferred portions of federal income tax expense follows:

| | |
|---|---|
| Current portion | $XX |
| Deferred | XX |
| Adjustment due to change in tax rates | (35,000) |
| Total income tax expense | XX |

If there is a valuation allowance account, it too should be adjusted to reflect the reduction in the federal marginal tax rate with the offset to income tax expense as part of continued operations.

# ¶ 304 DEFERRED INCOME TAX ASSETS FROM NOLS

ASC 740 requires a company to record a deferred income tax asset for the tax benefit of a net operating loss (NOL) carryforward. The asset represents the tax benefit that will be received when the company ultimately uses that NOL in future years. In order to actually use the NOL, the company must have future income to absorb that NOL. Under existing federal tax law, a company can carry back an NOL two years, and then carry forward the unused NOL for 20 years. Of course, a company can elect to forego carryback of the NOL and instead carry forward the NOL. The following example illustrates how these rules are applied in practice:

Company X generates a federal income tax loss in 20X5 in the amount of $500,000. The company carries back $200,000 of the $500,000 to years 20X3 and 20X4 by filing a Form 1139 and obtains a refund from the IRS. The remaining $300,000 NOL is carried forward to years 20X6 and beyond and can be used through year 20X25. For simplicity, assume there are no surtax rates and that the federal tax rate is 35 percent. The entry in 20X5 follows:

| | dr | cr |
|---|---|---|
| IRS refund receivable (1) | 70,000 | |
| Income tax expense- current federal | | 70,000 |
| Deferred income tax asset (2) | 105,000 | |
| Income tax expense-deferred federal | | 105,000 |
| (1): NOL carryback: $200,000 x 35% = $70,000. | | |
| (2): Unused NOL carryforward: $300,000 x 35% = $105,000. | | |

Now, the IRS refund of $70,000 will be received by the company. As to the deferred income tax asset, the tax benefit of $105,000 will be received only if and when the company has future federal taxable income of $300,000 to utilize the NOL carryforward. In addition, the company has 20 years in which to generate a total of $300,000 of future taxable income to use the NOL. In many cases, an active going concern entity will have no problem using the NOL so that the full deferred income tax asset of $105,000 will be utilized within the 20 year time frame.

In addition, ASC 740 requires a company to recognize a valuation account against a deferred income tax asset if based on the weight of available evidence; it is *more likely than not* (more than 50-percent probability) that some portion or all of the deferred tax asset will not be realized. The valuation allowance should be sufficient to reduce the deferred tax asset to the amount that is more likely than not to be realized. In order to determine the amount of the valuation account, the entity should determine whether it will have enough future taxable income during the NOL carryforward period to use the unused NOL. If the answer is "yes," there is no need for a valuation account. However, if the answer is "no," a valuation account must be established for a portion or the entire deferred tax asset.

When determining whether there is enough future income to which the NOL can be applied, an entity can take into account income from all of the following sources:

- Reversal of existing taxable temporary differences into taxable income assuming taxable income is zero
- Estimated future taxable income (exclusive of reversing temporary differences and carryforwards)
- Taxable income in prior carryback year(s) if carryback is permitted under the tax law, and
- Tax-planning strategies that the company would, if necessary, implement to utilize an expiring NOL such as:

  - Accelerate taxable amounts to utilize expiring carryforwards

  - Change the character of taxable or deductible amounts from ordinary income or loss to capital gain or loss

  - Switch from tax-exempt to taxable investments

While there are several sources of future income, in most cases involving a deferred income tax asset, future taxable income comes from either estimated future taxable income during the 20-year carryforward period and taxable temporary differences that will reverse into taxable income during the 20-year carryforward period as evidenced by the existence of deferred income tax liabilities. Additionally, in most cases, if a company has deferred income tax liabilities equal to or in excess of the deferred income tax asset related to the NOL, that fact, in and of itself, means the company will have enough future income to utilize the NOL.

ASC 740, *Income Taxes* does give a list of factors that should be considered in determining whether there will be sufficient future taxable income during the NOL carryforward period to utilize the deferred income tax asset. These are summarized in the following table:

| Evidence Used To Determine Whether A Valuation Account Is Needed | |
|---|---|
| Negative Evidence Leading to a Conclusion that Valuation Account is Needed | Positive Evidence Leading to a Conclusion that a Valuation Account is Not Needed |
| • Cumulative losses in recent years (usually the last three years including the current year) | • Existing contracts or firm sales backlog that will produce more than enough taxable income to realize the deferred tax asset based on existing sales prices and cost structures |
| • History of operating loss or tax credit carryforwards expiring unused | • An excess of appreciated asset value over the tax basis of the entity's net assets in an amount sufficient to realize the deferred tax asset |
| • Losses expected in early future years (by a presently profitable entity) | • A strong earnings history, exclusive of the loss that created the future deductible amount (tax loss carryforward or deductible temporary difference), coupled with evidence indicating that the loss (e.g., an unusual, infrequent, or extraordinary item) is an aberration rather than a continuing condition |
| • Unsettled circumstances that, if unfavorably resolved, would adversely affect future operations and profit levels on a continuing basis in future years | |
| • A carryback or carryforward period that is so brief that it would limit realization of tax benefits if (1) a significant deductible temporary difference is expected to reverse in a single year, or (2) the enterprise operates in a traditionally cyclical business | |

Negative evidence, by itself, makes it difficult to reach a conclusion that a valuation is not needed. However, the existence of positive evidence might support a conclusion that a valuation allowance is not needed when there is negative evidence. In particular, ASC 740 notes that "forming a conclusion that a valuation allowance is not needed is difficult when there is negative evidence such as cumulative losses in recent years."

Following are a few examples that illustrate the guidance presented above:

Company X has the following information for year ended 2015:

| | |
|---|---|
| 2015 tax net operating loss | $(1,000,000) |
| Temporary difference: | |
| Accumulated depreciation at 12-31-15: | |
| Book | $2,000,000 |
| Tax | 3,500,000 |
| Temporary difference | $1,500,000 |

The $1 million 2015 net operating loss is available for carryforward to 2035 (20 years). The company had federal tax losses in the two carryback years (2013 and 2014) which were carried back to obtain a federal tax refund. As such, there is no portion of the 2015

NOL available for carryback. The temporary difference related to accumulated depreciation will reverse in years 2016 through 2025 and there are no other temporary differences and no state income taxes.

A deferred income tax asset and liability were recorded with balances at 12-31-15 as follows:

| | |
|---|---|
| Deferred income tax asset (federal): | |
| 2015 federal tax net operating loss $1,000,000 x 35% | $350,000 |
| [NOL expires in 2035, 20 years] | |
| Deferred income tax liability: | |
| Temporary difference: AD $1,500,000 x 35% | $(525,000) |

Should the company record a valuation account related to the $350,000 deferred income tax asset?

ASC 740 requires a company to recognize a valuation account against a deferred income tax asset if it is *more likely than not* (more than 50-percent probability) that some portion or the entire deferred tax asset will not be realized. In making the assessment, the Company must consider whether there will be enough future taxable income during the 20-year NOL carryforward period to utilize the $1 million NOL and $350,000 deferred tax asset.

One of the sources of future taxable income is if there are existing taxable temporary differences that will reverse into taxable income during the 20-year carryforward period. In this example, the company already knows that it has $1.5 million of future taxable income from reversal of the accumulated depreciation temporary difference. That reversal will occur in years 2016 through 2025 which is within the NOL carryforward period.

Because the company has a taxable temporary difference ($1.5 million) in excess of $1 million that will reverse in the NOL carryforward period, the deferred tax asset of $350,000 will be realized. As a result, no valuation account is required.

**COMMENT:** The easiest source of future taxable income is where a company has a deferred tax liability from a temporary difference that will result in future taxable income during the NOL carryforward period. This source of future taxable income does not require any forecasts because it is based on events that have already occurred.

Company X has the following information for year ended 2015:

| | |
|---|---|
| 2015 net operating loss- tax purposes | $(1,000,000) |
| Temporary difference: | |
| Accumulated depreciation at 12-31-15: | |
| Book | $2,000,000 |
| Tax | 2,600,000 |
| Temporary difference | $ 600,000 |

The $1 million 2015 net operating loss is available for carryforward to 2035 (20 years).

The company had federal tax losses in the two carryback years (2013 and 2014) which were carried back to earlier years to obtain a federal tax refund. The company also had a tax loss in 2012. There is no portion of the 2015 available for carryback. The company also had pretax book losses in years 2012 through 2014 with no signs of improvement for 2015 and beyond. The temporary difference related to accumulated depreciation ($600,000) will reverse in years 2016 through 2025 and there are no other temporary differences and no state income taxes.

A deferred income tax asset and liability was recorded with balances at 12-31-15 as follows:

| | |
|---|---|
| Deferred income tax asset (federal): | |
| 2015 federal tax net operating loss $1,000,000 x 35% | $350,000 |
| [NOL expires in 20354, 20 years] | |
| Deferred income tax liability: | |
| Temp difference: AD $600,000 x 35% | $(210,000) |

The company can use the future taxable temporary difference of $600,000 as a source of future income that will utilize the $1 million NOL carryforward. However, there appears to be no other sources of future income that can be justified. In particular, the company has had a series of book losses in 2012 through 2014. ASC 740 states that "forming a conclusion that a valuation allowance is not needed is difficult when there is negative evidence such as cumulative losses in recent years." Given the fact that there is no positive evidence to support future taxable income beyond the $600,000 of future taxable income from the reversal of the temporary differences, a valuation account is required as follows:

| | | |
|---|---|---|
| Deferred income tax asset (federal): $1,000,000 x 35% | | $350,000 |
| Future income: | | |
| Deferred income tax liability reversal: $600,000 x 35% | | (210,000) |
| Valuation allowance required: $400,000 x 35% | | $(140,000) |
| Entry: | | |
| Income tax expense- deferred federal | 140,000 | |
| Valuation allowance | | 140,000 |

Balance sheet presentation:

| | |
|---|---|
| Assets: | |
| Deferred income tax asset | *$210,000 |
| Long-term Liabilities: | |
| Deferred income tax liability | **(210,000) |
| * DIT asset of $350,000 less valuation of $140,000 = $210,000. | |
| ** DIT liability related to accumulated depreciation temporary difference. | |

**COMMENT:** In using existing taxable temporary differences (deferred income tax liabilities) to justify future taxable income to utilize a deferred income tax asset from an NOL carryforward, the analysis is done based on the assumption that there is no other taxable income or loss during the years in which the taxable temporary differences reverse. The taxable temporary difference is scheduled without regard to any other taxable income or loss. In Example 1, the analysis indicates that there is $1.5 million of future taxable income that the company will have when the accumulated depreciation reverses in future years. Notice that the analysis assumes that taxable income in those future years is zero and that the only taxable income in those future years is the reversal of the taxable temporary difference of $1,5 million.

## STUDY QUESTIONS

**1.** In accordance with ASC 740, a company is required to record a valuation account against a deferred income tax asset if it is ____________ that some portion of or the entire deferred tax asset will not be realized.

- **a.** Probable
- **b.** Reasonably possible
- **c.** More likely than not
- **d.** Highly likely

**2.** With respect to deferred tax assets, in accordance with ASC 740, future income can come from which of the following?

- **a.** Estimated future taxable income, including the reversal of temporary differences and carryforwards
- **b.** Switching from tax-exempt to taxable investments as part of a tax-planning strategy
- **c.** Reversal of existing taxable temporary differences assuming taxable include is greater than book income
- **d.** Current year tax losses

**3.** Which of the following identifies an impact of lowering the corporate tax rate?

- **a.** Deferred tax assets would be adjusted downward.
- **b.** Deferred tax assets would be adjusted upward.
- **c.** There would be no effect on deferred tax assets, but there is an impact on the accrued federal tax liability.
- **d.** A larger valuation account would be required for deferred tax assets.

# ¶ 305 BALANCE SHEET PRESENTATION

ASC 740 requires that deferred tax liabilities and assets be classified on the balance sheet as current or noncurrent based on the classification of the related asset or liability for financial reporting. A deferred tax liability or asset that is not related to an asset or liability for financial reporting, including deferred tax assets related to NOL carryforwards, shall be classified according to the expected reversal date of the temporary difference.

In the previous example, the $210,000 deferred income tax asset (net of the valuation), does not relate to an underlying asset or liability that created a temporary difference. Therefore, the deferred tax asset is split on the balance between current and long-term based on the estimated reversal date of the asset. That portion of the asset that is expected to reverse based on future taxable income occurring within one year is presented current, while the remainder of the deferred tax asset is presented long-term. As for the liability, because it related to a long-term asset (accumulated depreciation), the resulting deferred tax liability is presented as a long-term liability.

> **COMMENT:** There are certain states that allow net operating losses to be carried forward indefinitely. If this is the case, a deferred income tax liability related to an indefinite lived asset (such as goodwill) can be used as a source of income that can support the realization of the deferred tax asset. The reason is because the temporary difference from the indefinite lived asset has no deadline to reverse into taxable income. When the temporary difference reverses from an

ultimate sale or impairment writedown, that taxable income will utilize the NOL given the fact that the state NOL has an unlimited carryforward period.

**COMMENT:** In November 2015, the FASB issued ASU 2015-17, *Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes.* The ASU amends ASC 740 to provide that deferred income tax assets and liabilities should be presented as noncurrent on the balance sheet instead of being presented as current or long-term based on the classification of the underlying temporary difference. The FASB made this change as part of its Simplification Initiative. For public entities, the ASU is effective for financial statements issued for annual periods beginning after December 15, 2016, and interim periods within those annual periods. For all other entities, (including nonpublic entities) the amendments in this Update are effective for financial statements issued for annual periods beginning after December 15, 2017, and interim periods within annual periods beginning after December 15, 2018.

## ¶ 306 FUTURE INCOME

Previously, we addressed the situation in which future taxable temporary differences, such as those related to accumulated depreciation, are an easy source of future income that would absorb a deferred income tax asset. Now let's assume there are no deferred tax liabilities related to future taxable temporary differences. Therefore, the only way to avoid having to record a valuation allowance is to estimate future taxable income (exclusive of reversing temporary differences) that the company will generate during the 20-year NOL carryforward period.

In concept, such an exercise should yield plenty of taxable income. After all, a company has 20 years of estimated taxable income to use the NOL carryforward. Although it is true that estimating enough future taxable income over a 20-year period that is sufficient to use an unused NOL carryforward should be easy, it may be impossible to do under the "cumulative loss" rule. Previously, it was noted that in assessing whether a valuation allowance is needed, both positive and negative evidence must be considered. If it is more likely than not, based on the evidence, that the deferred tax asset will not be realized by future taxable income, a valuation is required for any shortfall. ASC 740 states that cumulative losses in recent years is a negative factor that may be difficult to overcome with other positive factors.

The question is, how many years of cumulative losses create a pattern of negative evidence that is so great that one cannot estimate that future taxable income will exist and therefore a valuation account is required?

In Appendix A to ASC 740, the FASB was quite careful not to create a bright-line test as it relates to cumulative losses. Although many companies and their accountants use three years of losses (current year and two prior years) to define the term "cumulative losses," such an approach is non-authoritative but has become generally accepted. ASC 740 does not give any guidance as to how to determine cumulative losses and the number of years of losses that would suggest a negative trend.

Although not authoritative, many CPA firms and their clients are using a "soft" three-year period (current year and two prior years) to assess whether there are cumulative losses, based on the following structure:

- "Cumulative losses" is based on the last three years of pre-tax book income (losses) consisting of the current year and two prior years.
- Pre-tax GAAP income is used instead of taxable income.

**COMMENT:** Because the FASB places so much weight on the cumulative losses as a component of negative evidence, companies should be careful not to fall into the trap of doing a mechanical three-year computation of pre-tax GAAP losses to define cumulative losses. What is more important is the direction in which the losses are headed and whether there are any non-recurring transactions that might distort the real upward or downward trend.

At December 31, 20X3, Company X has a deferred tax asset in the amount of $1 million due to an unused NOL carryforward. The company also has no deferred tax liabilities.

Pre-tax book income is:

| **Year** | |
|---|---|
| 20X3 (current year) | $(2,000,000) |
| 20X2 | (1,200,000) |
| 20X1 | (500,000) |
| | $(3,700,000) |

Cumulative losses total $3.7 million over the most recent three-year period and the trend appears to be leading toward greater losses in the most recent year 20X3. The fact that there are cumulative losses is strong negative evidence that it is more likely than not that the company will not have sufficient future taxable income to utilize the $1 million deferred income tax asset during the NOL carryforward period. That is, the company cannot estimate future taxable income will exist. As a result, it is highly unlikely that X can gather sufficient positive evidence to override the cumulative losses' negative evidence. Consequently, X should record a $1 million valuation allowance to offset the $1 million deferred income tax asset as illustrated below.

| **Entry:** | dr | cr |
|---|---|---|
| Income tax expense- deferred federal | 1,000,000 | |
| Valuation allowance | | 1,000,000 |

Previously, we saw that one way to determine future taxable income is to look to deferred income tax liabilities that will reverse into income during the NOL carryforward period. Clearly, having deferred income tax liabilities that equal or exceed the deferred income tax asset is the easiest and most verifiable way to prove future income because it is based on transactions that have already occurred; that is, the deferred tax liability has already been measured and the timing and amount of its reversal are quantifiable.

When there is not a sufficient amount of deferred income tax liability to use the deferred income tax asset, the company should look to other sources of future taxable income. This step involves estimating the amount of taxable income the company will have during the NOL carryforward period without regard to any taxable income that would be created from the reversal of existing deferred income tax liabilities. Estimating future taxable income is difficult as it requires use of forecasted information which is imperfect at best. Moreover, if the company has cumulative losses (assume over the past three years including the current year), it is generally assumed that the company will not have future taxable income and a valuation allowance will be required for the entire amount of the deferred tax asset. Refer to the example below for an illustration of this topic.

Let's assume that the company has no deferred tax liabilities that will reverse into taxable income. Let's further assume that there is no negative evidence of cumulative losses. That is, the deferred tax asset was created because a significant tax loss in the current year due to a sizeable M-1 tax deduction.

Pre-tax book income is:

| Year | |
|---|---|
| 2014 (current year) | $(200,000) |
| 2013 | 100,000 |
| 2012 | 50,000 |

At December 31, 2014, the Company had an unused federal tax NOL carryforward of $230,000.

The 2014 book loss was a direct result of additional depreciation from 2014 fixed asset additions. The company uses the same book and tax depreciation. Historically, the company has had taxable income in the $50,000 to $100,000 range depending on the amount of officer bonuses taken each year. At December 31, 2014, the company has a very strong sales backlog for the next three to five years and there are no temporary differences or state income taxes.

A deferred income tax asset was recorded at 12-31-14 as follows:

| | |
|---|---|
| Deferred income tax asset (federal): | |
| 2014 federal tax net operating loss $230,000 x 34% | $78,200 |
| [NOL expires in 2034, 20 years] | |

The company is required to record a valuation allowance against the $78,200 deferred tax asset to the extent that it is more likely than not that a portion of all of the deferred tax asset will not be realized from future taxable income during the 20-year NOL carryforward period. In order to avoid having to record a valuation allowance, the company must justify that the company will have future taxable income from 2015 to 2034 (20 years) of at least $230,000. If so, the NOL carryforward of $230,000 will be utilized. As for sources of future taxable income, the company has no deferred tax liabilities that will reverse into future taxable income. Thus, the company should estimate future taxable income.

In this case, the company should look at the positive and negative evidence in assessing whether there will be future taxable income. Evidence to consider in estimating future taxable income includes the following:

- The company has had a strong earnings history (exclusive of the loss) in the annual amount of $50,000 to $100,000 of taxable income.
- 2012 book loss of $(200,000) as an aberration based on the existence of a non-recurring amount of depreciation. ASC 740 specifically states that in estimating future taxable income, a company should consider the existence of evidence indicating that the loss is an aberration rather than a continuing condition. Clearly, the 2014 loss is an aberration.
- There is no evidence of cumulative pre-tax book losses over the past three years including 2012.
- The company has a strong sales backlog that will produce sufficient taxable income over the next three to five years.

Based on a weight of the positive and negative evidence, the company should estimate future taxable income for years 2034 as follows:

| | |
|---|---|
| Estimated annual federal taxable income | $50,000 |
| # years in NOL carryforward period | x 20 |
| Estimated future taxable income | $1,000,000 |
| Unused NOL carryforward from 2014 | $(230,000) |

The company estimates that there will be $1 million of future taxable income generated during the NOL carryforward period, which is sufficient to utilize the entire $(230,000) of net operating loss. The result is that there is no need to record a valuation allowance.

## Tax-Planning Strategies

Tax-planning strategies consist of actions (including elections for tax purposes) that:

- Are prudent and feasible with management having the ability to implement the strategy
- An enterprise ordinarily might not take, but would take to prevent an operating loss or tax credit carryforward from expiring unused, and
- Would result in realization of deferred tax assets.

Examples of tax-planning strategies include a plan to do any of the following:

- Accelerate taxable amounts to use expiring NOLs:

  - Selling appreciated assets and inventory, including inventory that would trigger a recapture of the LIFO reserve

  - Selling investments including available-for-sale securities

  - Electing out of the installment sales method to accelerate taxable income on a sale

  - Changing the tax status

  - Making an election to change a tax accounting method that triggers taxable income
- Change the character of items from ordinary income to capital gain (loss)
- Switch from tax-exempt to taxable investments

  **COMMENT:** Tax-planning strategies are a way of life for all taxpayers, corporate and individual, alike. Inherent in the use of a tax-planning strategy is the goal to make sure that an NOL carryforward does not expire unused. ASC 740 requires that a company consider the use of tax-planning strategies in determining the need for a valuation allowance; that is, in estimating future taxable income.

## Deferred Tax Asset on Carryforwards other than NOLs?

While ASC 740 requires that a deferred tax asset be recorded for the tax benefit of an NOL carryforward, what about other types of carryforwards that reflect a future tax benefit such as unused charitable contributions carryforward, Section 179 deduction carryforward, and capital loss carryforward? The listing below provides an overview of each of the previously mentioned other carryforwards.

- Charitable contributions:

  - Can be carried over for five years for that portion that exceeds 10 percent of taxable income (without regard to the deduction for the contribution and other items).
- Section 179 deduction:

  - Is limited to taxable income with the unused portion carried forward indefinitely.
- Capital loss carryover:

  - Any unused capital loss is carried forward for five years from the loss year.

The overall principle is that a deferred tax asset should be recorded on “carryforwards” without regard to the types of carryforwards. In theory, each carryforward may provide a future tax benefit that should be captured by recording the deferred tax asset. However, as an additional point of emphasis, a valuation account should be recorded to the extent that it is more likely than not that carryforward will not be realized during the carryforward period. Moreover, materiality should be considered. For example, is the amount of an unused charitable contribution material?

Company X is a C corporation and has the following at December 31, 20X1:

| | Expiration date | Amount |
|---|---|---|
| Unused Federal NOL carryforward | 20 years | $(1,000,000) |
| Unused Charitable contributions carryfoward | 5 years | (50,000) |
| Unused Section 179 deduction carryforward | Unlimited | (100,000) |
| Unused Capital loss carryforward | 5 years | (150,000) |
| Totals | | $(1,300,000) |

Assume the following information:

- There is a federal tax rate of 34 percent in future years with no surtax rates and no state taxes.
- X expects to have future taxable income of $200,000 per year, and the $1 million NOL was based on a non-recurring transaction.
- There is no DIT asset on the balance sheet.
- The company has a tax-planning strategy under which it will not allow the capital loss carryforward to expire. That is, it will sell a capital asset and generate a capital gain within the five-year period.

Conclusion

X should record a deferred tax asset as follows:

| | |
|---|---|
| Combined carryfowards | ($1,300,000) |
| Tax rate | 34% |
| DIT asset | $442,000 |

| Entry: | dr | cr |
|---|---|---|
| Deferred income tax asset-federal | 442,000 | |
| Income tax expense- federal deferred | | 442,000 |

Based on the assumption of future taxable income of $200,000 per year, all carryforwards should be utilized during their respective carryforward periods except the capital loss carryforward. However, the company has a tax-planning strategy that will result in a capital gain being created within the five-year carryforward period. Thus, the capital loss carryforward will be utilized and a valuation account is not required.

> **COMMENT:** Obviously, materiality must be considered in deciding whether to record a deferred tax asset on a carryforward. For example, a small amount of unused contributions may not warrant a deferred tax asset. Conversely, a large amount of unused Section 179 depreciation may require a deferred tax asset.

## Presentation of Tax Benefit of NOL Carryforward

One of the key questions to ask is how the use of a net operating loss carryover should be presented on the income statement. ASC 740 requires the tax benefit of the NOL to be presented as a direct reduction in the current portion of income tax expense with a corresponding disclosure. The following example illustrates the application of this guidance.

A company has a $(300,000) NOL carryforward in 20X1 and records a deferred income tax asset as follows:

| Entry: 20X1 | dr | cr |
|---|---|---|
| DIT asset ($300,000 x 34%) | 102,000 | |
| Income tax expense- deferred | | 102,000 |

The $300,000 unused NOL is carried over from 20X1 to 20X2. Also assume the following 20X2 information:

| | |
|---|---|
| Taxable income before NOL | $800,000 |
| NOL carryforward utilized | (300,000) |
| Taxable income | 500,000 |
| Tax rate | 34% |
| Current FIT provision | $170,000 |

As a result, the December 31, 20X2 entry consists of two components:

- Current accrual provision of $170,000
- Reversal of the $102,000 deferred income tax asset that is used in 20X2.

| Entry: 20X2 | dr | cr |
|---|---|---|
| Income tax expense- current provision | 170,000 | |
| Accrued FIT | | 170,000 |
| Income tax expense-deferred | 102,000 | |
| Deferred income tax asset | | 102,000 |

The total federal income tax expense in 20X2 looks like this:

| | |
|---|---|
| Current provision (net of NOL) | $170,000 |
| Deferred | 102,000 |
| Total provision (FIT expense) | $272,000 |
| Presentation on the statement of income: | |
| Net income before income taxes | $XX |
| Income tax expense | 272,000 |
| Net income | $XX |

The provision for income includes federal taxes currently payable and deferred income taxes arising from assets and liabilities whose basis is different for financial reporting and income tax purposes. The majority of the deferred tax provision is the result of basis differences in recording depreciation and accruing certain expenses. The provision for income taxes is summarized as follows:

| | | |
|---|---|---|
| Federal: | | |
| Currently payable | $ 272,000 | (1) |
| Deferred | 102,000 | |
| Reduction due to use of net operating loss carryforward | (102,000) | (2) |
| Total federal provision | 272,000 | |
| State: | | |
| Currently payable | xx | |
| Deferred | xx | |
| Total state provision | xx | |
| Total provision | xx | |

| | |
|---|---|
| (1) 800,000 x 34% = | 272,000 |
| (2) 300,000 x 34% = | (102,000) |
| Net current provision | 170,000 |

## Tax Rate to use for DITs when there are Surtax Rates

ASC 740-10-30-8 states that a deferred tax liability or asset is recorded using the enacted tax rate(s) expected to apply to taxable income in the periods in which the deferred tax liability or asset is expected to be settled or realized. Furthermore, in situations in which graduated (marginal) tax rates are a "significant factor," ASC 740-10-30-9 states that the deferred liability or asset shall be measured using the average graduated tax rate applicable to the amount of estimated annual taxable income in the periods in which the deferred tax liability or asset is expected to be settled or realized. Thus, the average graduated tax rate should be used based on the level of taxable income (including reversal of the temporary difference) in the reversal years.

Consider the following table as an example:

| Taxable income increment | Cumulative taxable income (B) | Marginal tax rate on increment | Marginal tax | Cumulative Tax (A) | Average graduated tax rate (A)/(B) |
|---|---|---|---|---|---|
| $50,000 | $50,000 | 15% | $7,500 | $7,500 | 15% |
| 25,000 | 75,000 | 25% | 6,250 | 13,750 | 18% |
| 25,000 | 100,000 | 34% | 8,500 | 22,250 | 22% |
| 100,000 | 200,000 | 39% | 39,000 | 61,250 | 31% |
| 100,000 | 300,000 | 39% | 39,000 | 100,250 | 33% |
| 35,000 | 335,000 | 39% | 13,650 | 113,900 | 34% |
| 65,000 | 400,000 | 34% | 22,100 | 136,000 | 34% |
| 100,000 | 500,000 | 34% | 34,000 | 170,000 | 34% |
| 9,500,000 | 10,000,000 | 34% | 3,230,000 | 3,400,000 | 34% |
| | >$10,000,000 | 35% | | | 35% |

**EXAMPLE:** Company X has a temporary difference related to accumulated depreciation in the amount of $40,000 that will reverse evenly over the next 10 years. Assume that X estimates that its taxable income, including the reversal of the temporary difference, will be approximately $100,000 in each of the 10 reversal years.

Because estimated taxable income in the 10 reversal years will be approximately $100,000, the graduated tax rates range from 15 percent to 34 percent and those rates will be significant. Therefore, GAAP requires that average graduated tax rates for the estimated amount of taxable income (including the reversal of the temporary difference) should be used to record the deferred income tax liability. The average graduated income tax rate on $100,000 of taxable income is 22 percent.

The deferred tax liability should be recorded as follows:

| | |
|---|---|
| Temporary difference | $40,000 |
| Average graduated tax rate | 22% |
| Deferred tax liability | $8,800 |

## Problems on the Uncertain Tax Positions Front

The rules for recording uncertain tax benefit liabilities under FASB Interpretation 48 (FIN 48) have been around since 2006. Yet, these rules continue to be controversial and reach far beyond the financial statements. The purpose of this section is to address some of the current developments related to FIN 48 including:

- Clarification of the disclosures related to nonpublic entities
- Impact that FIN 48 liabilities have on SEC companies
- Roadmap that FIN 48 liabilities are providing to the IRS

The rules for uncertain tax positions were issued approximately one decade ago in FIN 48, which is now part of ASC 740. Although the rules for uncertain tax positions may not be applicable to many smaller, nonpublic entities, there have been questions as to whether nonpublic entities are required to include certain FIN 48 disclosures if an entity has no uncertain tax positions.

The authority for tax positions is found in ASC 740 which provides guidance on the treatment of derecognition, classification, interest and penalties, accounting in interim periods, disclosures and transition, as they relate to tax positions. The rules apply to all tax positions accounted for under ASC 740.

A tax position results in:

- A permanent reduction in income taxes payable,
- A deferral of income taxes otherwise currently payable to future years, or
- A change in the expected realizability of deferred tax assets.

The rules found in ASC 740 apply as follows:

- If it is more likely than not (more than 50-percent probability) that a tax position will be sustained upon IRS or state tax examination (including any appeals or litigation process), the amount of the tax effect of a tax position is retained on the financial statements.
- If it is not more likely than not (not more than 50-percent probability) that the tax position will be sustained upon an IRS or state tax examination, all of the tax effect of the tax position is eliminated in the financial statements by recording a liability for the hypothetical additional tax that will be paid when the tax position is disallowed upon IRS or state examination.

The rules for uncertain tax positions apply to federal, state and local and foreign income taxes, but do not apply to sales and use taxes, franchise taxes, real estate and personal property taxes, and fees that are not taxes. Moreover, it is assumed that a company goes through an IRS or state tax examination, including, if applicable, appeals.

**EXAMPLE:** Tax Deduction:

Company X computes its 20X7 tax provision as follows:

| | Taxable Income | Tax rate | Tax (Fed/state) |
|---|---|---|---|
| Net sales | $1,000,000 | | |
| Operating expenses: | | | |
| *Travel* | *(2,500)* | | |
| All other | (597,500) | | |
| Total operating expenses | (600,000) | | |
| NIBT | 400,000 | 40% | 160,000 |
| M-1: Depreciation | (50,000) | 40% | (20,000) |
| Taxable income | $350,000 | 40% | $140,000 |

| | | |
|---|---|---|
| Entry: | | |
| Income tax expense | 160,000 | |
| Deferred income tax liability | | 20,000 |
| Accrued tax liability | | 140,000 |

Company X takes a $2,500 tax deduction for certain items that may be nondeductible travel related to a shareholder's spouse. The tax benefit of the item embedded within the tax provision is $1,000 ($2,500 x 40%). X believes that if it were audited by the IRS and Massachusetts Department of Revenue, it is more likely than not (more than 50-percent probability) that the entire deduction is sustainable even if X has to go to appeals or even tax court.

As a result, X would retain the tax benefit of the tax deduction on its financial statements. That means that X would not record an additional liability for the additional tax that would be paid if the deduction were disallowed upon examination.

However, what if X believes that upon examination, the entire $2,500 deduction would be disallowed? In this case, it is not more likely than not that the $2,500 deduction would be sustained, resulting in an additional tax in the amount of $1,000, for which an additional liability is recorded as follows:

The revised entry looks like this:

| | | |
|---|---|---|
| Revised Entry: | | |
| Income tax expense | 161,000* | |
| Deferred income tax liability | | 20,000 |
| Accrued tax liability | | 140,000 |
| Liability for unrecognized tax benefit | | 1,000 |

* Book income ($400,000) plus unrecognized deduction ($2,500) = $402,500 x 40% = $161,000.

FIN 48 applies to all entities including:

- For-profit entities
- Not-for-profit entities
- Pass-through entities (S corporations, LLCs, and partnerships)
- Entities taxed in a manner similar to pass-through entities such as REITs and registered investment companies (Entities whose liability is subject to 100 percent credit for dividends paid (REITs and registered investment companies)).

**COMMENT:** Not-for-profit, pass-through entities, and tax-exempt organizations are subject to FIN 48 because they can pay taxes in certain situations. For example, an S corporation can be subject to a built-in-gains tax under Internal Revenue Code (Code) Sec. 1374. Similarly, a not-for-profit entity can be subject to a tax on unrelated business income.

A reporting entity must consider the tax positions of all entities within a related-party group of entities regardless of the tax status of the reporting entity. ASU 2009-06 amended FIN 48 to include under the definition of a tax position an entity's tax status such as an entity's status as a pass-through entity (S corporation) or a tax-exempt not-for-profit entity. For example, one such tax position is the company's position that it is properly in compliance with the Code to be taxed as an S corporation, or it is an LLC that is taxed as a partnership instead of a corporation.

## STUDY QUESTIONS

**4.** Under existing GAAP per ASC 740, how should a deferred tax liability be classified on the balance sheet?

- **a.** Always shown as current and long-term based on the estimated reversal date
- **b.** Current and long-term based on the classification of the related asset or liability
- **c.** Always long-term
- **d.** Always current

**5.** Company X is a C corporation with estimated annual taxable income of $100,000 in periods in which its deferred tax liability is expected to be settled. Which of the following federal tax rates should X use to record the deferred tax liability?

- **a.** 35 percent
- **b.** 25 percent
- **c.** 22 percent
- **d.** 34 percent

**6.** Which of the following can be carried forward indefinitely?

- **a.** NOLs
- **b.** Section 179 deductions
- **c.** Capital losses
- **d.** Charitable contributions

## FIN 48 Disclosures

FIN 48 requires the following disclosures which apply to all entities:

- The entity's policy on classification of interest and penalties assessed by taxing authorities
- As of the end of each annual reporting period presented:

  - The total amounts of interest and penalties assessed by taxing authorities that are recognized in the statement of operations, and the total amounts of interest and penalties recognized in the statement of financial position.

  - For positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date:
- The nature of the uncertainty
- The nature of the event that could occur in the next 12 months that would cause the change

- An estimate of the range of the reasonably possible change or a statement that an estimate of the range cannot be made

  - A description of tax years that remain open subject to examination by major tax jurisdictions.

- Public companies only shall include the following additional disclosures as of the end of each annual reporting period presented:

  - A tabular reconciliation of the total amounts of unrecognized tax benefits at the beginning and end of the period which shall include at a minimum:

- The gross amounts of the increases and decreases in unrecognized tax benefits as a result of tax positions taken during a prior period.

- The gross amounts of increases and decreases in unrecognized tax benefits as a result of tax positions taken during the current period.

- The amounts of decreases in the unrecognized tax benefits relating to settlements within taxing authorities.

- Reductions to unrecognized tax benefits as a result of a lapse of the applicable statute of limitations.

  - The total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate.

Below are sample disclosures based on the guidance presented above:

**EXAMPLE 1 Disclosure: Public Company**

**Note X: Tax Uncertainties**

The Company files income tax returns in the U.S. federal jurisdiction and various states (not required).

The Company is subject to U.S. federal and state income tax examinations for tax years 20X4, 20X5, 20X6, and 20X7.

The Internal Revenue Service (IRS) commenced an examination of the Company's U.S. income tax returns for 20X3 and 20X4 in the first quarter 20X7, which is expected to be completed by the end of 20X8. As of December 31, 20X7, the IRS has proposed certain significant tax adjustments to the Company's research credits. Management is currently evaluating those proposed adjustments to determine if it agrees. If accepted, the Company anticipates that it is reasonably possible that an additional tax payment in the range of $80,000 to $100,000 will be made by the end of 20X8.

A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows (public company disclosure only):

| | |
|---|---|
| Balance at January 1, 20X7 | $ 0 |
| Additions based on tax positions related to the current year | 210,000 |
| Additions for tax positions of prior years | 30,000 |
| Reductions for tax positions of prior years | (50,000) |
| Reductions due to settlements with taxing authorities | (40,000) |
| Reductions due to lapse in statute of limitations | (10,000) |
| Balance at December 31, 20X7 | $140,000 |

The Company's policy is to record interest expense and penalties assessed by taxing authorities in operating expenses.

For years ended December 31, 20X7, 20X6, and 20X5, the Company recognized approximately $12,000, $15,000, and $17,000, respectively of interest and penalties expense. At December 31, 20X7 and 20X6, accrued interest and penalties were $50,000 and $45,000, respectively.

Included in the balance at December 31, 20X7 and 20X6 are $30,000 and $25,000, respectively, of tax positions that relate to tax deductions that upon audit could be disallowed, resulting in a higher effective tax rate. Management believes that it is more likely than not that these tax positions would be sustained in the event of audit (public company disclosure only).

**EXAMPLE 2 Disclosure: Nonpublic Company**

**Note X: Tax Uncertainties**

The Company's policy is to record interest expense and penalties assessed by taxing authorities in operating expenses.

For years ended December 31, 20X7 and 20X6, the Company recognized approximately $5,000 and $6,000, respectively of interest and penalties expense. At December 31, 20X7 and 20X6, accrued interest and penalties were $2,000 and $3,000, respectively.

The Company is subject to U.S. federal and state income tax examinations for tax years 20X4, 20X5, 20X6 and 20X7.

The Internal Revenue Service (IRS) commenced an examination of the Company's U.S. income tax returns for 20X3 and 20X4 in the first quarter 20X7 which is expected to be completed by the end of 20X8. As of December 31, 20X7, the IRS has proposed certain significant tax adjustments to the Company's research credits. Management is currently evaluating those proposed adjustments to determine if it agrees. If accepted, the Company anticipates that it is reasonably possible that an additional tax payment in the range of $80,000 to $100,000 will be made by the end of 20X8.

**EXAMPLE 3 Disclosure: Nonpublic Company - Abbreviated Disclosure**

Most nonpublic companies do not have tax positions that require the recording of an unrecognized liability. In such cases, the disclosures are as follows:

**Note X: Tax Uncertainties**

The Company's policy is to record interest expense and penalties assessed by taxing authorities in operating expenses.

For years ended December 31, 20X7 and 20X6, there was no interest and penalties expense and no accrued interest and penalties recorded.

The Company is subject to U.S. federal and state income tax examinations for tax years 20X4, 20X5, 20X6 and 20X7.

## Fixing the Disclosures in Uncertain Tax Positions for Nonpublic Entities

Since the issuance of FIN 48, the FASB has issued additional guidance with FASB Staff Position (FSP) FIN 48-1, and ASU 2009-6, *Income Taxes: Implementation Guidance on Accounting for Uncertainty in Income Taxes and Disclosure Amendments for Nonpublic Entities (ASC 740)*. ASU 2009-6 amends FIN 48 to eliminate certain disclosures for nonpublic companies and to clarify the scope to which FIN 48 applies. FIN 48, as amended by ASU 2009-6, requires numerous disclosures related to tax positions.

Among those disclosures are three specific disclosures that have caused controversy in practice, particularly with respect to those companies that have no unrecognized tax positions recorded on their balance sheets. These include the following:

- The company's policy on classification of interest expense and penalties assessed by taxing authorities
- The total amounts of interest and penalties assessed by taxing authorities that are recognized in the statement of operations, and the total amounts of interest and penalties assessed by taxing authorities that are recognized in the statement of financial position
- A description of tax years that remain open subject to examination by major tax jurisdictions

In May 2010, the AICPA's Financial Reporting Executive Committee (FinREC) issued a technical practice aid, TPA 5250-15, "Application of Certain FASB Interpretation No. 48 (codified in FASB ASC 740-10) Disclosure Requirements to Nonpublic Entities That Do Not Have Uncertain Tax Positions." In that TPA, the AICPA concluded that when a nonpublic entity did not have uncertain tax positions, the disclosure found in ASC 740-10-50-15(e) of the number of years that remain open subject to tax examination was still required to be disclosed. Since issuance of the TPA, critics have argued that the conclusion reached in the TPA is flawed and inconsistent with ASU 2009-6.

In the Basis of Conclusions section of ASU 2009-6, the FASB states:

> BC13. The board concluded that the disclosure requirements in paragraph 740-10-50-15(c.) through (e) still provide value to users of nonpublic entity financial statements even without the disclosure of total unrecognized tax balances. As a result, the Board decided not to require nonpublic entities to disclose total unrecognized tax positions at the balance sheet dates.
>
> BC14. One respondent asked if a disclosure would be required if management determined that there are no unrecognized tax benefits to record. The Board concluded that such a disclosure would not be required because it will set a precedent for requiring a similar disclosure for all accounting standards for which there was no material effect on the financial statements.

Although BC14 does not explicitly identify what "a disclosure" references, at a minimum it references the disclosure of the number of tax years that remain open as follows:

> *A description of tax years that remain open subject to examination by major tax jurisdictions*

The FASB states that if there are no material uncertain tax positions recorded, the disclosure of "a description of tax years that remain open subject to examination by major tax jurisdiction" is not required. But TPA 5250-15 erroneously contradicted the FASB's conclusion by stating that the disclosure of the number of years open IS required even if an entity has no uncertain tax positions recorded. Some respondents have stated that the AICPA was not inconsistent with the FASB's position because the Basis of Conclusions section is not formally part of the FASB's Codification.

Additionally, the FASB and the Private Company Council (PCC) discussed FIN 48 at a February 2015 PCC meeting. At that meeting, the FASB reaffirmed its position in Paragraph B14 by stating that it did not intend to require disclosure of tax examination years that are open when a nonpublic entity does not have any (material) uncertain tax positions. The result is that a nonpublic entity that has no uncertain tax positions liability recorded is not required to disclose the number of tax years open for examination.

As a result, the AICPA has deleted TPA 5250-15 and has scheduled a reissue of the TPA shortly. That revised TPA will be consistent with ASU 2009-6 and will state that a description of tax years that are open subject to examination by major tax jurisdictions will not be required if an entity has no material unrecognized tax positions.

If an entity has no material unrecognized tax positions, the third disclosure (description of tax years open) is not required. But what about the other two disclosures related to interest and penalties? Are they required if an entity has no interest and penalties related to taxes?

Remember that Paragraph B14 of ASU 2009-6 states:

> BC14. One respondent asked if a disclosure would be required *if management determined that there are no unrecognized tax benefits to record*. The Board concluded that *such a disclosure would not be required because it will set a precedent* for requiring a similar disclosure for all accounting standards for which there was no material effect on the financial statements.

The FASB notes that a disclosure is not required (of open tax years) if there are no unrecognized tax obligations or benefits. The FASB goes on to state that to require such an irrelevant disclosure would not be required because it will *"set a precedent"* meaning it would result in entities including disclosures on elements that do not exist. In other words, the FASB is saying that it does not want to set a precedent for requiring disclosures where an item to which the disclosure relates is not material to the financial statements. The same conclusion should apply to disclosures above involving interest and penalties on taxes. If an entity has no interest or penalties related to their taxes, there is no requirement to disclose the company's policy to record interest expense and penalties assessed. Nor is a company required to disclose the total amounts of interest and penalties recognized in the statement of operations and the total amounts of interest and penalties recognized in the statement of financial position assessed by taxing authorities.

As to the disclosure of the number of years open for examination, no disclosure is required if using tax basis financial statements. The reason is because it is not required unless an entity has an unrecognized tax benefit liability, which is not recorded for tax basis financial statements. With respect to the disclosures about interest and penalties, such disclosures would only be required in a year in which an entity that uses the tax basis of accounting has interest and penalties related to a tax obligation that are either recorded as expense or accrued. Otherwise, no disclosures would be required.

## Significance of unrecognized tax benefit liabilities to company financial statements

For most nonpublic entities, the recording of unrecognized tax benefit liabilities is a nonstarter. Such nonpublic entities and their accountants and audits avoid recording liabilities like the plague. For public entities, where transparency is at a higher level, the recording of unrecognized tax benefit liabilities is a regular event. The key question to ask is, how significant are these liabilities?

In March 2014, The Georgia Tech College of Business published a study entitled *Understanding Unrecognized Tax Benefits*. In the Study, the authors examined the unrecognized tax benefits for the firms in the S&P 100. The goal of the study was to clarify the accounting and measurement of the liabilities relative to each entity's assets, income tax expense, and net income. The results of the study included the following:

- The median unrecognized tax benefit liabilities was 0.8 percent of total assets, but increased to as high as 9.6 percent for certain companies.
- Seventy-eight percent of the unrecognized tax benefit would reduce net income if it were recognized (reversed).
- In general, unrecognized tax benefit liabilities represent an after-tax reserve that is quite subjective and can have a material effect on income if it were to be recognized (reversed).

The following table presents the liabilities for selected S&P 100 companies:

**Unrecognized Tax Benefit Liabilities- Selected S&P 100 Companies**

| Company | Liability Balance at 2012 | % total assets | % average NI (last 3 years) |
|---|---|---|---|
| Accenture | $1.6 billion | 9.6% | 33% |
| IBM | 5.7 billion | 4.8% | 32% |
| Dell | 2.4 billion | 5.1% | 97% |
| Oracle | 3.3 billion | 4.2% | 40% |
| BOA | 3.7 billion | .2% | 274% |
| HP | 2.6 billion | 2.4% | 132% |
| JP Morgan | 7.2 billion | .3% | 22% |
| Median all companies | | .8% | 11.8% |

**Source:** Georgia Tech Financial Analysis Lab, *Understanding Unrecognized Tax Benefits* (March 2014)

The above table illustrates the impact that unrecognized tax benefit liabilities have on certain entities. For some companies, the impact is that the liability is a large percentage of total assets such as Accenture's 9.6 percent. For others, the impact is that the liability, if recognized through a reversal, represents a high percentage of net income. For example, Bank of America's $3.7 billion liability represents 274 percent of average net income. If the liability were to reverse in part, it would have a significant impact of increasing net income.

Consider the disclosure found in the notes to Honeywell:

| | |
|---|---|
| Balance at beginning of year | $815 |
| Gross increases related to current period tax positions | 25 |
| Gross increases related to prior periods tax positions | 44 |
| Gross decreases related to prior periods tax positions | (62) |
| Decreases related to settlements with tax authorities | (40) |
| Expiration of the statute of limitations for the assessment of taxes | (64) |
| Foreign currency translation | 4 |
| Balance at end of year | $722 |

**Source:** *Georgia Tech Financial Analysis Lab, Understanding Unrecognized Tax Benefits* (March 2014)

Looking at the Honeywell disclosure above, Honeywell has $722 million of unrecognized tax benefit liabilities recorded on its balance sheet at year end. Notice the activity in and out of this liability account consisting of changes in volatile estimates computed based on a high degree of subjectivity. In reviewing the results of the study, one conclusion can be easily reached. Unrecognized tax benefit liabilities represent to some companies, a significant liability as a percentage of total assets. Furthermore, such liabilities are very subjective in nature and can be easily manipulated as reserve or "cushion" accounts.

When FIN 48 was issued, its critics warned the FASB that FIN 48 would give the IRS an easy roadmap to audit questionable tax positions. Embedded in the notes to financial statements of public companies is a disclosure of the activity in the unrecognized tax benefit liability, which FIN 48 requires, and is presented in the following format:

**NOTE X: Unrecognized Tax Benefit Liability**

A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

| | |
|---|---|
| Balance at January 1, 20X1 | $XX |
| Additions based on tax positions related to the current year | XX |
| Additions for tax positions of prior years | XX |
| Reductions for tax positions of prior years | (XX) |
| Reductions due to settlements with taxing authorities | (XX) |
| Reductions due to lapse in statute of limitations | (XX) |
| Balance at December 31, 20X1 | $XX |

Due to the required disclosures under FIN 48, there is far greater transparency into a company's tax positions than ever before. Under FIN 48, a company is required to record a tax liability if the probability is 50 percent or less that a particular tax position will be sustained in an IRS or state tax audit. That liability is required and is reflective of the uncertainty that exists in a tax position. Thus, the total liability represents the cumulative uncertainty of sustaining the tax benefit of all tax positions. That liability is not only presented separately on a company's balance sheet, but also must be reconciled in the notes to financial statements. In essence, FIN 48 lays out important information about a company's tax positions which can be used against it by the IRS or a state tax authority.

If a company has a sizeable balance in its unrecognized tax benefit liability account, that fact suggests that there are several significant positions that may be challengeable by the IRS and other tax jurisdictions. A company is essentially saying that it has taken tax positions which it may not be able to support and justify if the company is audited by the IRS or a state tax authority. Those tax authorities have access to the footnotes that include information on the unrecognized tax benefits.

The list of third parties interested in a company's FIN 48 information includes not only the IRS, but also state departments of revenue. Both the IRS and states have a vested interest in knowing a company's tax positions to assist in uncovering potential understated tax liabilities.

There are also a few instances where the IRS or other taxing authorities cross over to use GAAP information to assist them in conducting federal and state tax audits. The issuance of FIN 48 has given the IRS an opening to use FIN 48 working papers and disclosure information to identify uncertain tax positions. The IRS has had a long-standing policy of restraint in seeking accountants' or auditors' tax accrual workpapers (IRS Announcement 2002-63), requesting them in rare and unusual circumstances or where the taxpayer was involved in certain listed transactions. In situations in which the IRS has demanded tax accrual workpapers, they have won in court such as in the case of ***United States v. Textron, Inc.*** (577 F.3d 21 (1st Cir. 2009), in which the court held that tax accrual workpapers are not privileged work product.

In early 2010, the IRS issued Announcement 2010-9 to address disclosures of uncertain tax positions on an entity's federal tax return. Subsequently, the IRS issued Announcement 2010-75, in which it stated that it was releasing a schedule in which certain taxpayers would be required to disclose uncertain tax positions related to their Form 1120 corporate tax return or other returns. For tax years beginning in 2014 and later, the asset threshold for reporting uncertain tax positions on Schedule UTP (Form 1120) *Uncertain Tax Position Statement* decreased from $50 million to $10 million.

Corporations meeting all other Schedule UTP filing requirements must file a Schedule UTP if total assets equal or exceed $10 million. This asset threshold decrease for 2014 was the final phase of the five-year Schedule UTP filing requirement phase-in. The asset threshold for tax years 2010 and 2011 was $100 million, decreasing to $50 million for tax years 2012 and 2013.

- A corporation must file Schedule UTP with its income tax return if:

  - The corporation files Form 1120, U.S. Corporation Income Tax Return; Form 1120-F, U.S. Income Tax Return of a Foreign Corporation; Form 1120-L, U.S. Life Insurance Company Income Tax Return; or Form 1120-PC, U.S. Property and Casualty Insurance Company Income Tax Return,

  - The corporation has assets that equal or exceed $10 million,

  - The corporation or a related party issued audited financial statements reporting all or a portion of the corporation's operations for all or a portion of the corporation's tax year, and

  - The corporation has one or more tax positions that must be reported on Schedule UTP.

- On the Schedule UTP, the taxpayer must:

  - Disclose a concise description of each uncertain tax position, and

  - Rank all of the reported tax positions based on the federal income tax reserve recorded for the position taken on the tax return, and designate the tax positions to which the reserve exceeds 10 percent of the aggregate amount of reserve for all tax positions reported.

- The types of tax positions that require disclosure on the Schedule UTP include:

  - Uncertain tax positions for which a taxpayer has recorded a reserve in its audited financial statements, and

  - Uncertain tax positions for which the corporation did not record a reserve because the corporation expects to litigate the tax position.

- The Schedule is not applicable to pass-through entities although the IRS has authority to extend the application of Schedule UTP to pass-through entities or tax-exempt organizations.

In Announcement 2010-76, the IRS stated that it has expanded its policy of restraint in connection with its decision to require certain corporations to complete Schedule UTP, and will forego seeking particular documents that relate to uncertain tax positions and the workpapers used to prepare the Schedule UTP. Although the IRS may not seek use of tax accrual workpapers, the IRS has announced that it is using the footnote disclosures required by FIN 48 to audit uncertain tax positions. In 2007, the IRS Large Business and International Division (LB&I) issued *FIN 48 Implications LB&I Field Examiners' Guide.*

Moreover, recent cases in which the IRS has sought copies of tax accrual workpapers, the decisions have been split. These include the following:

- On June 29, 2010, the U.S. Court of Appeals for the District of Columbia Circuit found that documents the government subpoenaed from Dow Chemical Company's independent auditors were protected from discovery under the work-product doctrine. ***U.S. v. Deloitte*, LLP,** 106 AFTR 2d 2010-5053.

- The IRS won a victory in ***Textron Inc.*** (discussed previously) where the U.S. Court of Appeals for the First Circuit rejected the taxpayer's argument that its tax accrual workpapers were entitled to work-product protection.

- More recently, the issue was revisited in response to the IRS's summons of KPMG's tax accrual workpapers related to Wells Fargo. In June 2013, the U.S. District Court for the District of Minnesota ruled that Wells Fargo's measurement of and analysis with respect to its so-called uncertain tax positions, or UTPs, is entitled to work product protection, but that the identification of the types of UTPs is not. The court determined that the work-product doctrine did not protect from disclosure the identification of UTPs and related factual information because that information is created in the ordinary course of business.

So the fundamental question to be asked is, are FIN 48 Disclosures a Roadmap for the IRS?

**IRS Answer:** The disclosures required under FIN 48 should give the Service a somewhat better view of a taxpayer's uncertain tax positions; however, the disclosures still do not have the specificity that would allow a perfect view of the issues and amounts at risk. For example, there may be a contingent tax liability listed in the tax footnotes of a large multi-national taxpayer with a description called "tax credits," however, tax credits could be U.S., foreign, or state tax credits. So the "tax credits" in this example, may or may not have a U.S. tax impact. Even with the lack of specificity, tax footnotes included in financial statements, including FIN 48 disclosures, should be carefully reviewed and analyzed as part of the audit planning process. For example, if a taxpayer reflecting a contingent tax liability in the year under audit for Subpart F income does not reflect Subpart F in the tax return, questions could develop about why Subpart F income does not appear in the tax return, but is mentioned in the tax footnotes as creating a contingent tax liability.

State tax agencies also have a strong interest in FIN 48 information. With sizeable budget shortfalls, going after companies that have underreported state taxes provides the states with the opportunity to retrieve significant tax revenue. In particular, states are using FIN 48 information to attack two particular areas of vulnerability for companies:

- Factors that lead to nexus within a particular state
- Computation of apportionment

Because of the current state tax environment in which many states are creating their own rules as to whether there is state nexus, it may be difficult to conclude whether there is a more-than-50-percent likelihood that a company's position will be challenged.

> **COMMENT:** One approach a company can take to avoid disclosing information about its tax positions is to remove the disclosure from its financial statements and reference a GAAP departure in the auditor's report.

Regardless of what the IRS says about its focus or lack thereof on FIN 48 disclosures, a recent study suggests the IRS is particularly focused on corporate disclosures. In October 2014, a group of educators published a study (*IRS Attention,* Zahn Bozanic, Jeffrey L. Hoopes, Jacob R. Thornock, and Braden M. Williams) which examined IRS download (through IP addresses) timing and frequency patterns of firms' annual reports from EDGAR, which has the mandatory SEC disclosures, and noted the following:

- Despite the IRS having large amounts of private information on companies, IRS agents are pulling information from the EDGAR database of required public filings based on certain areas of interest.

  - There is a high pattern of downloads from "9 to 5" with a significant dropoff after those hours and on weekends.

- The patterns indicate that human beings, rather than computer algorithms, are pulling information from EDGAR during IRS hours.

- The average downloaded 10-K is more than one year old (448 days on average) suggesting that the financial statements are being used for tax enforcement purposes and not for information content purposes.

- The IRS attention is strongly driven by firm characteristics such as:

  - Firm size
  - Foreign profitability
  - NOLs

- There is a strong correlation between IRS attention to certain information and uncertain tax positions supporting the conclusion that the FIN 48 disclosures provide a roadmap to the IRS.

  - The IRS attention after the effective date of FIN 48 has been four times greater than other U.S. government agencies.
  - The IRS has particular interest in 10-K filings especially since companies have been reporting uncertain tax positions under FIN 48.

- Four financial statement measures appear to be used by the IRS and are correlated with information used

  - Cash effective tax rate (Taxes paid/Pretax income)
  - GAAP effective tax rate, including the breakdown of current, deferred, and foreign/domestic taxes
  - Book/tax differences
  - Unrecognized tax benefits liabilities (UTB)

- *A lower cash effective rate (cash ETR) is correlated with higher IRS attention.*

| | | |
|---|---|---|
| Cash effective tax rate: | | |
| Income taxes paid | XX | = Cash effective tax rate |
| Pretax income | XX | |

- There is a strong correlation between IRS attention and the geographic footprint disclosed in the 10-K such as number of subsidiaries in tax havens, number of subsidiaries in foreign countries, and number of geographic segments disclosed in the financial statements.

**COMMENT:** IRS attention has increased in measures of multinational operations but not for the measures of tax complexity.

- Certain information found in the 10-K discloses important information that is used in tax avoidance and that is not reported to the IRS elsewhere such as:

  - Narrative descriptions of company goals
  - Management style
  - Intentions behind M&A activities
  - Estimations about future business prospects
  - Supply chain
  - Business operations
  - Products

- Strategy
- Competition

- The IRS focus on disclosures increased after the effective date of Schedule M-3 and Schedule UTP.

## FASB continues to increase income tax disclosures

If FIN 48 disclosures were not enough, the FASB is at it again. This time, the FASB has proposed increasing disclosures of undistributed foreign earnings as part of its disclosure framework project. Although the framework project is supposed to streamline disclosures, requiring additional disclosures of undistributed foreign earnings appears to be going in the opposite direction. In its February 2015 meeting, the FASB decided that entities would be required to disclose the following:

- Income before taxes disaggregated between domestic and foreign earnings. Foreign earnings would be further disaggregated for any country that is significant to total earnings.
- Domestic tax expense recognized in the period for taxes on foreign earnings
- Undistributed foreign earnings that are no longer asserted to be indefinitely reinvested during the current period and an explanation of the circumstances that cause the entity to make that assertion. Separate disclosure should be made for any country that is significant to the disclosed amount.
- A further disaggregation of the current requirement to disclose the temporary difference for the cumulative amount of indefinitely reinvested foreign earnings if any country represents at least 10 percent of the disclosed amount

The FASB decided not to require disclosure of the following:

- Disaggregation of deferred tax liabilities (DTL) recorded for unremitted foreign earnings by country
- An estimate of the unrecognized DTL on the basis of simplified assumptions
- Past events or current conditions that have changed management's plans for undistributed foreign earnings

**COMMENT:** According to several studies, U.S. company profits and cash held off shore exceed $2 trillion. Those companies are not motivated to repatriate the profits and cash to the United States given the existing corporate tax rate of 35 percent. One firm estimated that the amount of foreign earnings remaining off shore increased by 93 percent from 2008 to 2013 (*Audit Analytics 2014*, as reported by Thompson Reuters).

## Impact of Reduction in Tax Rates on Deferred Taxes

For the past decade, there have been numerous proposals and suggestions that U.S. corporate tax rates should be reduced as part of an overall tax reform. In the joint committee report entitled, *The Moment of Truth: Report of the National Commission on Fiscal Responsibility and Reform* (Report issued by the National Commission on Fiscal Responsibility and Reform), the committee recommended that the top corporate federal tax rate be reduced from 35 percent to a rate within the range of 23-29 percent. Recently, the Treasury and White House mentioned a 25 percent target rate.

The current U.S. corporate tax rate is 35 percent, which is considered one of the highest among all countries. When one adds a state tax rate in the 5 to 10 percent range, net of the federal tax benefit, most corporations have a federal and state effective tax rate that exceeds 40 percent. According to the Tax Foundation, the following is noted (Tax Foundation, *Corporate Income Tax Rates Around the World, 2014)*:

- The United States has the third highest general top marginal corporate income tax rate (federal and state) in the world at 39.1 percent, exceeded only by Chad and the United Arab Emirates, and the highest federal corporate income tax rate among the 34 industrialized nations of the Organization for Economic Cooperation and Development (OECD).
- The worldwide average top corporate income tax rate is 22.6 percent (30.6 percent weighted by GDP).
- By region, Europe has the lowest average corporate tax rate at 18.6 percent (26.3 percent weighted by GDP); Africa has the highest average tax rate at 29.1 percent.
- Larger, more industrialized countries tend to have higher corporate income tax rates than developing countries.
- The worldwide (simple) average top corporate tax rate has declined over the past decade from 29.5 percent to 22.6 percent.
- Every region in the world has seen a decline in their average corporate tax rate in the past decade.

**Corporate Tax Rates By Country**

| Country | Corporate Tax Rate |
|---|---|
| United Arab Emirates | 55% |
| Chad | 40% |
| **United States** | **35%** |
| Japan* | 37% |
| France | 34.4% |
| India | 34% |
| Australia | 30% |
| UK | 21% |
| Italy | 27.5% |
| Greece | 26% |
| Mexico | 30% |
| Spain | 28% |
| Austria | 25% |
| Israel | 26.5% |
| Sweden | 22% |
| Ireland | 12.5% |
| Switzerland | 8.5% |
| Bahamas | 0% |
| British VI | 0% |
| Bermuda | 0% |
| **Worldwide average** | **22.6%** |

* Japan has approved tax reform that will lower its corporate rate.
**Sources:** Tax Foundation and Organization for Economic Co-operation and Development (*OECD*)

As corporate tax revenues decline and U.S. companies continue to hold more than $2 trillion of cash off shore, there is impetus to reduce the U.S. corporate tax rate from 35 percent to a rate that is in the 25 to 28 percent range.

## STUDY QUESTIONS

**7.** Based on the study, *The Effects of Tax Reform on Deferred Taxes: The Winners and Losers*, which of the following industries would benefit from a reduction in tax rates?

- **a.** Pharmaceuticals
- **b.** Biotechnology
- **c.** Financial companies
- **d.** Oil and gas exploration

**8.** Which of the following statements is correct with respect to the Tax Foundation's study entitled *Corporate Income Tax Rates around the World, 2014*?

- **a.** The worldwide average top corporate income tax rate is 35 percent.
- **b.** Europe has the highest average tax rate at 29.1 percent.
- **c.** Africa has the lowest average tax rate at 22.6 percent.
- **d.** The United States has the third highest general top marginal corporate income tax rate in the world.

**9.** Based on the Tax Foundation's study entitled *Corporate Income Tax Rates around the World, 2014*, which country had the highest corporate tax rate?

- **a.** United Arab Emirates
- **b.** Australia
- **c.** United States
- **d.** Switzerland

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**CPE NOTE:** When you have completed your study and review of chapters 1-3, which comprise Module 1, you may wish to take the Final Exam for this Module. Go to **CCHGroup.com/PrintCPE** to take this Final Exam online.

# MODULE 2: FINANCIAL STATEMENT REPORTING—CHAPTER 4: Financial Performance Reporting by Business Enterprises

## ¶ 401 WELCOME

Over the past decade, the financial community has been fickle in conveying to the FASB, SEC and others the type of financial information it would like to see in financial statements and related disclosures. Unfortunately, events such as the Enron and WorldCom frauds have resulted in the passage of the over-reaching provisions of Sarbanes-Oxley, which created a new oversight board (PCAOB), expansive auditing requirements, Section 404 compliance, and a host of extensive rules and regulations costing billions to implement and manage. This chapter examines studies and recommendations that will hopefully lead to a comprehensive business reporting model that is valuable from the investor's perspective.

## ¶ 402 LEARNING OBJECTIVES

Upon completion of this chapter, you will be able to:

- Identify some of the 12 recommended principles for the Comprehensive Business Reporting Model
- Recall the definition of free cash flow
- Recognize some of the key ratios used to analyze working capital
- Identify some of the symptoms of inefficiently managed working capital

## ¶ 403 INTRODUCTION

Over the past decade, the financial community has been fickle in conveying to the FASB, SEC and others the type of financial information it would like to see in financial statements and related disclosures.

First, there were the Enron and WorldCom frauds in the early 2000s, which created an onslaught of demand for further transparency, additional disclosures, and the recording of off-balance-sheet transactions. Investor demand for more information culminated with the passage of the Sarbanes-Oxley Act of 2002. As history has shown, single, sizeable events, such as the Enron and WorldCom frauds, can result in the passage of bad law, as evidenced by the over-reaching provisions of Sarbanes-Oxley, which created a new oversight board (PCAOB), expansive auditing requirements, Section 404 compliance, and a host of extensive rules and regulations costing billions to implement and manage.

Interestingly, even though there were several sizeable frauds that occurred in the early 2000s, the expansive changes made by Sarbanes-Oxley were disproportionate to the satisfaction level of financial statement users. For example, financial statement users wanted some improvement with disclosures as they rated the quality of information as being good to average. Yet, Sarbanes-Oxley expanded various requirements as if the overall financial reporting system was broken, which it was not.

Thus, it appeared that the additional demands of Sarbanes-Oxley were made at the will of Congress and the SEC, within an over-reactive, politically charged climate.

## ¶ 404 FINANCIAL COMMUNITY'S VIEW OF FINANCIAL REPORTING AND DISCLOSURES

Right after the passage of Sarbanes-Oxley, in 2003, AIMR did a survey to determine the extent to which portfolio and fund managers and securities analysts were satisfied with the quality of financial reporting and disclosures. At the time of the survey, the effects of the changes made by Sarbanes had not been felt. Therefore, one should treat these results as being part of a pre-Sarbanes survey.

The survey, conducted by AIMR, entitled *Global Corporate Financial Reporting Quality,* asked: How do you rate the quality of the financial reporting and disclosures you receive? The results were as follows:

| | |
|---|---|
| ***Good to excellent*** | ***45%*** |
| Average | 44% |
| Below average | 7% |
| Poor | 1% |
| No answer | 3% |
| | 100% |

The survey further sought to determine the interrelation between the importance of financial information and disclosures, and quality of that information, by category. Only 45 percent of those surveyed rated the information they received in the pre-Sarbanes environment as either good or excellent.

The results of the survey suggested the following:

- There was a real disconnect between the importance of certain financial information and the perceived quality of that information. In particular, the respondents suggested that the quality of disclosures was generally poor relative to their importance. For example, the survey suggested that overall, the importance of footnotes was either very or extremely important (85 percent of the respondents) while only 35 percent of those respondents stated that the overall quality of the footnotes was good to excellent.
- Only 34 percent of the respondents noted that overall footnotes improved while 10 percent said they had not improved.
- At the time of the survey, the top 10 disclosures of most importance were:

| | **% very or extremely important** |
|---|---|
| Off-balance-sheet items | 83% |
| Extraordinary, unusual, non-recurring charges | 78% |
| Pension and other retirement benefits | 76% |
| Contingencies, litigation, legal risks | 73% |
| Explanation of accounting principles | 72% |
| Revenue recognition criteria | 72% |

| | % very or extremely important |
|---|---|
| Costs capitalized versus expensed | 70% |
| Segment reporting | 71% |
| Forward-looking information | 70% |
| Risk factors, sensitivity of assumptions | 69% |

## A Second Study

As a further study on evaluating the financial reporting model, the Centre for Financial Market Integrity (CFA Institute) issued a report after Sarbanes-Oxley entitled A Comprehensive Business Reporting Model, Financial Reporting for Investors. In its report, CFA outlined the comprehensive business reporting model that is important from the investor's perspective, and outlined 12 principles for a comprehensive reporting model as summarized in the following chart:

**12 Recommended Principles for a Comprehensive Business Reporting Model**

| Principle | Reason for Importance of Principle |
|---|---|
| The company must be viewed from the perspective of a current investor in the company's common equity. | The current common shareholder is the last to receive a share of the company's assets and earnings. The common shareholder must have complete, accurate information about all other claims that will be paid before it gets paid including potential risk exposures and possible returns. |
| *Fair value* information is the only information relevant for financial decision making. | Currently, financial statements include some items reported at historical cost and others at fair value, under a mixed-attribute system.<br>Decisions about whether to purchase, sell, or hold investments are based on the fair values of the investments and expectations about future changes in their values. Financial statements based on outdated historical costs are less useful for making such assessments. |
| Recognition and disclosure must be determined by the relevance of the information to investment decision making and not based upon measurement reliability alone. | Financial information may be completely reliable if it is easily verifiable using one or more criteria. Yet, such information may not be relevant for financial decision making. For example, the purchase by a company of a major manufacturing facility 30 years ago at recorded cost is easily verifiable. However, such information is not useful or relevant for today's decision making. |
| All economic transactions and events should be completely and accurately recognized as they occur in the financial statements. | The purpose of financial reporting is to convey the economic position of the company and changes in that position to investors. Reporting methods that omit or fail to reflect the economic essence of events and transactions as they occur do not achieve the purpose of financial reporting.<br>All activities that are currently off the balance sheet must be recognized, including executory contracts. |

**12 Recommended Principles for a Comprehensive Business Reporting Model**

| Principle | Reason for Importance of Principle |
|---|---|
| Investors' wealth assessments must determine the materiality threshold. | Under current practice, materiality is typically determined by the company or auditor using some arbitrary threshold such as five percent of an income statement or balance sheet number.<br>Financial statements are prepared for investors who need information and who base their financial decisions upon it. The materiality threshold should be based on what will affect investors' decisions and not upon preparers' arbitrary assessments (e.g., five percent of net income or assets). These decisions should be based on both quantitative and qualitative factors. Example: A small amount of fraud committed by company managers would likely be considered highly material to investors in assessing the integrity of those to whom they entrust their assets. |
| Financial reporting must be neutral. | Reporting of economic transactions and events should not be influenced by the outcomes of the financial reporting or the effects that the reporting may have on one or more interests. In the past, concern for outcomes has caused political forces to challenge standard setters.<br>Example: During the stock option debate, those opposed to expensing stock options argued that expensing would reduce net income, causing companies that issue options to reduce the number of options granted to employees, making it more difficult to attract talented employees.<br>Example: Pension accounting does not present fair value because of previous pressures placed on the FASB to water down its standards. |
| All changes in net assets must be recorded in a single financial statement: the *Statement of Changes in Net Assets Available to Common Shareholders.* | Under present practice, changes in net assets are scattered throughout the financial statements in the income statement, cash flow statement, balance sheet, and changes in stockholders' equity. Further, the netting and aggregation of transactions makes analyses of changes in net assets difficult.<br>All changes in net assets should be reported clearly and understandably and in a single statement. Investors must now expend great effort to locate these changes and make use of them. Further, investors must resort to a great deal of analysis to determine the source and magnitude of many asset changes. |
| The *Statement of Changes in Net Assets Available to Common Shareholders* should include timely recognition of all changes in *fair values* of assets and liabilities. | If investors are to be able to evaluate how the value of their investment is increasing or decreasing, they must be able to fully understand the change in fair value of the assets they hold and the obligations they have incurred. The clearest measures of a company's wealth-generating or consuming patterns are changes in the fair values of these assets and obligations.<br>The Statement should also reflect the changes in fair value including remeasurements due to changes in interest rates.<br>Delayed recognition of fair value, such as the unrealized gain or loss related to available-for-sale securities should be eliminated so that all gains and losses flow through the income statement. |
| The cash flow statement provides essential information and should be prepared using the direct method only. | Under present practice, few companies use the direct method of presenting the operating activities of the statement of cash flows. A clear picture of the company's current means of generating cash flows, the patterns of those cash flows, and its effectiveness in producing cash is essential. The current cash flow statement format of most companies does not provide this information. |

**12 Recommended Principles for a Comprehensive Business Reporting Model**

| Principle | Reason for Importance of Principle |
|---|---|
| Changes affecting each of the financial statements must be reported and explained on a disaggregated basis. | Today, most company financial statements are highly summarized and condensed. Aggregation of information with different economic attributes, different measurement bases, trends, and operations results in substantial loss of information. |
| Individual line items should be reported based on the nature of the items rather than the function for which they are used. | Under current practice, information in financial statements is aggregated in major functional categories, such as cost of goods sold and selling, general, and administrative activities.<br>The forecasting of individual line items for use in valuation and other decisions requires that they be relatively homogeneous and represent a single economic attribute or an aggregation of very similar attributes. For example, labor cost, pension cost, materials cost, energy cost, etc. that are part of cost of goods sold should be reported individually as each has very different economic characteristics, trends, and measurement bases. |
| Disclosures must provide all the additional information investors require to understand the items recognized in the financial statements, their measurement properties, and risk exposures. | In current practice, disclosures vary widely in both quality and quantity. Investors must have sufficient supplementary disclosures to evaluate the numbers, including:<br>• Financial reporting methods used<br>• Models used for estimation and measurement<br>• Assumptions used<br>• Sensitivity analyses of point estimates<br>• Information about risk exposures<br>• Information explaining why changes in important items have occurred |

## The Disclosure Overload (Or, be careful what you ask for . . . )

As you can see from the two reports previously discussed, in the wake of Enron and WorldCom, investors and third party users wanted more financial information and disclosures and they certainly received it.

During 2003 to 2014, there were several new accounting pronouncements issued in response to requirements of Sarbanes-Oxley, the SEC, and the FASB. Some of the pronouncements were issued in response to requirements of Sarbanes-Oxley, such as the issuance of FIN 46R, the consolidation of variable interest entity rules, and the newly issued revenue recognition standard.

Now, after a decade of expanded disclosures and new GAAP standards, investors and third-party users are complaining that they are inundated with too many disclosures and far too much information. The result is that they want more quality and less quantity of information.

Let's first look at some statistics based on a recently issued KPMG/FEI study:

- In the 20 years since 1994, there have been more than 200 new GAAP documents issued in the form of Emerging Issues Task Force (EITF) consensuses, new GAAP statements, Accounting Standards Updates (ASUs), SEC Staff Accounting Bulletins (SABs), and Financial Reporting Releases, along with many interpretive guidance related to these documents (Disclosure Overload and Complexity: Hidden in Plain Sight, KPMG and FEI, 2012). In fact, a large number of those new standards have been issued during the period 2003 to early 2015.

- The volume of new standards has accelerated since the Sarbanes-Oxley Act with growing pressure placed on the FASB to “clean up” accounting standards, with particular interest in resolving GAAP for revenue recognition and off-balance-sheet transactions.

- The anticipated convergence with international standards has created an impetus for the FASB to accelerate new standards involving the FASB-IASB joint projects including leases, revenue recognition, and financial instruments, among others.

- The SEC’s mandate that each financial statement disclosure be tagged in XBRL has resulted in the cost of each additional disclosure increasing.

A sample of those pronouncements issued from 2003 to early 2016, is noted in the chart below:

**Selected Pronouncements Issued 2003 to 2016**

| Original Reference | Pronouncement |
|---|---|
| FIN 45 | *Guarantor’s Accounting and Disclosure Requirements for Guarantees* |
| FIN 46-R | *Consolidation of Variable Interest Entities* |
| FAS 158 | *Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans* |
| FAS 157 | *Fair Value Measurements* |
| FAS 123 | *Share-Based Payment (Stock Options)* |
| FAS 159 | *Fair Value Option* |
| FASs 141R and 160 | *Business Combinations and Non-Controlling Interests* |
| FAS 161 | *Disclosures about Derivative Instruments and Hedging Activities* |
| FAS 156 | *Accounting for Servicing of Financial Assets* |
| FAS 166 and ASU 2009-16 | *Accounting for Transfers of Financial Assets* |
| FAS 132 | *Disclosures About Pensions and Other Postretirement Plan Assets* |
| ASU 2009-05, ASU 2009-12, and ASU 2010-06 | *Fair Value Measurements and Disclosures* |
| ASU 2010-20 | *Disclosures about the Credit Quality of Financial Receivables and the Allowance for Credit Losses* |
| ASU 2012-02 | *Intangibles—Goodwill and Other: Testing Indefinite-Lived Intangible Assets for Impairment* |
| ASU 2013-04 | *Liabilities (Topic 405): Obligations Resulting from Joint and Several Liability Arrangements for Which the Total Amount of the Obligation Is Fixed at the Reporting Date (a consensus of the FASB Emerging Issues Task Force)* |
| ASU 2014-09 | *Revenue from Contracts with Customers (Topic 606)* |
| ASU 2014-10 | *Development Stage Entities* |
| ASU 2014-17 | *Business Combinations (Topic 805): Pushdown Accounting (a consensus of the FASB Emerging Issues Task Force)* |
| ASU 2014-18 | *Business Combinations (Topic 805): Accounting for Identifiable Intangible Assets in a Business Combination (a consensus of the Private Company Council)* |

| Selected Pronouncements Issued 2003 to 2016 | |
|---|---|
| **Original Reference** | **Pronouncement** |
| ASU 2015-01 | *Income Statement- Extraordinary and Unusual Items (Subtopic 225-20): Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items* |
| **Source:** The Author | |

The list of pronouncements identified in the previous chart is only a small sample of the total population of new pronouncements issued from 2003 to early 2016.

Take a look at any annual report of a public company and read the pages of footnotes. Any rational person will conclude that there is no shortage of disclosures. Are most of the disclosures meaningful to the end user?

One study suggests that the volume of disclosures has expanded, but not necessarily the quality. The study reviewed selected annual reports for the period 2004 to 2010. Updated information from 2010 through early 2016 has not yet been published although it is assumed that the results will show a similar pattern.

Consider the following results from the KPMG/FEI Report (*Disclosure Overload and Complexity: Hidden in Plain Sight*, KPMG and FEI, 2012):

1. Disclosures found in 10-k reports have expanded approximately 16 percent overall during the six-year period from 2004 to 2010, and footnote disclosure have grown 28 percent over the same period as noted in the following chart:

| | Mean Increase 2004 to 2010 |
|---|---|
| Volume of Form 10-K pages | 16% |
| Volume of footnote disclosure pages | 28% |
| **Source:** *Disclosure Overload and Complexity: Hidden in Plain Sight*, KPMG/FEI | |

The pace of the increase in disclosures has been just as brisk from 2011 to 2015. Although not quantified, all indication is that the increase in the volume of disclosures for nonpublic entities is at least as high as that for public companies.

2. Over the six-year period 2004 to 2010, there was approximately a 50-percent growth in the volume of footnote disclosures related to pensions and other postretirement benefits.

Take a look at the following excerpts from the survey that compared certain data from 2004 to 2010. (The survey did not expand into periods after 2010.)

**Comparison- Number of Pages in Footnotes**

| | Number of Pages | | % increase |
|---|---|---|---|
| | 2004 | 2010 | |
| Archer Daniels Midland | 20 | 42 | 110% |
| Wells Fargo | 45 | 109 | 142% |
| Target | 10 | 28 | 180% |
| Johnson & Johnson | 19 | 27 | 42% |
| AT&T | 25 | 40 | 60% |

**Comparison- Number of Pages in Footnotes**

| | Number of Pages | | % increase |
|---|---|---|---|
| | 2004 | 2010 | |
| IBM | 43 | 63 | 47% |
| Wal-Mart | 12 | 23 | 92% |

**Source:** *Disclosure Overload and Complexity: Hidden in Plain Sight*, KMPR/FEI, 2012, as modified by the author

**NOTE:** Footnote disclosures have grown at a rapid pace with particular expansion in the areas of pension and post-retirement benefits, fair value, financial derivatives and hedges. An important contributor to disclosure overload is increased complexity of the underlying transactions, investments, financial instruments, and relationships.

## Financial Statement User Comments

The KPMG/FEI study states that financial statement users complain as to the quality of the disclosures and readability issue when trying to comprehend the information in the financial reports. Many users believe that complexity in financial reporting confuses investors and therefore they cannot make optimal decisions. Users have become concerned that the proliferation of required disclosures makes it difficult to decipher a company's performance and factors that drive performance.

Investors are concerned with longer and more opaque annual reports because:

- More complex (longer and less readable) filings are associated with lower overall trading.
- There appears to be an association between report complexity and lower abnormal trading.
- Smaller investors reduce their trading when filings increase in length of pages.

## Preparer Comments

Many preparers of financial statements find the requirements for reporting financial instruments too complex. In fact, some preparers are concerned that the direction of the FASB and IASB toward principle-based standards will result in further confusion and complexity in disclosures.

Consider the following results from the same survey as they relate to preparer issues:

- Preparers are concerned about the amount and speed of changes in regulations governing financial reporting. While there is some support for recent improvement in accounting for impairments, there is frustration that some standards are inconsistent, which makes it harder for preparers to see financial reports as a fair reflection of the business in question.
- Some preparers believe that many of the disclosures are either unnecessary for their businesses or create confusion around the total remuneration for executives when they use complex reward mechanisms.

## General Conclusions

The study offers the following conclusions reached by both users and preparers:

- Complexity of accounting standards and volume of mandated disclosures are the most significant contributors to the issue of disclosure complexity. Fair value, derivatives and hedging are the most significant sources or causes of disclosure complexity under specific GAAP requirements.

- Overall, SEC initiatives (e.g., the plain English initiative) to reduce disclosure complexity have not had much impact.
- Most companies have not taken steps to reduce disclosure complexity in their financial statements and continue to include numerous disclosures (material and immaterial) in their notes.
- Companies are reluctant to omit disclosures (other than those that are clearly immaterial), out of concern that the SEC or auditor will require the company to revise its reporting to include the immaterial item.

  - 61 percent are concerned that the SEC or other regulators will object to the removal of a disclosure, even if immaterial.

  - 56 percent are concerned that the external auditors will object to the removal of the disclosure, even if immaterial.

  - 71 percent say once a disclosure is included in notes, financial statement or public filing, it is rarely or never omitted from future financial statements or filings, resulting in an accumulation of excess disclosures over several years.
- Companies *over disclose* to protect against potential litigation:

  - 73 percent say their company's disclosures are influenced by concerns over potential future litigation.

  - Most companies stated that their inside or outside legal counsel does not significantly direct disclosure in some or all parts of public filings or footnotes to financial statements.

  - 71 percent say that if legal counsel is significantly involved with disclosures, it is likely to involve risk factors.
- Most respondents stated that the complexity of accounting standards and volume of mandated disclosures are significant contributors to disclosure complexity.

  - Almost all respondents stated financial reporting preparation time and information review time are impacted by expanded disclosure requirements.

  - Fair value and derivatives and hedging requirements is a primary source or cause of disclosure complexity.

  **NOTE:** With respect to complexity, not only has the volume of footnotes grown at a rapid pace, but the topics of disclosure have also become more complex. Such complex topics include new standards and disclosures about variable interest entities, derivative instruments, pensions and other post-retirement benefits and fair value. In fact variable interest entities and the financial reporting concepts that they embody only came into being within the last decade. The FASB's multiple attempts to issue guidance on variable interest entities illustrates that, even for these sophisticated and knowledgeable standards setters, this accounting and disclosure has been abnormally challenging.
- Information presented on the face of the financial statements has a greater impact on users' understanding of the information than if provided in a footnote.

## Recommendations from the Study

The respondents developed the following recommendations to streamline disclosures without sacrificing important information:

- The SEC should issue an interpretive release to address the permissibility of cross-referencing to avoid duplicate disclosures including business description, risk factors, accounting policies, litigation and other contingencies; and the manner of addressing immaterial items. (Note that both the FASB and SEC have issued guidance that indicates that requirements need not be applied to immaterial items. Many registrants are concerned that any omission will lead to SEC staff comments and potential amendments to filings. One possible approach would be a single footnote that briefly identifies disclosures omitted due to immateriality.)
- Summaries of significant accounting policies and discussions of newly implemented or soon to be implemented accounting policies should not include a detailed description of patently immaterial matters.
- Disclosures in the financial statements and elsewhere should make maximum use of tables and graphics and avoid the use of long textual discussions.
- The SEC should move forward with its *21st Century Disclosure Project* and should consider rulemaking to permit companies to omit or incorporate by reference information included in other filings that continue to be available on the company's or SEC Web site.
- The FASB should accelerate work on its Disclosure Framework project to establish a systemic approach to disclosure that properly balances disclosure considerations.
- Disclosure of risk factors should be limited to company-specific unique risks and should not recite the obvious risks of the general environment.

  **NOTE:** Risk factor disclosure in most periodic filings was observed to go much further than the rule, which made it difficult to determine factors that were truly matters for concern from those that were routine general risks. As a result of the volume of routine risk disclosures, readers are tempted to skim these factors and thus there is a greater chance that they will fail to read the uniquely risky factors.
- Both public and private companies should be permitted to omit interim period disclosures concerning financial statement items that have not substantially changed since the end of the prior fiscal year.
- The FASB and SEC should take various incremental procedures in consideration of cost-benefit analysis as a part of developing proposals for new accounting standards.

  **NOTE:** In particular, the respondents believe that the FASB should consider any new disclosure requirements from the context of the overall current disclosure environment rather than considering disclosure from the perspective of each individual topic as it is addressed in standards-setting. This macro disclosure consideration, together with more rigorous cost-benefit analysis and field testing of disclosures should be considered prospectively and retrospectively.

## STUDY QUESTIONS

**1.** Which of the following is correct as it relates to the current practice of determining financial statement materiality as noted in the report entitled, A Comprehensive Business Reporting Model?

**a.** Materiality is typically determined by the investor or other third party using some arbitrary threshold.

**b.** Materiality is typically measured using a statistical, computed threshold.

**c.** The materiality threshold should be based on what will affect investors' decisions and not upon preparers' arbitrary assessments.

**d.** Materiality should reflect only quantitative factors.

**2.** According to one study, if a company includes a disclosure in its notes, which of the following is correct?

**a.** That disclosure usually has a shelf life of one year before it is replaced.

**b.** It is rarely omitted from future financial statements or filings.

**c.** That disclosure begins as a quantitative disclosure and is converted to a qualitative one in either the second or third year.

**d.** If it is an SEC company, a regulator typically will make the company change the disclosure.

## ¶ 405 FASB STARTS UP FINANCIAL PERFORMANCE REPORTING PROJECT

In 2014, the FASB has announced that it was starting up its financial statement presentation project which stalled in 2011. The project was renamed *Financial Performance Reporting Project.*

The objective of the project is to evaluate ways to improve the relevance of information presented in the performance statement (income statement). The project will explore and evaluate improvements to the performance statement that would increase the understandability by presenting certain items that may affect the amount, timing, and uncertainty of an entity's cash flows.

In July 2010, the FASB staff issued *Staff Draft of an Exposure Draft on Financial Statement Presentation,* which reflected the FASB's and IASB's cumulative tentative decisions on financial statement presentation at that time.

Key proposed changes identified in the Staff Draft included:

- Financial statements would be functionalized and separated into *five main categories* as follows:
  - Business section
  - Financing section
  - Income taxes section
  - Discontinued operations section
  - Multi-category transaction section
- The indirect method of presenting the operating activities section of the statement of cash flows would be replaced by required use of the direct method.
- The use of the term *cash equivalents* would be eliminated in the statement of cash flows and statement of financial position and replaced with the term *cash*.
- The statement of comprehensive income would replace the statement of income.

In 2011, the financial statement presentation project was one of the top priorities at the FASB. But, given the importance of other projects, including revenue recognition, financial instruments, and leases, the financial statement project was taken off the FASB's docket.

The FASB announced it was bringing the financial statement project back to life under the name *Financial Performance Reporting Project*. The plan is to bring the project back as a re-scoping of a research project.

Although the project is in its infancy, the direction of the changes being considered is significant and would dramatically change the way in which financial statements are presented. Moreover, the scope of the project is supposed to include both public and non-public entities, alike.

The FASB has directed the FASB Staff to focus on the following two areas within the scope of the project:

- A framework for determining an operating performance metric
- Distinguishing between recurring and nonrecurring or infrequently occurring items within the performance statement.

In addition, the project will address potential related changes that may include the following areas:

- Additional disaggregation in the performance (income) statement
- Transparency of remeasurements
- Related changes to segment reporting
- Linkages across the primary statements

Changes in the financial statement format and presentation would have some obvious impacts as follows:

- The cost of such a change would be significant. Everything from textbooks to internal and external financial statement formats would have to be changed. The change to the direct method alone would be costly.
- There could be significant fluctuations in comprehensive income from year to year as more items are brought onto that statement than were not on the income statement before.
- Contract formulas for bonuses, joint ventures, etc. that are based on GAAP net income would have to be rewritten.
- Tax return M-1 reconciliations would differ.

**Project update:** At the January 20, 2016 FASB meeting, the project staff made a presentation of its research into the current practice of reporting functional and nature lines in the performance statement as well as considering how to disaggregate functional lines into certain nature components. This project is still in its infancy is will take several years to reach conclusion.

## STUDY QUESTIONS

**3.** Which of the following is ***not*** a category or subcategory of financial statements proposed under the financial performance reporting project?

**a.** Business section

**b.** Financing section

**c.** Income taxes section

**d.** Debt section

**4.** Which of the following is the FASB proposing would be the category of cash on the statement of cash flows?

**a.** Cash equivalents

**b.** Cash and cash equivalents

**c.** Cash only

**d.** Cash and short-term investments

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# ¶ 406 THE FOCUS ON CASH FLOW, WORKING CAPITAL AND OTHER FINANCIAL MEASUREMENTS

Furthering the scrutiny and mistrust of GAAP earnings, more analysts and investors are focusing on cash flow, working capital, and other financial measurements instead of accrual basis income in evaluating a company's financial performance. With the confusion over GAAP, third parties are focusing on other measures that they understand, such as cash flow.

Many analysts are using several key ratios and calculations that track cash flow and other financial measurements in relation to GAAP income. Those ratios and calculations are:

- Free Cash Flow
- Working Capital Ratios and Measurements
- Core Earnings

## Free Cash Flow

Free cash flow has become an important performance measurement used by financial analysts. Although the formula for free cash flow can vary, typically it is based on the ratio of free cash flow to common equity.

Free cash flow is just that—the amount of cash flow that is free for common shareholders after accounting for fixed commitments such as capital expenditures and preferred stock dividends.

The formula typically used for computing free cash flow is as follows:

| | |
|---|---|
| **Free Cash Flow:** | |
| Net income: | xx |
| Adjustments to reconcile net income to cash from operations: | |
| Depreciation and amortization | xx |
| Deferred income taxes | xx |
| Gain/loss on sale of assets | xx |
| Change in receivables | xx |
| Change in inventories | xx |
| Change in prepaid items | xx |
| Change in accounts payable and accrued expenses | xx |
| ***Net cash from operations (statement of cash flows)*** | ***xx*** |

| | |
|---|---|
| Less: Fixed items: | |
| Capital expenditures (net of dispositions) | (xx) |
| Preferred stock dividends | (xx) |
| ***Free cash flow*** | ***xx*** |

Free cash flow can be further adjusted to reflect certain non-recurring items such as cash paid for acquisitions (net of cash received from divestitures), and restructuring and severance costs. Some companies and third parties shift certain items that are included in the operating activities of the statement of cash flows to investing or financing activities, and vice versa.

Although more third parties and analysts are focusing on cash flow as a measurement that is equally important to GAAP accrual basis income, what is becoming clear is that there are no standards for computing cash flow. In fact, GAAP does not define any formulas for computing cash flow except those presented in the statement of cash flows by ASC 230, *Statement of Cash Flows,* such as those categorized in the operating, investing, and financing activities sections, along with cash from operations. Therefore, concepts such as free or adjusted free cash flow and other cash flow variations will continue to be subject to alteration and manipulation until standards are adopted by the FASB, SEC, or others.

## Free cash flow and non-cash investing and financial activities

In computing free cash flow, a deduction is made for property, plant, and equipment which are fixed obligations that must be incurred to feed continued growth. However, problems exist in calculating free cash flow when an entity has non-cash purchases of capital assets that are not displayed on the statement of cash flows. As a result, these non-cash items are typically not adjusted in arriving at free cash flows, thereby distorting the resulting free cash flow amount.

ASC 230, *Statement of Cash Flows*, requires that non-cash investing and financial activities be excluded from the statement of cash flows and, instead, be disclosed.

Examples of typical non-cash include:

- Purchase of equipment by issuance of a note
- Establishment of capital leases
- Conversion of debt to equity

In these transactions, no immediate cash is expended even though the entity is obligated under the transactions.

Companies can "play games" in increasing their free cash flow simply by changing the way in which they make capital expenditures.

**EXAMPLE:** Company X has the following statement of cash flows:

| | |
|---|---|
| Cash flow from operating activities | $2,000,000 |
| Cash flow from investing activities: | |
| Capital expenditures | (3,000,000) |
| Cash flow from financing activities | 3,000,000 |
| Increase in cash and cash equivalents | $2,000,000 |

| | |
|---|---|
| Free cash flow: | |
| Cash flow from operating activities | $2,000,000 |
| ***Capital expenditures*** | ***(3,000,000)*** |
| Free cash flow | $(1,000,000) |

Because the $3 million of capital expenditures was made in cash and presented on the statement of cash flows, the capital expenditures are deducted in computing free cash flow.

**Change the facts:** Assume the company purchases the capital expenditures with debt.

| | |
|---|---|
| Cash flow from operating activities | $2,000,000 |
| Cash flow from investing activities: | |
| Capital expenditures | ( 0) |
| Cash flow from financing activities | 3,000,000 |
| Increase in cash and cash equivalents | $5,000,000 |
| Supplementary disclosure: | |
| Company purchased $3,000,000 of equipment under a long-term debt obligation. | |
| Free cash flow: | |
| Cash flow from operating activities | $2,000,000 |
| ***Capital expenditures*** | ***( 0)*** |
| Free cash flow | $2,000,000 |

**Conclusion:** Free cash flow increases from $(1 million) to $2 million and does not reflect the non-cash capital expenditures of $3 million.

Note further that when the $3 million of debt related to the capital expenditure is paid down, the principal payments are shown in the financial activities section and do not impact the free cash flow computation. Thus, no part of the non-cash transaction impacts free cash flow.

> **OBSERVATION:** The previous analysis exposes the loophole that exists when an entity finances its capital expenditures. Under ASC 230, the expenditures are treated as a non-cash transaction which is disclosed and not presented in the body of the statement of cash flows. In disclosing the non-cash transaction, the capital expenditure is not deducted in computing free cash flow. Moreover, when the debt is repaid over time, the cash paid toward principal payments will be presented in the financing activities section and has no impact on free cash flow. The result is that none of the cash associated with the purchase of the capital expenditures is deducted in computing free cash flow. In the previous example, none of the $3,000,000 of capital expenditures ever impacts free cash flow.

## Does it matter what type of non-cash capital expenditure transaction is made?

There is a difference between how a capital expenditure is financed and its impact on free cash flow.

Consider the following three transactions:

- Equipment is purchased through accounts payable that is outstanding at year end.
- Equipment is leased through a capital lease.
- Equipment is purchased through long-term debt.

Under all three transactions, the equipment purchased is presented as a supplementary non-cash disclosure and is not deducted in computing free cash flow. Thus, there is no fundamental difference on the front end of the transaction. However, the back end of the transactions differs profoundly.

When equipment is purchased through accounts payable, there is ultimately an impact on free cash flow. When the accounts payable is paid in the following period, the change in accounts payable is an adjustment to cash from operating activities, thereby affecting free cash flows. Thus, purchasing equipment with accounts payable does, in fact, ultimately result in the cash flow impacting free cash flow.

As for equipment purchased with long-term debt, or leased through a capital lease, there is no impact on free cash flows. That is, the capital expenditure related to the equipment purchase never impacts free cash flow. The reason is because when the long-term debt or capital lease obligation is repaid over time or in lump sum, the repayment is presented in the financing activities section of the statement of cash flows and does not impact free cash flow.

## Georgia Tech Financial Analysis Lab Study

A study was published by Georgia Tech Financial Analysis Lab entitled *Non-cash Investing and Financial Activities and Free Cash Flow*. The purpose of this Study was to consider the effect of companies that do not deduct non-cash capital expenditures in computing free cash flow.

The result is summarized in the following chart:

**Free Cash Flow – Adjustments for Non-Cash Capital Expenditures**

| Company | Operating cash flows | Capital expend. | Free cash flows, as reported | Non-cash capital Expend* | Adjusted FCF | % change in FCF |
|---|---|---|---|---|---|---|
| Safeway | $1,609,000 | $(795,000) | $814,000 | $(113,000) | $701,000 | (14%) |
| Williams-Sonoma | 209,000 | (211,000) | (2,000) | (1,000) | (3,000) | (50%) |
| Albertson's | 1,545,000 | (1,022,000) | 523,000 | $(62,000) | 461,000 | (12%) |
| Pathmark Stores | 90,000 | (51,000) | 39,000 | (10,000) | 29,000 | (26%) |
| Maxwell Tech | 150,000 | (95,000) | 55,000 | (18,000) | 37,000 | (33%) |
| Flowers Foods | 88,000 | (44,000) | 44,000 | (55,000) | (11,000) | (125%) |
| BJ's Wholesale | 200,000 | (177,000) | 23,000 | (4,000) | 19,000 | (17%) |
| Plastipak Holdings | 75,000 | (99,000) | (24,000) | (7,000) | (31,000) | (29%) |

**Free Cash Flow – Adjustments for Non-Cash Capital Expenditures**

| Company | Operating cash flows | Capital expend. | Free cash flows, as reported | Non-cash capital Expend* | Adjusted FCF | % change in FCF |
|---|---|---|---|---|---|---|

* Non-cash expenditures presented as supplementary disclosure and not presented on the face of the statement of cash flows.

**Source:** *Non-cash Investing and Financing Activities and Free Cash Flow*, Georgia Tech College of Management, as modified by the author.

The Study illustrates that many companies are distorting their published free cash flows by not reflecting non-cash capital expenditures in the computation of free cash flows. For example, Safeway's operating cash flows are $1,609,000 while adjusted free cash flow (FCF) is only $701,000.

Because free cash flow is not based on GAAP income, no standards exist that require companies to adjust their free cash flow to include the adjustment for non-cash capital expenditures.

## Free cash flow and incentive compensation

Due to the increase in the importance of free cash flow in analyzing financial performance, some companies tie their incentive compensation plans into free cash flow.

Most valuation models suggest that an increase in free cash flow ultimately translates directly into increases in stock price. Consequently, linking compensation plans to free cash flow is essentially the same as providing a nexus between income and compensation.

The following companies are a sample of those that have reflected free cash flow into their incentive compensation calculations:

| **Company** | **Basis for compensation plan** |
|---|---|
| American Standards | Sales, earnings, free cash flow, etc. |
| Bausch & Lomb | Sales, earnings, free cash flow, etc. |
| Kraft Foods | Income growth, volume growth, free cash flow, etc. |
| Motorola | Operating earnings and free cash flow |
| Tyco | EBIT and segment free cash flow |

**Source:** *Free Cash Flow and Compensation: A Fashionable Fad or Something More?* Georgia Tech College of Management.

Other companies, such as Newell, Washington Post, Weyerhauser, General Electric, and Comcast, included some form of cash flow in their incentive compensation formulas, but did not specifically mention free cash flow.

## Working Capital

All working capital ultimately leads to cash. In evaluating cash flow of a company, it is important to look at the flow of individual working capital components, namely trade receivables, inventories, and trade payables.

Four key ratios provide a thorough analysis of working capital. They are:

$$\text{Days Sales in Accounts Receivable} = \frac{\text{Trade receivables*}}{\text{Net sales}} \times 365$$

| | | | | |
|---|---|---|---|---|
| Days Supply in Inventory | = | Inventory* / Cost of goods sold** | X | 365 |
| Days Payables Outstanding | = | Accounts payable* / Cost of goods sold** | X | 365 |
| Days in Working Capital | = | AR + Inventory – AP* / Net sales | X | 365 |

* Average numbers can also be used (beginning + ending balances/2).

** Purchases can also be used in place of cost of goods sold.

*** Another variation is to include purchases and cash operating expenses in the denominator.

Each of these above working capital ratios should be compared with the *best possible ratio*.

> **EXAMPLE:** If credit terms to customers are 30 days, and the number of days' sales in receivables is 49 days, there is a 19-day spread between the best possible ratio (30 days) and the actual ratio (49 days).

## How important is working capital to analysts and investors in their evaluation of a company?

The cost of tying up cash due to ineffective working capital management can be significant. Because working capital flow ultimately leads to cash flow, analysts pay great attention to it as a measure of financial performance. In turn, companies are responding by increasing their focus on working capital management, particularly at year-end.

A study performed by REL Consulting Group that was published by CFO Magazine suggests that:

- Working capital is so important to third-party financial statement users that companies have stepped up their effort to manage their working capital at year end through window dressing.
- One of the easiest ways to improve cash flow is to reduce the number of days in net working capital.

In the Study, REL performed working capital analysis on numerous companies in the fourth quarter versus the following first quarter of the past three years to determine if there was manipulation of working capital at year end.

The results were as follows:

- There is a widespread pattern across industries that net working capital drops dramatically in the fourth quarter of the fiscal year, and dramatically increases in the following first quarter once the annual report has been published.
- U.S. companies tend to leave too much "housekeeping" of their working capital to year end in terms of writing off bad debts and discarding obsolete inventory.
- Companies continue to reward executives based on operating income and not working capital management. The interest cost of holding excess working capital is not reflected in operating income.

**OBSERVATION:** The result of the survey suggests that management takes actions to reduce its working capital position at year end to maximize its cash position. Once year-end financial statements are issued, net working capital increases back to its normal level.

## 2015 REL Consulting Group Study

In 2015, a study on working capital (2015 U.S. Working Capital Survey, REL Consulting (The Hackett Group)) was published that assessed the working capital performance of the largest 967 U S. companies (based on sales) during the years 2005 to 2014. (2015 information has not been published.) The Study concludes that U.S. companies' working capital position is flat at about 33 days of working capital outstanding. There is about $1 trillion of excess working capital, which is defined as nothing more than excess cash tied up in working capital due to inefficiency in working capital management. (For purposes of the study, net working capital is defined as trade receivables plus inventory less trade payables.)

Following is a summary of the change in working capital from 2013 to 2014 (2015 data was not available at the time of publication):

| **2014 results: [967 Largest U.S. Companies]** | **2014** | **2013** | **Change in net WC** | **% change** |
|---|---|---|---|---|
| Days in receivables | 36 | 36 | (0) | |
| Days in inventory | 43 | 43 | (0) | |
| Days in payables | (46) | (46) | (0) | |
| Days in net working capital | 33 | 33 | (0) | 0% |
| % change 2014 vs. 2013 | 0% | | | |
| % change 2013 vs. 2012 | 0% | | | |
| % change 2012 vs. 2011 | (3.0%) | | | |
| % change 2011 vs. 2010 | (3.0%) | | | |
| % change 2010 vs. 2009 | (3.0%) | | | |
| % change 2009 vs. 2008 | 8.0% | | | |
| % change 2008 vs. 2007 | (6.0%) | | | |
| % change 2007 vs. 2006 | (1.0%) | | | |
| % change 2006 vs. 2005 | (2.0%) | | | |

Specific conclusions reached by the study include (2015 U.S. Working Capital Survey, REL Consulting (The Hackett Group):

- Companies are cash rich with cash positions increasing by 74 percent from 2013 to 2014 to an aggregate cash balance of about $932 billion.
- The ability to raise cash through cheap debt has reduced companies' incentive to release cash tied up in working capital. At the end of 2014, the top 967 U. S. companies had $1 trillion unnecessarily tied up in excess working capital, representing about six percent of U.S. GDP.
- Days in working capital hovering between 39 and 33 days from 2009 to 2014.

**NOTE:** In 2008, at the peak of the economy before the downturn, the number of days in net working capital was 35 days. From 2008 to 2010, net working capital increased significantly due primarily to the poor economy. In 2011 through 2014, the number of days in working capital became stable and ultimately settled at 33 days at the end of 2014.

- Days in working capital improved slightly declining from 38 days in 2010 to 33 in 2014.

Prior to 2009, there had been continued effort by U.S. companies to reduce net working capital by implementing efficient systems to manage their working capital. In particular, there had been improvement in managing inventory as companies no longer stock piled inventories and were able to better match inventory supplies with product demand due to efficiencies in the supply chain. When the U.S. economy declined, those entities were able to effectively shave their inventory supply down to match lower demand. A similar situation occurred with manufacturing labor whereby entities were able to better match their labor supply with manufacturing demand. In doing so, there was little "fat" existing in the manufacturing labor resulting in a challenge for those same companies to find further cuts in their manufacturing labor. In essence, during the strong economic years of the early-to-mid 2000s, those entities had already implemented efficient cost cuts to the extent that there was no significant room for improvement.

To no surprise, with the deteriorated economy in 2009, the number of days' sales in receivables increased from 35 days in 2008 to 39 in 2009, and ultimately came down and leveled off at 36 days in 2014. Once published, 2015 days sales in receivables is expected to be the same as 2014.

Another interesting statistic is that the top 1,000 U.S. companies continue to have cash tied up in excess working capital which was estimated at $1 trillion at the end of 2014. This excess working capital curtails companies from being able to expand and requires them to seek liquidity from outside sources. This cost of inefficient working capital is significant. Consider the cost of capital required to replace $1 trillion of excess working capital.

Given the tight financial markets, companies need to manage their working capital as they must gather additional net cash to subsidize the potential financing shortfall. With financing difficult to obtain or expand, the least expensive and available alternative is to squeeze the missing portion of required financing out of net working capital by reducing inventories, coercing or incentivizing customers to pay earlier, and by stretching payables.

## Measuring Collections of Receivables

Historically, companies have used the number of days sales outstanding (DSO) as the primary gauge of credit-collection efficiency in connection with trade receivables.

As a reminder, DSO is calculated as follows:

$$\text{Days Sales in Accounts Receivable} = \frac{\text{Last three months ending total trade receivables}}{\text{Net sales for the quarter}} \times 30$$

Although DSO is typically useful in following trends in collections, it is not necessarily the only measure that should be used. In particular, it is effective to look at both DSO and average days delinquent (ADD). ADD reflects the average number of days' invoices that are past due and is based on the following formula:

ADD = DSO – Best Possible DSO

Best Possible DSO expresses the best possible level of receivables under the most favorable conditions, with no delinquencies.

| | | | | |
|---|---|---|---|---|
| Best possible days sales outstanding in accounts receivable (BPDSO) | = | Last three months ending current portion of trade receivables / Net sales for the quarter | X | 30 |

**EXAMPLE 1:** Assume the following facts:

DSO = 45 days

Best possible DSO = 35 days

ADD = 45- 35 = 10 days

The ADD result means that customers were on average 10 days past due on their receivable balances.

**EXAMPLE 2:** Assume the following facts:

At December 31, 20X1, accounts receivable consists of the following:

| **AR at December 31, 20X1:** | **October 31** | **November 30** | **December 31** | **Three-month Total** |
|---|---|---|---|---|
| Current | $700,000 | $650,000 | $750,000 | $2,100,000 |
| 31-60 | 200,000 | 150,000 | 100,000 | 450,000 |
| 61-90 | 125,000 | 75,000 | 100,000 | 300,000 |
| More than 90 | 60,000 | 50,000 | 40,000 | 150,000 |
| | $1,085,000 | $925,000 | $990,000 | $3,000,000 |

Net sales are $2 million for the fourth quarter 20X1.

| | | | | |
|---|---|---|---|---|
| DSO | = | 1,085,000 + 925,000 + 990,000 / 2,000,000 | X | 30 = 45 days |

DSO =45 days

| | | | | |
|---|---|---|---|---|
| Best possible DSO | = | 700,000 + 650,000 + 750,000 / 2,000,000 | X | 30 = 32 days |

Best possible DSO = 32 days

| | |
|---|---|
| DSO | 45 |
| Best possible DSO | 32 |
| Average days delinquent (ADD) | 13 |

**Conclusion:** The ADD is 13 days which means that customers were 13 days late on paying their receivables.

## DSO and ADD can move in different directions

There are instances in which DSO and ADD can move in different directions for reasons other than efficiency of collections.

**EXAMPLE:** Assume the following:

| | 20X1 | 20X2 |
|---|---|---|
| DSO | 45 | 42 |
| Best possible DSO | 35 | 30 |
| ADD | 10 | 12 |

**Conclusion:** This is an example where DSO declines while ADD increases. When this occurs, the decline in DSO is likely to be due to factors other than collection efficiency.

The fact that the Best Possible DSO declined may be a result of several factors not related to collection efficiency such as:

- Changes in the receivable terms from net 35 to net 30
- Instituting an effective discount program such as changing from one percent to two percent discount in 10 days
- Eliminating confusion and smoothing order processing procedures to shorten the receivables cycle
- Tightening up sales personnel's willingness to extend payment terms to special customers
- Adopting stricter policies for receivable payment given up front as a result of changes from Sarbanes-Oxley

In this example, the company's collection efforts have actually deteriorated from 20X1 to 20X2 even though DSO has declined from 45 to 42 days. The benchmark for perfect collections is Best Possible DSO which has declined from 35 to 30 days due to a change in the payment terms from net 35 to net 30. Thus, one would expect that DSO would decline by at least five days (from 45 to 40) just to retain the same level of collection quality in 20X2 versus 20X1. Yet this result did not occur as DSO declined by only three days (45 to 42 days) and ADD increased from 10 to 12 days.

**OBSERVATION:** Because most companies and their accountants and auditors typically use DSO as the only benchmark for collection efficiency, they are looking at a result that does not benchmark DSO against Best Possible DSO. Failure to do so means that a company's collection efficiency may actually be deteriorating even though DSO is declining. It is important that companies start using DSO and ADD in evaluating receivables collections.

## What is the Financial Cost of Having ADD?

Average Days Delinquent (ADD) means there is capital tied up in receivable balances and a related carrying cost thereto. To assist employees in understanding the cost associated with having too high of an ADD, a company can translate the cost into a lost opportunity cost as follows:

**EXAMPLE:** Company X has the following monthly receivables information for 20X9:

| Month | AR Balance | DSO | Best DSO* | ADD | % ADD/ DSO | ADD portion of AR |
|---|---|---|---|---|---|---|
| | (A) | | | | (B) | (A x B) |
| January 1 | $4,000,000 | 42 | 27 | 15 | 36% | $1,429,000 |
| January 31 | 4,200,000 | 44 | 29 | 15 | 34% | 1,431,000 |
| February 28 | 4,400,000 | 46 | 30 | 16 | 35% | 1,530,000 |
| March 31 | 4,500,000 | 45 | 29 | 14 | 31% | 1,400,000 |
| April 30 | 4,400,000 | 41 | 28 | 13 | 32% | 1,395,000 |
| May 31 | 4,500,000 | 39 | 27 | 12 | 31% | 1,385,000 |
| June 30 | 4,700,000 | 46 | 29 | 17 | 37% | 1,737,000 |
| July 31 | 4,900,000 | 48 | 30 | 18 | 38% | 1,838,000 |
| August 31 | 3,800,000 | 45 | 29 | 16 | 36% | 1,351,000 |
| September 30 | 4,300,000 | 43 | 28 | 15 | 35% | 1,500,000 |
| October 31 | 4,100,000 | 42 | 28 | 14 | 33% | 1,367,000 |
| November 30 | 3,900,000 | 39 | 26 | 13 | 33% | 1,300,000 |
| December 31 | 4,200,000 | 41 | 27 | 14 | 34% | 1,434,000 |
| **Average** | **$4,300,000** | | | | | **$1,469,000** |

* Number of days in Best DSO is computed using the current portion of receivables off the month's AR aging. Typically, Best DSO will be less than the net terms (e.g., 30 days) due to incentive discounts such 2/10, net 30.

Assume further that the Company borrows on its working capital line of credit at an average rate of five percent in 20X9.

**Conclusion:** On average, the Company has $1,469,000 of excess receivables outstanding which represents that portion of receivables (ADD) in excess of the best possible balance outstanding. The result is that the excess receivables of $1,469,000 costs the company the following in additional interest costs for 20X9.

$1,469,000 x 5% = $73,450 additional interest cost

**OBSERVATION:** Obviously, no company can achieve the Best Possible DSO level of receivables. Therefore, a company can build in a tolerable error that is given to the collections department and by which its performance is evaluated such as the following:

| Acceptable receivables level | |
|---|---|
| Best possible DSO: | |
| Net 30 terms | 30 |
| Effect of discounts | (2) |
| Best possible DSO | 28 |
| Acceptable ADD | 7 |
| Acceptable DSO | 35 |

## STUDY QUESTIONS

5. Which of the following does ***not*** ultimately impact free cash flow?
   - **a.** Collection of receivables
   - **b.** Purchasing equipment through long-term debt
   - **c.** Purchasing equipment with accounts payable outstanding at year end
   - **d.** Payment of preferred stock dividends
6. The following formula is entitled ________________:

$$\frac{AR + Inventory - AP}{Net\ sales} \times 365$$

   - **a.** Days supply in inventory
   - **b.** Days payable outstanding
   - **c.** Days in working capital
   - **d.** Days left in the sales cycle
7. One study indicated that at the end of 2014, U.S. companies ________________.
   - **a.** Had very little excess working capital
   - **b.** Had about $1 trillion tied up in excess working capital
   - **c.** Had fewer days outstanding in accounts payable versus accounts receivable
   - **d.** Had days in working capital increase from 2009 to 2014

# ¶ 407 WORKING CAPITAL MANAGEMENT

## Are There Signs that a Company has Poor Working Capital Management?

A report entitled *Improving Shareholder Value Through Total Working Capital*, by REL Consulting Group, emphasizes the importance of working capital management and the fact that analysts and investors need to evaluate the working capital efficiencies of the companies in which they have an interest.

In the Report, REL identifies symptoms that exist in companies with poor working capital management techniques. The following chart identifies those symptoms:

**Symptoms of Inefficiently Managed Working Capital**

**Trade receivables:**

- Bad debts are increasing.
- Past due receivables (e.g., 90 days or older) are increasing.
- The company is unable to collect the majority of past due amounts due to customer complaints.
- Customers are paying short due to quality issues.
- The company has imposed credit sanctions on its customers.
- The predictability of the company's cash flow forecast is deteriorating.

**Symptoms of Inefficiently Managed Working Capital**

- The company requires additional staff to process a backlog of unprocessed invoices.
- Receivables are growing disproportionately to sales.
- Receivables staff morale is deteriorating due to being overworked and making collections calls.
- The company has delays in closing the month-end due to billing problems.
- The company has month-end pressure to get as much sales and cash as possible.
- Number of days in payables is lower than the number of days in receivables.

**Inventories:**

- The company does not have detailed information of all inventories located at all points at the same time.
- The company does not know the amount of its product that is being held by its top 10 customers.
- The company does not know how much inventory it holds from its top 10 suppliers.
- Customer service levels are low.
- Sales and productions managers argue over product flexibility or availability.
- The company is increasing its "safety stocks" in response to unreliable sources of supply and inter-company production.
- The warehouse is running out of space despite flat or lower sales.
- Inventory obsolescence and writeoffs are increasing.
- The company's distribution network and its replenishment strategy have resulted in stocking the same slow-moving items in various warehouses.
- Discontinued items clutter storerooms, warehouses, and the balance sheet.

**Payables:**

- Interest payments to suppliers are increasing.
- Payment disputes are increasing.
- The company has a payment run each day or quite frequently.
- The supplier list has expanded.
- The same supplier delivers to different sites based on different terms.
- There is no payment term "floor" that represents the minimum terms the purchasing department should obtain.
- The company does not have an authorization procedure that demands approval for non-standard terms.
- Vendors have imposed credit sanctions on the company.
- Many of the non-cost-of-goods purchases are made outside the formal purchasing system.
- ***Purchase discounts have declined (emphasized)***

**Source:** *Improving Shareholder Value Through Total Working Capital™ Management*, REL Consultancy Group

## The Push Toward Holding Management Accountable for Working Capital Management

There is certainly a disconnect between profitability and working capital. Yet, the two are quite interrelated. Efficient working capital management can significantly improve not only cash flow but also profitability in several ways:

- Excess cash from efficient cash flow management can be used to pay down debt and, in turn, minimize interest expense.
- Efficient trade receivable collection procedures can minimize bad debts.
- Efficient inventory management can reduce the amount of obsolescence.
- Excess cash generated from trade receivable and inventory management can allow a company to maximize purchase discounts.

Recently, companies have started considering cash flow/working capital management as a benchmark component used to compute management compensation.

One example is General Electric (GE) that uses performance share units (PSUs) to compute equity compensation in lieu of stock options. GE executives are given PSUs that vest in five years provided cash from operating activities increases at least 10 percent per year during the five-year period. Thus, GE, like other companies, links compensation to cash/working capital management (*Compensation and Cash Flow*-CFO.com).

Some of the practices that companies can implement to create a long-term working capital management program include (*U. S. Working Capital Survey,* REL):

- Make cash flow improvement a strategic priority with visible senior management backing.
- Link cash flow performance and working capital management to compensation structure.
- Make cash flow one of the key metrics for performance management within operations and finance.
- Focus on lead time compression and increasing manufacturing flexibility.
- Standardize customer and supplier payment terms and control exceptions through an escalation process.
- Segregate customers and suppliers based on value and risk to support.
- Automate and eliminate high-volume, low-margin transactions to free up resources.

As suggested in the previous list of recommendations, cash flow and working capital management is becoming a key factor in compensation:

- More companies are using cash flow factors from the statement of cash flows to reward management rather than using only the statement of income.
- Many of the largest U.S.-based, publicly held companies use a cash-flow measurement to calculate short-term compensation, with the percentage continuing to rise.
- Cash flow/working capital management allows the company to focus on the balance sheet rather than the income statement.
- Corporate boards are motivated to use cash flow because GAAP income, EPS, and revenue are subject to management's manipulation.

- With the FASB change to expensing stock options, companies have shied away from stock options as a form of compensation.
- Some companies are using a blend of factors in their executive compensation bonus plans, such as 50 percent of bonuses based on the income statement and 50 percent based on cash flow/working capital management.

## Core Earnings

As a follow up to the FASB's financial reporting project, Standard & Poor's led the way in publishing performance data on the S&P 500 using a benchmark other than net income. More than one decade ago, Standard & Poor's created a research project with a goal of developing a standard measurement that would most effectively measure operating earnings, without the distortions on net income created by GAAP. The results of the research project were published in *Measures of Corporate Earnings (*Report published by Standard & Poor's).

The formula for core earnings used by S&P follows:

**Computation of the S&P's Core Earnings** (*Measures of Corporate Earnings,* Standard & Poor)

| | |
|---|---|
| Net income | $XX |
| Exclude: | |
| Non-recurring items: | |
| Discontinued operations | XX |
| Extraordinary items | XX |
| ***As reported income (used for EPS)*** | ***XX*** |
| ***Exclude:*** | |
| Goodwill impairment charges (1) | XX |
| Gains/losses from asset sales (2) | XX |
| Reversal of prior-year charges and provisions (5) | XX |
| Merger/acquisition related expenses (2) | XX |
| Litigation/insurance settlements and proceeds (2) | XX |
| ***Include:*** | |
| Employee stock option grant expense (3) | (XX) |
| Pension costs (4) | (XX) |
| ***Core earnings*** | ***$XX*** |

(1) Goodwill impairment charges are non-recurring items that do not result in the generation of period revenue.

(2) Non-recurring items are excluded from core earnings such as gains/losses from asset sales, merger and acquisition expenses, and litigation/insurance settlements and proceeds.

(3) Stock options expense is recorded using external fair value method, rather than intrinsic method.

(4) Pension costs on defined benefit plans are adjusted to compute cost based on actual investment returns instead of expected returns.

(5) There is a reversal into income of portions of restructuring charges and other provisions booked in prior periods.

Standard & Poor calculates and reports core earnings on U. S. equities, including the S&P 500.

## What is the impact of publishing core earnings for the S&P 500?

In general, there continues to be a significant difference between reported GAAP operating earnings per share and core EPS, with particular differences resulting from stock options, pensions, and goodwill amortization.

Historically, the percentage of core EPS to operating EPS for the S&P 500 ranged from 80 to 92 percent from 2003 to 2015 (S&P published core earnings per share, 2003-2015). Entities that have high quality earnings typically have a relatively high percentage of core earnings to operating earnings, which is conclusive that most of the earnings are convertible into cash and not merely a function of manipulation of GAAP. Conversely, a ratio of a company's core earnings to GAAP operating earnings that is less than 80 percent may indicate that the quality of earnings is poor and that GAAP income is not fully convertible into cash.

## STUDY QUESTIONS

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**8.** The REL report, Improving Shareholder Value Through Total Working Capital, identified what symptom that exists in companies with poor working capital management techniques?

**a.** Inventory obsolescence is decreasing.

**b.** Past due receivables are decreasing.

**c.** Suppliers deliver to other sites based on similar terms.

**d.** Vendors have imposed credit sanctions on the company.

**9.** How can working capital management significantly improve cash flow and profitability?

**a.** Efficient accounts payable procedures can minimize bad debts.

**b.** Efficient inventory management can increase obsolescence.

**c.** Excess cash from efficient cash flow management can be used to establish more accounts.

**d.** Excess cash generated can allow a company to maximize purchase discounts.

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# MODULE 2: FINANCIAL STATEMENT REPORTING—CHAPTER 5: Consolidation Analysis

## ¶ 501 WELCOME

This chapter provides an overview of the consolidation guidance prescribed within ASC 810 along with the significant amendments to the guidance from ASU 2015-02. This includes an in-depth analysis of five specific areas where ASU 2015-02 made specific amendments to the consolidations guidance along with illustrative examples.

## ¶ 502 LEARNING OBJECTIVES

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Upon completion of this chapter, you will be able to:

- Recognize a key aspect of a VIE
- Recall situations in which use of combined statements is useful and not useful
- Identify when a limited partner has a controlling financial interest in a limited partnership under the voting interest model per ASU 2015-02
- Recognize a key change to the consolidation model made by ASU 2015-02 with respect to a general partner of a limited partnership
- Identify some of the rights a noncontrolling limited partner might have in a limited partnership

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## ¶ 503 INTRODUCTION

The objective of ASU 2015-02, issued in February 2015, is to provide guidance as to the accounting for consolidation of certain legal entities. The amendments are effective for public business entities for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2015. For all other entities, the ASU is effective for fiscal years beginning after December 15, 2016, and for interim periods within fiscal years beginning after December 15, 2017. Early adoption is permitted, including adoption in an interim period.

## ¶ 504 OVERVIEW OF EXISTING GAAP RULES FOR INVESTMENTS AND CONSOLIDATIONS

This section summarizes the existing (pre-ASU 2015-02) general accounting rules for investments and consolidations. The accounting for investments is generally based on the percentage ownership of the voting interest that one entity holds in another entity. The three tiers of ownership and the accounting rules related to each are summarized as follows:

| Ownership level | General accounting treatment |
|---|---|
| 1. Ownership of less than 20 percent of the voting shares | Investment recorded at cost or fair value depending on whether the investment is a security or non-security |
| 2. Ownership of 20-50 percent of the voting shares or when one entity has *significant influence* over another entity | Use the equity method |
| 3. Ownership of more than 50 percent of the voting shares | Consolidate the entities (controlling financial interest) |

In addition to the above, the following chart summarizes the accounting treatment in greater detail for all three tiers.

GAAP for Investments

| Ownership of voting stock | Accounting Treatment |
|---|---|
| **TIER 1: Less than 20 percent ownership (**In January 2016, the FASB issued ASU 2016-01, *Financial Instruments—Overall (Subtopic 825-10) Recognition and Measurement of Financial Assets and Financial Liabilities*, which changes the accounting for certain equity investments. The ASU is effective for 2018 for public entities, and 2019 for non-public entities. The changes made in ASU 2016-01 are not reflected in this chapter due to the delayed effective date.) | |
| a. Non-securities—closely held investments | ASC 210 — Investments recorded at amortized cost. A write-down is made to lower of cost or fair value if a loss is other than temporary (permanent) |
| b. Securities- debt or equity- placed into three categories: | ASC 320 — Securities are recorded at fair value or cost based on three investment categories: |
| | 1. *Held to maturity securities*— Recorded at amortized cost |
| | 2. *Trading securities*— Recorded at fair value—gain/loss presented on the income statement |
| | 3. *Available-for-sale securities*— Recorded at fair value-gain/loss presented in stockholders' equity, net of taxes (other comprehensive income) |
| **TIER 2: 20-50 percent or significant influence** | ASC 323–Use the equity method |
| **TIER 3: Consolidation or Combined Financial Statements** | |
| a. Consolidation based on more than 50 percent ownership of voting stock | ASC 810—Consolidate in all cases |
| b. Exceptions where consolidation is based on other than ownership | Four exceptions to the more than-50-percent consolidation rules—Consolidate even if more-than-50 percent ownership threshold is not met: |
| [controlling financial interest] | 1. Entities controlled by contract |
| | 2. General partner that controls a limited partnership |
| | 3. Miscellaneous transactions involving research and development arrangements and rabbi trusts |
| | 4. Variable interest entities (VIEs) |
| c. Combined financial statements | Option to combine financial statements of two or more entities when it is more meaningful to do so. |

Following this section, this chapter author focuses only on Tier 3 of the ownership hierarchy, involving consolidation.

# ¶ 505 CONSOLIDATIONS AND COMBINED STATEMENTS

The overall rules for consolidations are found in ASC 810, Consolidation. ASC 810 states that "there is a presumption that consolidated statements are more meaningful than separate statements . . . " In general, ASC 810 requires the consolidation of all majority-owned subsidiaries; that is, a situation in which one entity has a controlling financial interest (through ownership of more than 50 percent voting shares) in another entity.

## Exceptions to the CHAPTER More Than-50-Percent Ownership Test

Under existing GAAP (pre ASU 2015-02), the general rule is that consolidation is required when one entity has a controlling financial interest in another entity through owning more than 50 percent of that entity's voting stock. For tax purposes, consolidation generally occurs when an 80 percent or more ownership threshold is met. Although more-than-50 percent ownership is the minimum threshold for consolidation, existing GAAP provides four exceptions as noted in the table above. In such cases, an entity has a controlling financial interest through other than ownership.

## Exception 1: Entities Controlled by Contract

ASC 810-10-15 provides an exception to the more-than-50 percent ownership threshold. Specifically, there are situations in which one entity controls another through a contractual management agreement without having ownership of a majority of the outstanding voting equity. The most common example of this arrangement is found in the medical field in which a physician practice (PP) engages in a contract with a physician practice management entity (PPME) for the PPME to manage the PP. In such cases, it is typical for the PPME to control the PP but have no ownership in the practice. In such circumstances, the PPME should consolidate with the physician's practice.

In particular, ASC 810-10-15 applies to contractual management arrangements with both of the following characteristics:

- Relationships between more than one physician practices (PP) that operate in the health care industry including the practices of medicine, dentistry, veterinary science, and chiropractic medicine
- Relationships in which the PPME does not own the majority of the outstanding voting equity of the physician practices either because the PPME is precluded by law from owning the equity, or because the PPME has elected not to own the equity

If the following criteria are met, the PPME has a controlling financial interest in the PP and should consolidate the PP:

1. The contractual arrangement a) has a term that is either the entire remaining legal life of the physician practice entity or a period of 10 years or more, and b) is not terminable by the physician practice except in cases of gross negligence, fraud, other illegal acts, or bankruptcy by the PPME.
2. The PPME has exclusive authority over all decision making involving the practice operations and compensation of the medical professionals.
3. The PPME must have a significant (but not necessarily majority) financial interest in the physician practice that meets certain criteria.

**COMMENT:** ASC 810-10-15 states that the guidance for entities controlled can be used in other industries and similar circumstances. The conclusion suggests that in other circumstances in which control is determined by a contract other than ownership, entities may consolidate. However, the guidance should not be taken out of context. Because ASC 810-10-15 gives no examples of where circumstances would be considered "similar," it may not be prudent to apply a control standard that is measured on other-than majority ownership (e.g., more than 50 percent ownership).

## Exception 2: General Partner in a Limited Partnership

ASC 810 applies to general partners in limited partnerships or similar entities (such as limited liability companies that have governing provisions that are the functional equivalent of a limited partnership) that are not variable interest entities (VIEs) under FIN 46R. The general rules follow:

- A general partner (GP) that controls a limited partnership should consolidate the partnership into its financial statements.
- There is a presumption that general partners control a limited partnership regardless of the extent of the general partners' ownership interest in the limited partnership.
- The presumption that general partners control a partnership is overcome (the general partners do not control the limited partnership) if the limited partners have either:

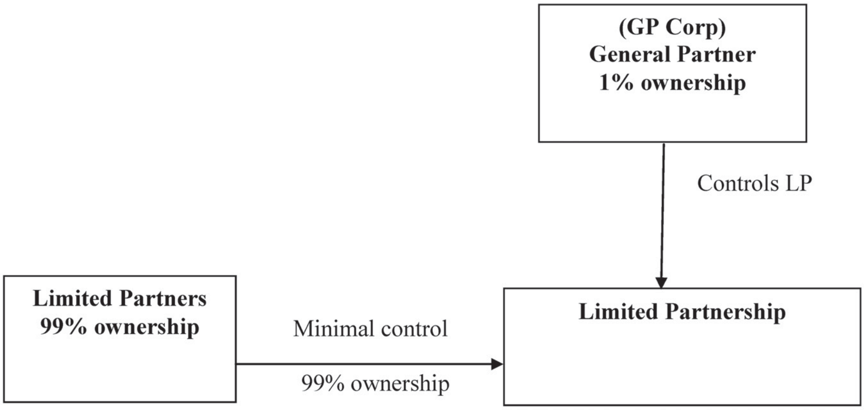
  - Substantive kick-out rights: The substantive ability to dissolve (liquidate) the limited partnership or otherwise remove the general partners without cause

  - Substantive participating rights: The ability to effectively participate in certain actions of the limited partnership

**COMMENT:** Protective rights that would allow the limited partners to block partnership actions (e.g., amendments to the agreement, pricing on transactions, liquidation of the partnership, or acquisitions and dispositions of assets) would be considered protective (rather than participating) rights and would not overcome the presumption of control by the general partners. A limited partner's unilateral right to withdraw from the partnership in whole or in part (withdrawal right) that does not require dissolution or liquidation of the entire limited partnership would not overcome the presumption that the general partners control the limited partnership.

**EXAMPLE:** Assume that a general partner (GP Corp) controls a real estate limited partnership, yet owns only one percent of the limited partnership. The remaining 99 percent is owned by the limited partners who have minimal control over the limited partnership. Further, there are no restrictions on the general partner and the limited partners do not have the right to remove the general partner unless there is proven fraud.

The ownership structure looks like this:




**Conclusion**

Under existing GAAP, the GP would consolidate with the limited partnership even though it has only one percent ownership. This conclusion is based on the fact that the general partner controls the partnership with minimal restrictions on that control.

However, consider if the partnership agreement restricts certain rights of the general partner by giving those rights to the limited partners. Those restrictive rights include the right to replace the general partner by a super-majority vote, approval required for the sale of assets, and refinancing or acquisition of principal assets. In this situation, because the general partner's control is restricted by additional rights given to the limited partners, the general partner would not consolidate with the limited partnership.

## Exception 3: Miscellaneous Transactions Involving Research and Development Arrangements and Rabbi Trusts

Another exception under which an entity should consolidate another entity even though there is no majority ownership among the entities is in the case where there is a research and development arrangement among the entities. The other is in circumstances in which an employer should consolidate into its financial statements the accounts of a Rabbi Trust.

## Exception 4: The Variable Interest Entity Rules-FIN 46R

Under existing GAAP, the fourth exception to the more-than-50 percent-ownership rule for consolidation is where there is an off-balance-sheet entity that is categorized as a variable interest entity (VIE) as discussed in FASB Interpretation No. 46R, Consolidation of Variable Interest Entities—An Interpretation of ARB No. 51, now part of ASC 810, Consolidation. FIN 46R requires a primary beneficiary to consolidate a VIE. In general, a VIE is an entity that is not self-supportive. An entity is considered a VIE if, by design (FIN 46R states that the phrase "by design" refers to entities that meet the conditions of being a VIE because of the way they are structured. For example, an entity under the control of its equity holders that originally was not a VIE does not become one because of operating losses), it has one or both of the following two conditions:

1. The total equity investment at risk is not sufficient to permit it to finance its activities without obtaining additional subordinated financial support provided by any parties (e.g., individual or entity), including equity holders.

2. As a group, the holders of equity investments at risk lack any one of the following three characteristics:
   - Lack the power through voting rights or similar rights to direct the entity's activities that most significantly impact the entity's economic performance
   - Lack the obligation to absorb the expected losses of the entity
   - Lack the right to receive expected residual returns of the entity.

A VIE is consolidated by a primary beneficiary entity if that entity has a controlling financial interest in the VIE model through having *both* of the following:

a. The power to direct the activities that most significantly impact the VIE's economic performance

b. The obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE

**EXAMPLE:** Harry owns 100 percent of companies A and B, yet there is no direct ownership between A and B. A sells 25 percent of its product to B but there is no indication of control or financial support between A and B. The two entities are not required to be consolidated under the VIE rules of FIN 46R. Because consolidation is not required for the two entities, the entities may elect to issue combined financial statements.

**EXAMPLE:** Harry owns 100 percent of Company A. Company A rents the real estate used in its operations from Company B, which is an LLC, solely owned by Harry. The two entities are not required to be consolidated under FIN 46R. Because consolidation is not required, issuing combined financial statements is an option and may be more meaningful.

Combined financial statements are never required, but may be useful in certain cases. Combining is treated essentially in the same manner as a consolidation with all intercompany transactions eliminated. Although there are similarities, combined financial statements differ from consolidated financial statements in two ways:

- Stockholders' equity is combined, not eliminated, because there is no investment to eliminate.
- The report must be altered to reflect the combined entities.

## VIE Exemption for Private Companies in Common Control Leasing Arrangements

In March 2014, the Private Company Council (PCC) issued, and the FASB endorsed, ASU 2014-07: *Consolidation (Topic 810): Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements-A consensus of the Private Company Council*. This ASU provides a private company exemption from consolidation under FIN 46R VIE rules.

The general provisions of ASU 2014-07 are summarized as follows:

a. A private company lessee (the reporting entity) may elect an accounting alternative not to apply the FIN 46R VIE guidance to a lessor entity (not consolidate a real estate lessor) if four criteria are met:
   - The private company lessee and the lessor entity are under common control.
   - The private company lessee has a lease arrangement with the lessor entity.

- Substantially all of the activities between the private company lessee and the lessor entity are related to leasing activities (including supporting leasing activities) between those two entities.
- If the private company lessee explicitly guarantees or provides collateral for any obligation of the lessor entity related to the asset leased by the private company, the principal amount of the obligation at inception of the guarantee or collateral arrangement does not exceed the value of the asset leased by the private company from the lessor entity.

b. A private company lessee that elects the accounting alternative not to consolidate the real estate lessor is required to expand certain disclosures.

It should be noted that the ASU 2014-07 exemption only applies to private company leasing arrangements and does not exempt private companies from applying the VIE consolidation rules to other non-leasing arrangements such as management contracts, etc.

## ¶ 506 ASU 2015-02 OVERVIEW

The FASB issued ASU 2015-02 to respond to stakeholders' comments about the current accounting for consolidation of certain legal entities. Stakeholders expressed concerns that current GAAP for consolidations required modifications. As a result, the FASB issued amendments in ASU 2015-02, which change the analysis that a reporting entity must perform to determine whether it should consolidate certain types of legal entities. The table below provides an overview of the key changes from the ASU.

**Comparison of Consolidation Models Existing ASC 810 GAAP Versus Changes by ASU 2015-02 [General Rule: Consolidate if there is a controlling financial interest]**

| **Existing GAAP- ASC 810** | **Changes to ASC 810 by ASU 2015-02** |
|---|---|
| Voting interest entity model: | |
| Consolidate based on ownership of more than 50 percent of voting shares | No change |
| VIE Model: | |
| Variable interest entities | Several changes involving:<br>• Fees paid to decision makers and service providers<br>• Determination of the primary beneficiary including related parties |
| Entities controlled by contract: | No change |
| Physician Practice Management Entities (PPME) | |
| General partner that controls a limited partnership | Changed under the voting interest entity model:<br>• Presumption that GP consolidates LP is eliminated<br>• Rules changes to provide that investor with majority of kick-out rights consolidates LP (voting interest entity model) |
| Miscellaneous transactions involving R&D arrangements and Rabbi Trusts | No change |

The amendments in the ASU affect reporting entities that are required to evaluate whether they should consolidate certain legal entities. All legal entities are subject to reevaluation under the revised consolidation model. Specifically, the amendments prescribe the following:

- Reduce the number of consolidation models by eliminating the special model for limited partnerships.
- Modify the evaluation of whether limited partnerships and similar legal entities are VIEs or voting interest entities.
- Eliminate the presumption that a general partner should consolidate a limited partnership.
- Affect the consolidation analysis of reporting entities that are involved with VIEs, particularly those that have fee arrangements and related party relationships.
- Provide a scope exception from consolidation guidance for most money market funds; reporting entities with interests in legal entities that are required to comply with or operate in accordance with requirements that are similar to those in Rule 2a-7 of the Investment Company Act of 1940 for registered money market funds.

Additionally, the amendments in ASU 2015-02 affect the following areas, each of which is described in greater detail in the following sections:

- Limited partnerships and similar legal entities
- Evaluating fees paid to a decision maker or a service provider as a variable interest
- The effect of fee arrangements on the primary beneficiary determination
- The effect of related parties on the primary beneficiary determination
- An exemption for certain investment funds

## Limited Partnerships and Similar Legal Entities

The ASU changes three main provisions that affect the consolidation of limited partnerships and similar legal entities, such as LLCs. This includes the following:

- There is an additional requirement that limited partnerships and similar legal entities must meet to qualify for consolidation as voting interest entities.
- A limited partnership must provide partners with either substantive kick-out rights or substantive participating rights over the general partner to meet this requirement.
- The specialized consolidation model and guidance for limited partnerships and similar legal entities have been eliminated.
- There is no longer a presumption that a general partner should consolidate a limited partnership.
- For limited partnerships and similar legal entities that qualify as voting interest entities, a limited partner with a controlling financial interest should consolidate a limited partnership.
- A controlling financial interest may be achieved through holding a limited partner interest that provides a majority of substantive kick-out rights.

## Evaluating Fees Paid to a Decision Maker or a Service Provider as a Variable Interest

In the VIE model, a reporting entity must determine whether it has a variable interest in the entity being evaluated for consolidation. Current GAAP provides six criteria that must be met in order for fees paid by a legal entity (VIE) to a decision maker or a service provider not to be a variable interest in the legal entity. The ASU eliminates three of these six conditions for evaluating whether a fee paid to a decision maker or a service provider represents a variable interest. If a reporting entity (decision maker or service provider) fails any of the remaining three conditions, it has a variable interest in a VIE. Consequently, the reporting entity (decision maker or service provider) must evaluate whether its variable interest represents a controlling financial interest in the VIE; that is, whether the reporting entity is the primary beneficiary that should consolidate the VIE. Because only three conditions must be met for fees not to be a variable interest, the change is likely to result in fewer decision makers and service providers consolidating VIEs.

## The Effect of Fee Arrangements on the Primary Beneficiary Determination

Under both current GAAP requirements and the amendments in ASU 2015-02, a decision maker is determined to be the primary beneficiary of a VIE if it satisfies both the power and the economics criteria. As a result, the primary beneficiary consolidates a VIE because it has a controlling financial interest.

Under existing GAAP, if a fee arrangement paid to a decision maker, (such as an asset management fee), is determined to be a variable interest in a VIE (it fails the 6 conditions), the decision maker must include the fee arrangement in its determination as to whether it is the primary beneficiary analysis that consolidates the VIE. Consequently, the fees paid to the decision maker give considerable weight to concluding that the decision maker is the primary beneficiary. Under existing GAAP, the decision maker or service provider uses the fees it has received in performing the analysis as to whether the decision maker meets both the power criterion and economic criterion. If both are satisfied, the decision maker or service provider is considered the primary beneficiary and must consolidate the VIE.

The amendments in the ASU specify that some fees paid to a decision maker or service provider are excluded from the evaluation of the economics criterion (second criterion) if the fees are both customary and commensurate with the level of effort required for the services provided. The ASU amendments make it less likely for a decision maker or service provider to meet the economics criterion solely on the basis of a fee arrangement. As a result, fewer decision makers and service providers will be considered a primary beneficiary and will not likely consolidate a VIE to which they provide services.

## The Effect of Related Parties on the Primary Beneficiary Determination

In instances in which no single party has a controlling financial interest in a VIE, current GAAP requires interests held by a reporting entity's related parties to be treated as though they belong to the reporting entity when evaluating whether a related-party group has the characteristics of a primary beneficiary. The amendments in ASU 2015-02 reduce the application of the related party guidance for VIEs on the basis of the following three changes:

- For single decision makers, related party relationships must be considered indirectly on a proportionate basis, rather than in their entirety.
- After the assessment above is performed, related party relationships should be considered in their entirety for entities that are under common control only if that common control group has the characteristics of a primary beneficiary. That is, the common control group collectively has a controlling financial interest.
- If the second assessment is not applicable, but substantially all of the activities of the VIE are conducted on behalf of a single variable interest holder (excluding the decision maker) in a related party group that has the characteristics of a primary beneficiary, that single variable interest holder must consolidate the VIE as the primary beneficiary.

The ASU does not amend the related party guidance for situations in which power is shared between two or more entities that hold variable interests in a VIE.

## Exemption for Certain Investment Funds

The amendments in the ASU rescind the indefinite deferral of FASB Statement No. 167, Amendments to FASB Interpretation No. 46(R), included in FASB Accounting Standards Update No. 2010-10, *Consolidation (Topic 810): Amendments for Certain Investment Funds.* In addition, the amendments in the ASU provide a scope exception from the consolidation requirements for reporting entities with interests in legal entities that are required to comply with or operate in accordance with requirements similar to those in Rule 2a-7 of the Investment Company Act of 1940 for registered money market funds.

## STUDY QUESTIONS

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**1.** If one entity has between 20-50 percent of the voting shares in another entity, what is the general accounting treatment for the investment?

**a.** Consolidate the entities

**b.** Investment recorded at cost

**c.** Investment recorded at fair value

**d.** Use the equity method

**2.** The general rule for consolidation of entities found in ASC 810, *Consolidation*, is that consolidation occurs when:

**a.** One entity manages, but does not own, another entity.

**b.** One entity directly or indirectly has a controlling financial interest in another entity.

**c.** One entity owns less than 50 percent of the voting shares of another entity

**d.** There is an off-balance-sheet entity

**3.** Under GAAP in effect prior to ASU 2015-02, a general partner who controls a limited partnership should account for the limited partnership using which of the following?

**a.** By recording any investment that the GP has in the LP at amortized cost

**b.** By recording any investment that the GP has in the LP at fair value

**c.** By recording any investment that the GP has in the LP using the equity method

**d.** By consolidating the LP into the GP's financial statements

**4.** Under which of the following situations would it make sense for an entity to combine financial statements with another entity?

**a.** An entity owns none of another entity's voting stock. The entity has several different owners and no common ownership

**b.** An entity owns more than 50 percent of another entity's voting stock

**c.** An off-balance-sheet entity is a VIE and meets certain criteria under FIN 46R

**d.** Two entities under common control that do not meet the criteria for consolidation under FIN 46R

**5.** Which of the following is a characteristic of an entity that is a VIE? The holders of equity investments _______________:

**a.** Have the obligation to absorb the expected losses of the entity

**b.** Have the right to receive expected residual returns of the entity

**c.** Lack the power to direct the entity's activities

**d.** Created the entity at inception

**6.** Company X is performing a primary beneficiary test on Company VIE to determine whether X should consolidate VIE. In performing the test, how should X account for fees paid to X?

**a.** The fees paid are excluded if two conditions are met.

**b.** The fees are included in all instances.

**c.** The fees are excluded even if they expose the entity to risk of loss.

**d.** Fees paid to a service provider are not considered fees paid to a reporting entity.

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# ¶ 507 ASU 2015-02 AMENDMENTS

In addition to the information presented above, the ASU also added several definitions to the ASC Master Glossary. Each of these new definitions is described in detail below.

## Kick-Out Rights

With respect to VIEs, this is the ability to remove the entity with the power to direct the activities of a VIE that most significantly impact the VIE's economic performance or to dissolve (liquidate) the VIE without cause. Alternatively, for Voting Interest Entities, these are the rights underlying the limited partner's or partners' ability to dissolve (liquidate) the limited partnership or otherwise remove the general partners without cause.

## Participating Rights

With respect to VIEs, this is the ability to block or participate in the actions through which an entity exercises the power to direct the activities of a VIE that most significantly impact the VIE's economic performance. Participating rights do not require the holders of such rights to have the ability to initiate actions. Alternatively, for Voting Interest Entities, these are the rights that allow the limited partners or non-controlling shareholders to block or participate in certain significant financial and operating decisions of the limited partnership or corporation that are made in the ordinary course of business. Participating rights do not require the holders of such rights to have the ability to initiate actions.

### Protective Rights

For VIEs, these are the rights designed to protect the interests of the party holding those rights without giving that party a controlling financial interest in the entity to which they relate. For example, they include approval or veto rights granted to other parties that do not affect the activities that most significantly impact the entity's economic performance, the ability to remove the reporting entity that has a controlling financial interest in the entity in circumstances such as bankruptcy or on breach of contract by that reporting entity, or limitations on the operating activities of an entity. For Voting Interest Entities, these are the rights that are only protective in nature and that do not allow the limited partners or non-controlling shareholders to participate in significant financial and operating decisions of the limited partnership or corporation that are made in the ordinary course of business.

### Decision Maker

This is an entity or entities with the power to direct the activities of another legal entity that most significantly impact the legal entity's economic performance according to the provisions of the Variable Interest Entities Subsections of Subtopic 810-10.

### Decision-Making Authority

This is the power to direct the activities of a legal entity that most significantly impact the entity's economic performance according to the provisions of the Variable Interest Entities Subsections of Subtopic 810-10.

### Ordinary Course of Business

This includes decisions about matters of a type consistent with those normally expected to be addressed in directing and carrying out current business activities, regardless of whether the events or transactions that would necessitate such decisions are expected to occur in the near term. However, it must be at least reasonably possible that those events or transactions that would necessitate such decisions will occur. The ordinary course of business does not include self-dealing transactions.

### With Cause

With cause generally restricts the limited partners' ability to dissolve (liquidate) the limited partnership or remove the general partners in situations that include, but that are not limited to, fraud, illegal acts, gross negligence, and bankruptcy of the general partners.

### Without Cause

Without cause means that no reason need be given for the dissolution (liquidation) of the limited partnership or removal of the general partners.

## ¶ 508 CONSOLIDATION GUIDANCE

The general rule is that consolidation is required when one entity has a controlling financing interest in another entity. There are two primary models for determining whether one entity has a controlling financing interest in another entity. This includes the voting interest model and the variable interest model. Also, additional analysis is required for consolidation of entities controlled by contract, and a carve-out exception for R&D and miscellaneous other activities, which is applicable to entities that are not VIEs.

### Voting Interest Entity Model

Under the voting interest entity model, for legal entities other than limited partnerships, the usual condition for a controlling financial interest is ownership by one reporting entity, directly or indirectly, of more than 50 percent of the outstanding voting shares of another entity. For limited partnerships, the usual condition for a controlling financial interest is ownership by one limited partner, directly or indirectly, of more than 50 percent of the limited partnership's kick-out rights through voting interests. However, there is one exception. If noncontrolling shareholders or limited partners have substantive participating rights, the majority shareholder or limited partner with a majority of kick-out rights through voting interests does not have a controlling financial interest and would not consolidate the limited partnership.

### VIE Model

In the VIE model, a controlling financial interest is assessed differently than under the voting interest entity model. This difference in assessment is required because a controlling financial interest may be achieved other than by ownership of shares or voting interests, like is the case with the voting interest model. Under the VIE model, a controlling financial interest requires a reporting entity to have both the power to direct the activities that most significantly impact the VIE's economic performance, and the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE. A reporting entity with a controlling financial interest in a VIE is referred to as the primary beneficiary.

> **COMMENT:** The reporting entity could be, but is not limited to being, an equity investor, some other capital provider such as a debt holder, or a party with another contractual arrangement such as a guarantor. This model applies to all types of legal entities.

## ¶ 509 KEY CHANGES MADE BY ASU 2015-02

As previously noted, ASU 2015-02 amends ASC 810 to reflect five key changes discussed further on in this chapter, as follows:

1. Limited partnerships and similar legal entities
2. Evaluating fees paid to a decision maker or a service provider as a variable interest
3. The effect of fee arrangements on the primary beneficiary determination
4. The effect of related parties on the primary beneficiary determination
5. Certain investment funds

Each of the above changes is discussed in more significant detail in the following sections.

## ¶ 510 CHANGE 1: LIMITED PARTNERSHIP INTERESTS AND SIMILAR LEGAL ENTITIES

### EXISTING GAAP

A general partner that controls a limited partnership consolidates the partnership into its financial statements. In addition, there is a presumption that general partners control a limited partnership regardless of the extent of the general partners' ownership interest in the limited partnership. However, the presumption that general partners control a partnership is overcome (the general partners do not control the limited partnership) if the limited partners have either substantive kick-out rights or substantive participating rights.

## NEW RULES PER ASU 2015-02

The ASU changes three main provisions that affect the consolidation of limited partnerships and similar legal entities. This includes an additional requirement that limited partnerships and similar legal entities must meet to use the voting interest entity model. In addition, a limited partnership must provide partners with either substantive kick-out rights or substantive participating rights over the general partner to qualify for the voting interest entity model.

Also, the specialized consolidation model and guidance for limited partnerships and similar legal entities has been eliminated. As a result, the ASU eliminates the presumption that a general partner should consolidate a limited partnership. In most instances, a general partner will not consolidate a limited partnership. However, under the new rules, a limited partnership is evaluated for consolidation using either the voting interest entity model or the VIE model. For limited partnerships and similar legal entities that qualify as voting interest entities, a limited partner with a controlling financial interest should consolidate a limited partnership. A single limited partner has a controlling financial interest if it holds a limited partner interest that provides more than 50 percent of the substantive kick-out rights.

> **COMMENT:** A similar legal entity is an entity (such as a limited liability company) that has governing provisions that are the functional equivalent of a limited partnership. In such entities, a managing member is the functional equivalent of a general partner, and a nonmanaging member is the functional equivalent of a limited partner.

### General Rule for Consolidation of a Limited Partnership – Voting Interest Model

Under the voting interest entity model, the limited partnership must give its limited partners substantive kick-out rights or substantive participating rights over the general partner. If a limited partnership does not give its limited partners substantive kick-out rights or substantive participating rights, the limited partnership is evaluated for consolidation using the VIE model (discussed later). In a limited partnership, kick-out rights, through voting interests, are the same as voting rights held by shareholders of a corporation. As a result, under the voting interest entity model, a single limited partner consolidates a limited partnership if all of the following are true:

- The single limited partner holds a controlling financial interest by holding more than 50 percent of the limited partnership's kick-out rights through voting interests.
- The kick-out rights are substantive.
- Non-controlling limited partners do not have substantive participating rights that block the single limited partner's kick-out rights.

In measuring whether a single limited partner holds more than 50 percent of the kick-out rights, the kick-out rights held by general partners through voting interests are ignored. Under the new ASU rules, a general partner no longer consolidates the limited partnership under the voting interest entity model.

### Kick-Out Rights

For limited partnerships, the determination of whether kick-out rights are substantive is based on a consideration of all relevant facts and circumstances. For kick-out rights to be considered substantive, the limited partners holding the kick-out rights must have the ability to exercise those rights if they choose to do so; that is, there are no significant barriers to the exercise of the rights to either dissolve (liquidate) the limited partnership, or remove the general partners without cause. Barriers that may make kick-out rights less substantive include the following:

- Kick-out rights subject to conditions that make it unlikely they will be exercisable, for example, conditions that narrowly limit the timing of the exercise
- Financial penalties or operational barriers associated with dissolving (liquidating) the limited partnership or replacing the general partners that would act as a significant disincentive for dissolution (liquidation) or removal
- The absence of an adequate number of qualified replacement general partners or the lack of adequate compensation to attract a qualified replacement
- The absence of an explicit, reasonable mechanism in the limited partnership's governing documents or in the applicable laws or regulations, by which the limited partners holding the rights can call for and conduct a vote to exercise those rights
- The inability of the limited partners holding the rights to obtain the information necessary to exercise them

## Withdrawal Rights

Withdrawal rights are the limited partners' unilateral rights to withdraw from the partnership in whole or in part that does not require dissolution or liquidation of the entire limited partnership.. The requirement to dissolve or liquidate the entire limited partnership upon the withdrawal of a limited partner shall not be required to be contractual for a withdrawal right to be considered as a potential kick-out right.

Rights held by limited partners to remove the general partner(s) from the partnership shall be evaluated as kick-out rights as appropriate. Additionally, rights of the limited partners to participate in the termination of management (for example, management is outsourced to a party other than the general partner) or the individual members of management of the limited partnership may be substantive participating rights.

## General Rule for Consolidation of a Limited Partnership – VIE Model

A limited partnership is evaluated for consolidation under the VIE model if it does not qualify for the voting interest entity model because it is a VIE. An LP entity is considered a VIE if it meets the definition of a VIE (discussed earlier) and it does not provide its limited partners with substantive kick-out rights or substantive participating rights.

> **COMMENT:** If a limited partnership does not provide its limited partners with substantive kick-out rights or substantive participating rights, then the holders of equity investments (LPs) lack the power to direct the LP's activities and the LP is a VIE.

As previously discussed, the party that consolidates the limited partnership is called the primary beneficiary, which is the party that has a controlling financial interest in the limited partnership through both power and benefits. Under the VIE model, a general partner might be considered the primary beneficiary that consolidates the limited partnership (VIE). Under the voting interest model, the GP would not consolidate an LP unless the GP owns more than 50 percent of the kick-out rights through ownership of the LP interest.

## Effect of Noncontrolling Rights on Consolidation of Limited Partnerships

In some instances, the powers of a limited partner with a majority of kick-out rights through voting interests to control the operations or assets of the investee are restricted in certain respects by approval or veto rights granted to a limited partner (referred to as noncontrolling rights). This does not apply to entities that, in accordance with GAAP, carry substantially all of their assets, including investments in controlled entities, at fair value with changes in value reported in a statement of net income or financial performance, or investments in VIEs. Like many areas of GAAP, the assessment of whether the rights of a noncontrolling limited partner should overcome the presumption of consolidation by the limited partner with a majority of kick-out rights in its investee is a matter of judgment that depends on facts and circumstances.

The determination is based on whether the noncontrolling rights, individually or in the aggregate, allow the noncontrolling limited partner to effectively participate in certain significant financial and operating decisions of the investee that are made in the ordinary course of business.

> **COMMENT:** Effective participation means the ability to block significant decisions proposed by the general partner or investor who has a majority voting interest. When a noncontrolling limited partner has effective participation, control does not rest with the majority owner because the investor with the majority voting interest cannot cause the investee to take an action that is significant in the ordinary course of business if it has been vetoed by the noncontrolling shareholder.

For limited partnerships, control does not rest with the limited partner with the majority of kick-out rights if the limited partner cannot cause the general partner to take an action that is significant in the ordinary course of business if it has been vetoed by other limited partners. It is important to note that this assessment of noncontrolling rights should be made at the time a majority of kick-out rights through voting interests is obtained and should be reassessed if there is a significant change to the terms or in the exercisability of the rights of the noncontrolling limited partner.

Additionally, all noncontrolling rights may be described as protective of the noncontrolling limited partner's investment in the investee. Some noncontrolling rights allow the noncontrolling limited partner to participate in determining certain significant financial and operating decisions of the investee that are made in the ordinary course of business (referred to as participating rights).

> **COMMENT:** Participation means the ability to block actions proposed by the investor that has a majority voting interest or the general partner. Thus, the investor with the majority voting interest or the general partner must have the agreement of the noncontrolling shareholder or limited partner to take certain actions. Participation does not mean the ability of the limited partner to initiate actions.

Substantive noncontrolling rights that allow the noncontrolling limited partner to effectively participate in certain significant financial and operating decisions of the investee that are made in the investee's ordinary course of business (although also protective of the noncontrolling shareholder's or limited partner's investment) should overcome the presumption that the investor with a majority voting interest or limited partner with a majority of kick-out rights through voting interests shall consolidate its investee.

> **COMMENT:** It must be at least reasonably possible that those events or transactions that would necessitate such decisions will occur. The ordinary course of business definition would not include self-dealing transactions with controlling limited partners.

An entity that is not controlled by a limited partner who holds the majority of kick-out rights because of noncontrolling limited partner veto rights (through participating rights) is not a VIE if the partners as a group (the holders of the equity investment at risk) have the power to control the entity and the equity investment meets the other requirements. The following guidance addresses considerations of noncontrolling limited partner rights, specifically protective rights, participating rights, and factors to consider in evaluating whether noncontrolling rights are substantive participating rights.

## Protective Rights

Noncontrolling rights (whether granted by contract or by law) that would allow the noncontrolling limited partner to block partnership actions would be considered protective rights and would not overcome the presumption of consolidation by the limited partner with a majority of kick-out rights through voting interests in its investee. The following list is illustrative of the protective rights that often are provided to the noncontrolling shareholder or limited partner, but is not all-inclusive:

- Amendments to articles of incorporation or partnership agreements of the investee
- Pricing on transactions between the owner of a majority voting interest or limited partner with a majority of kick-out rights through voting interests and the investee and related self-dealing transactions
- Liquidation of the investee in the context of ASC 852 on reorganizations or a decision to cause the investee to enter bankruptcy or other receivership
- Acquisitions and dispositions of assets that are not expected to be undertaken in the ordinary course of business (noncontrolling rights) relating to acquisitions and dispositions of assets that are expected to be made in the ordinary course of business are participating rights; determining whether such rights are substantive requires judgment in light of the relevant facts and circumstances
- Issuance or repurchase of equity interests

## Participating Rights

Participating rights held by a noncontrolling limited partner may overcome the limited partner with the majority of kick-out rights ability to consolidate the limited partnership, depending on whether such rights are substantive or not. Substantive participating rights are those that overcome the presumption that the limited partner with the majority of kick-out rights shall consolidate the limited partnership, whereas nonsubstantive participating rights do not overcome the presumption that the limited partner with the majority of kick-out rights shall consolidate the limited partnership. The following list is illustrative of substantive participating rights, but is not necessarily all-inclusive:

- Selecting, terminating, and setting the compensation of management responsible for implementing the investee's policies and procedures
- Establishing operating and capital decisions of the investee, including budgets, in the ordinary course of business

> **COMMENT:** The rights noted above are participating rights because, in the aggregate, the rights allow the noncontrolling limited partner to effectively

> participate in certain significant financial and operating decisions that occur as part of the ordinary course of the investee's business and are significant factors in directing and carrying out the activities of the business. Individual rights, such as the right to veto the termination of management responsible for implementing the investee's policies and procedures, should be assessed based on the facts and circumstances to determine if they are substantive participating rights in and of themselves. The likelihood that the veto right will be exercised by the noncontrolling limited partner should not be considered when assessing whether a noncontrolling right is a substantive participating right.

## Factors to Consider in Evaluating Whether There Are Substantive Participating Rights

Certain factors shall be considered in evaluating whether noncontrolling rights that appear to be participating are substantive participating rights, and therefore, whether these factors provide for effective participation in certain significant financial and operating decisions that are made in the investee's ordinary course of business.

Consideration should be given to situations in which a limited partner with a majority of kick-out rights through voting interests owns such a significant portion of the investee that the noncontrolling limited partner has a small economic interest.

> **COMMENT:** As the disparity between the limited partner with a majority of kick-out rights through voting interests and noncontrolling limited partners increases, the rights of the noncontrolling limited partner are presumptively more likely to be protective rights and shall raise the level of skepticism about the substance of the right.

Similarly, although a majority owner is presumed to control an investee, the level of skepticism about such ability shall increase as the limited partner's economic interest in the investee decreases.

The governing documents shall be considered to determine at what level decisions are made, whether at the limited partner level or at the board level, and the rights at each level also should be considered. In all situations, any matters that can be put to a vote of the limited partners should be considered to determine if other investors, individually or in the aggregate, have substantive participating rights by virtue of their ability to vote on matters submitted to a limited partner vote.

Relationships between the majority and noncontrolling partners (other than an investment in the common investee) that are of a related-party nature, as defined in ASC 850, should be considered in determining whether the participating rights of the noncontrolling limited partner are substantive. One example is if the noncontrolling limited partner in an investee is a member of the immediate family of the majority shareholder, general partner, or limited partner with a majority of kick-out rights through voting interests of the investee, then the rights of the noncontrolling limited partner likely would not overcome the presumption of consolidation by the limited partner with a majority of kick-out rights through voting interests in its investee.

Additionally, certain noncontrolling rights may deal with operating or capital decisions that are not significant to the ordinary course of business of the investee. Noncontrolling rights related to decisions that are not considered significant for directing and carrying out the activities of the investee's business are not substantive participating rights and would not overcome the presumption of consolidation by the limited partner with a majority of kick-out rights through voting interests in its investee. Examples of such noncontrolling rights include all of the following:

- Location of the investee's headquarters
- Name of the investee
- Selection of auditors
- Selection of accounting principles for purposes of separate

reporting of the investee's operations

Certain noncontrolling rights may provide for the noncontrolling limited partner to participate in certain significant financial and operating decisions that are made in the investee's ordinary course of business; however, the existence of such noncontrolling rights should not overcome the presumption that the majority owner should consolidate, if it is remote that the event or transaction that requires noncontrolling limited partner approval will occur. Remote is defined in ASC 450, Contingencies, as the chance of the future event or events occurring being slight.

A limited partner with a majority of kick-out rights who has a contractual right to buy out the interest of the noncontrolling limited partner in the investee for fair value or less should consider the feasibility of exercising that contractual right when determining if the participating rights of the noncontrolling limited partner are substantive. If such a buyout is prudent, feasible, and substantially within the control of the majority owner, the contractual right to buy out the noncontrolling limited partner demonstrates that the participating right of the noncontrolling limited partner is not a substantive right.

**COMMENT:** The existence of such call options negates the participating rights of the noncontrolling limited partner to veto an action of the majority general partner, rather than create an additional ownership interest for that majority shareholder. It would not be prudent, feasible, and substantially within the control of the majority owner to buy out the noncontrolling limited partner if, for example, the noncontrolling limited partner controls technology that is critical to the investee or the noncontrolling limited partner is the principal source of funding for the investee.

## STUDY QUESTIONS

**7.** Which kind of rights may overcome the presumption that a limited partner with the majority of kick-out rights shall consolidate the limited partnership?

- **a.** Non-substantive participating rights
- **b.** Non-substantive protective rights
- **c.** Substantive participating rights
- **d.** Substantive protective rights

**8.** Which of the following is a barrier that may make kick-out rights less substantive?

- **a.** The limited partners have the ability to obtain the information necessary to exercise the rights.
- **b.** There exists an adequate number of qualified replacement general partners.
- **c.** The kick-out rights are subject to conditions that make it unlikely they will be exercisable.
- **d.** There exists an explicit, reasonable mechanism by which the LIMITED PARTNERs holding the rights can conduct a vote to exercise the rights.

**9.** Which of the following rights is considered a protective right?

- **a.** Acquisitions of assets undertaken in the ordinary course of business
- **b.** Dispositions of assets undertaken in the ordinary course of business
- **c.** Amendments to articles of incorporation
- **d.** Selecting and setting compensation of management

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## Examples of Assessing Individual Noncontrolling Rights-Participating or Protective Rights

An assessment is relevant for determining whether noncontrolling rights overcome the presumption of control by the limited partner with a majority of kick-out rights. Although the following examples illustrate the assessment of participating rights or protective rights, the evaluation should consider all factors to determine whether the noncontrolling rights, individually or in the aggregate, provide for the holders of those rights to effectively participate in certain significant financial and operating decisions that are made in the ordinary course of business.

The rights of the noncontrolling limited partner relating to the approval of acquisitions and dispositions of assets that are expected to be undertaken in the ordinary course of business may be substantive participating rights. Rights related only to acquisitions that are not expected to be undertaken in the ordinary course of the investee's existing business usually are protective and would not overcome the presumption of consolidation by the investor with a limited partner with a majority of kick-out rights through voting interests in its investee. Additionally, whether a right to approve the acquisition or disposition of assets is in the ordinary course of business should be based on an evaluation of the relevant facts and circumstances. If approval by the limited partner is necessary to incur additional indebtedness to finance an acquisition that is not in the investee's ordinary course of business, then the approval by the noncontrolling limited partner would be considered a protective right.

Existing facts and circumstances should also be considered in assessing whether the rights of the noncontrolling limited partner relating to an investee's incurring additional indebtedness are protective or participating rights. If it is reasonably possible or probable that the investee will need to incur the level of borrowings that requires noncontrolling limited partner approval in its ordinary course of business, the rights of the noncontrolling limited partner would be viewed as substantive participating rights.

The rights of the noncontrolling limited partner relating to dividends or other distributions may be protective or participating and should be assessed in light of the available facts and circumstances. In other words, rights to block customary or expected dividends or other distributions may be substantive participating rights, while rights to block extraordinary distributions would be protective rights.

The rights of the noncontrolling shareholder or limited partner relating to an investee's specific action (such as leasing property) in an existing business may be protective or participating and should be assessed in light of the available facts and circumstances. For example, if the investee had the ability to purchase, rather than lease, the property without requiring the approval of the noncontrolling shareholder or limited partner, then the rights of the noncontrolling shareholder or limited partner to block the investee from entering into a lease would not be substantive.

The rights of the noncontrolling limited partner relating to an investee's negotiation of collective bargaining agreements with unions may be protective or participating and should be assessed in light of the available facts and circumstances. For example, if an investee does not have a collective bargaining agreement with a union or if the union does not represent a substantial portion of the investee's work force, then the rights of the noncontrolling limited partner to approve or veto a new or broader collective bargaining agreement are not substantive.

Provisions that govern what will occur if the noncontrolling limited partner blocks the action of an owner of a majority voting interest or general partner need to be considered to determine whether the right of the noncontrolling limited partner to block the action has substance. For example, if the partnership agreement provides that if the noncontrolling limited partner blocks the approval of an operating budget, then the budget simply defaults to last year's budget adjusted for inflation, and if the investee is a mature business for which year-to-year operating budgets would not be expected to vary significantly, then the rights of the noncontrolling limited partner to block the approval of the operating budget do not allow the noncontrolling limited partner to effectively participate and are not substantive.

Noncontrolling rights relating to the initiation or resolution of a lawsuit may be considered protective or participating depending on the available facts and circumstances. If lawsuits are a part of the entity's ordinary course of business, as is the case for some patent-holding companies and other entities, then the noncontrolling rights may be considered substantive participating rights.

## EXAMPLE 1: Two Limited Partners and General Partner

**Facts:**

Company L is a limited partnership. There are two limited partners, with interests of 60 percent and 40 percent, respectively, and one general partner. The GP holds no interest in the limited partnership and under the partnership agreement, the limited partners have kick-out rights in terms of the right to terminate the general partner with a vote of more than 50 percent of the limited partner interests. The 40 percent limited partner does not have any substantive participating rights that can block the 60 percent limited partner from exercising its kick-out rights.

**Conclusion:**

Because the limited partnership offers its limited partners kick-out rights, L should be evaluated for consolidation using the voting interest entity model. Under this model, the limited partner that has, through voting interests, more than 50 percent of the kick-out rights should consolidate the limited partnership. In this case, the 60 percent limited partner holds more than 50 percent of the kick-out rights through its voting interests. There are no substantive participating rights held by the 40 percent partner that could block the 60 percent LP's kick-out rights. Therefore, the 60 percent LP should consolidate the limited partnership.

## EXAMPLE 2: Limited Partner and General Partner

**Facts:**

Company L is a limited partnership and the 100 percent interest in the limited partnership is held as follows: 80 percent held by one limited partner who is not related to the GP and 20 percent held by GP. The general partner owns 20 percent of the equity of the limited partnership and the limited partner has kick-out rights through voting interests, and a vote of a simple majority of the kick-out rights through voting interests to remove the general partner is required. There are no substantive participating rights

**Conclusion:**

Because the limited partner has kick-out rights, the limited partnership is evaluated for consolidation under the voting interest entity model. In evaluating whether the limited partner has kick-out rights, the rights held by the GP are ignored. Because the single limited partner (exclusive of the limited interests held by the GP) holds more than 50 percent of the kick-out rights, and there are no substantive participating rights that block the kick-out rights, the 80 percent single limited partner should consolidate the

LP. The GP does not consolidate the limited partnership. Under the voting interest entity model, in general, a GP does not consolidate a limited partnership.

## EXAMPLE 3: Four Equal Limited Partners

**Facts:**

Company L is a limited partnership. There are four independent limited partners that each own 10 percent of the equity of the limited partnership in the form of limited partnership voting interests. The general partner owns 60 percent of the equity of the limited partnership and does not have kick-out rights through voting interests. The limited partners have kick-out rights through voting interests, and a vote of a simple majority of the kick-out rights through voting interests to remove the general partner is required.

**Conclusion:**

Because the partnership gives its limited partners kick-out rights, L is evaluated for consolidation using the voting interest entity model. Accordingly, no partner would be deemed to have a controlling financial interest in the limited partnership because no single limited partner owns a majority of the limited partnership's kick-out rights through voting interests. Therefore, no partner consolidates the limited partnership.

## EXAMPLE 4: No Kick-out Rights

**Facts:**

Company L is a limited partnership with four independent limited partners (none of which have any relationship to the general partner) that each owns 20 percent of the equity of the limited partnership in the form of limited partnership voting interests. The general partner owns 20 percent of the equity of the limited partnership and the limited partners have no kick-out rights and have no participating rights through voting interests

**Conclusion:**

First, the limited partnership should be evaluated for consolidation using the VIE model because the limited partnership is a VIE. In this example, the limited partners lack kick-out and participating rights. Therefore, the equity holders (limited partners, in this case) lack the power to direct L's activities. Thus, the limited partnership is a VIE and should be evaluated for consolidation using the VIE model, not the voting interest entity model.

Next, because the VIE model is used, an evaluation must be performed to determine who is the primary beneficiary that should consolidate the limited partnership. Under the VIE model, the party that consolidates the limited partnership is called the primary beneficiary, which is the party that has a controlling financial interest in the limited partnership through both power and benefits. Based on the facts given, it would appear that the GP is the primary beneficiary that should consolidate the limited partnership. The GP has the power to direct the limited partnership's activities. Also, through its 20 percent interest in the limited partnership, the GP has the obligation to absorb losses or the right to receive benefits of the limited partnership.

> **COMMENT:** Under the revised voting interest entity model in ASU 2015-02, a general partner will not consolidate a limited partnership because only the limited partner with the majority of kick-out rights would consolidate the partnership. However, if the limited partnership is a VIE, the VIE model is used. Under the VIE model, the party that consolidates the limited partnership is the one with both the power and benefits.

# ¶ 511 CHANGE 2: FEES PAID TO DECISION MAKERS OR SERVICE PROVIDER AS A VARIABLE INTEREST

## EXISTING GAAP

Examples of fees paid to decision makers or service providers include those fees paid to asset managers, real-estate property managers, oil and gas operators, and outsourced R&D providers. Under existing GAAP's VIE model for consolidation, contracts related to fees paid to a decision maker or service provider, such as management or service fees, are generally not variable interests if all six conditions below are met:

- The fees are compensation for services provided and are commensurate with the level of effort required to provide those services (e.g., the fees are at an arms-length rate).
- Substantially all of the fees are at or above the same level of seniority as other operating liabilities of the entity that arise in the normal course of the entity's activities, such as trade payables.
- The decision maker or service provider does not hold other interests in the VIE that individually, or in the aggregate, would absorb more than an insignificant amount of the entity's expected losses or receive more than an insignificant amount of the entity's expected residual returns.
- The service arrangement includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length.
- The total amount of anticipated fees are insignificant relative to the total amount of the VIE's anticipated economic performance.
- The anticipated fees are expected to absorb an insignificant amount of the variability associated with the entity's anticipated economic performance.

Fees paid to decision makers or service providers that meet all of the above conditions are not considered variable interests. Therefore, if the decision maker or service provider has no variable interest in the VIE, the decision maker or service provider will not consolidate the VIE. If not all of the six conditions are met, the fees are a variable interest and the fee provider (reporting enterprise) must determine if it is a primary beneficiary that consolidates a VIE.

## NEW RULES PER ASU 2015-02

ASU 2015-02 changes existing GAAP by eliminating three of the six conditions above for evaluating whether a fee paid to a decision maker or a service provider represents a variable interest. As a result, fees paid to a legal entity's decision maker(s) or service provider(s) are not variable interests if all of the following three conditions are met:

- The fees are compensation for services provided and are commensurate with the level of effort required to provide those services.
- The decision maker or service provider does not hold other interests in the VIE that individually, or in the aggregate, would absorb more than an insignificant amount of the VIE's expected losses or receive more than an insignificant amount of the VIE's expected residual returns.
- The service arrangement includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length.

Simply put, facts and circumstances should be considered when assessing the three conditions above. An arrangement that is designed in a manner such that the fee is inconsistent with the decision maker's or service provider's role or the type of service would not meet those conditions. In order to assess whether a fee meets the three conditions, a reporting entity may need to analyze similar arrangements among parties outside the relationship being evaluated. Furthermore, a fee would not presumptively fail the three conditions if similar service arrangements did not exist in the following circumstances if the fee arrangement relates to a unique or new service or the fee arrangement reflects a change in what is considered customary for the services. The magnitude of a fee, in isolation, would not cause an arrangement to fail the conditions.

If the decision maker or service provider (reporting entity) concludes that fees received represent a variable interest in a VIE (because all three of the conditions are not met), the reporting entity must evaluate whether it is the primary beneficiary that should consolidate the VIE. As previously stated, the decision maker or service provider would evaluate whether it is the primary beneficiary by evaluating whether it has both power and benefits.

Certain fees or payments in connection with agreements that expose a reporting entity (the decision maker or the service provider) to risk of loss in the VIE are variable interests in the VIE because it would not satisfy the three conditions above. Thus, in testing to determine if the decision maker or service provider is the primary beneficiary, the decision maker or service provider could satisfy the economic criterion by absorbing some of the VIE's losses. Such fees that may absorb some of the VIE's losses include, but are not limited to, the following:

- Those related to guarantees of the value of the assets or liabilities of a VIE
- Obligations to fund operating losses
- Payments associated with written put options on the assets of the VIE
- Similar obligations, such as some liquidity commitments or agreements (explicit or implicit) that protect holders of other interests from suffering losses in the VIE

For purposes of evaluating the three conditions above, any interest in an entity that is held by a related party of the decision maker or service provider should be considered in the analysis. As a result, a decision maker or service provider should include its direct economic interests in the entity and its indirect economic interests in the entity held through related parties, considered on a proportionate basis. Indirect interests held through related parties that are under common control with the decision maker should be considered the equivalent of direct interests in their entirety.

The term *related parties* includes those parties identified in ASC 850, *Related Party Disclosures,* and certain de facto agents or principals of the variable interest holder. All of the following are considered to be de facto agents of a reporting entity:

- A party that cannot finance its operations without subordinated financial support from the reporting entity, for example, another VIE of which the reporting entity is the primary beneficiary
- A party that received its interests as a contribution or a loan from the reporting entity
- An officer, employee, or member of the governing board of the reporting entity
- A party that has an agreement that it cannot sell, transfer, or encumber its interests in the VIE without the prior approval of the reporting entity. The right of prior approval creates a de facto agency relationship only if that right could constrain the other party's ability to manage the economic risks or realize the

economic rewards from its interests in a VIE through the sale, transfer, or encumbrance of those interests. However, a de facto agency relationship does not exist if both the reporting entity and the party have right of prior approval and the rights are based on mutually agreed terms by willing, independent parties.

- A party that has a close business relationship like the relationship between a professional service provider and one of its significant clients

## EXAMPLE 1: ASU 2015-02, Case J: Investment Fund 1—Annual and Performance-Based Fees and Additional Interests, as modified by the author]

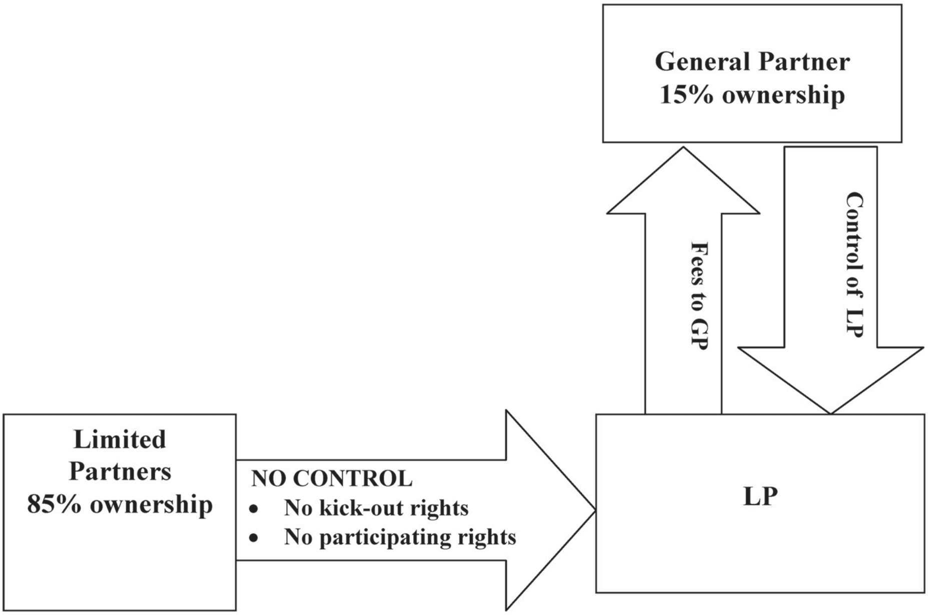
**Facts:**

A fund manager (general partner) creates and sells partnership interests in an investment fund (limited partnership) to external investors (limited partners). The general partner is not liable for any losses beyond the interest that the general partner owns in the fund, and the general partner has a 15 percent ownership interest in the LP. The general partner's 15 percent ownership interest in the fund is expected to absorb more than an insignificant amount of the fund's expected losses and receive more than an insignificant amount of the fund's expected residual returns. The individual limited partners do not hold any substantive rights (no kick-out or participating rights) that would affect the decision-making authority of the general partner, but they can redeem their interests within particular limits set forth by the fund. In addition, the limited partners do not have either of the following abilities:

- The ability to remove the general partner from its decision-making authority or to dissolve (liquidate) the fund without cause (as distinguished from with cause)
- The ability to block or participate in certain significant financial and operating decisions of the limited partnership that are made in the ordinary course of business

The limited partners also do not have the ability to direct the activities that most significantly impact the economic performance of the fund. Therefore, the limited partnership is a VIE because the limited partners do not have kick-out or participating rights. Thus, the limited partners lack the power, through voting rights or similar rights, to direct the activities of a legal entity that most significantly impact the entity's economic performance.

The general partner is paid an annual fixed fee for the assets under management, and a performance-based fee based on the fund's profits if it achieves a specified annual profit level. The annual and performance-based fees paid to the general partner are both compensation for services provided and commensurate with the level of effort required to provide those services and part of a compensation arrangement that includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length.




**Conclusion:**

Based on an evaluation of the three conditions above, the fees paid to the general partner meet two of the three conditions as follows:

- The fees are compensation for services provided and are commensurate with the level of effort required to provide those services. **-YES- GIVEN**
- The decision maker or service provider does not hold other interests in the VIE that individually, or in the aggregate, would absorb more than an insignificant amount of the VIE's expected losses or receive more than an insignificant amount of the VIE's expected residual returns. **NO- GP HOLDS 15 percent OF LP INTEREST**
- The service arrangement includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length. **YES- GIVEN**

The general partner and the limited partners are the variable interest holders in the VIE. The fees paid to the general partner (in its role as fund manager) represent a variable interest because the fees paid to the GP fails one of the three conditions (second one above), because of the general partner holding ownership interests that are expected to absorb more than an insignificant amount of the fund's expected losses and receive more than an insignificant amount of the fund's expected residual returns.

If the general partner was only receiving fees and did not hold ownership interests, and if its related parties did not hold any variable interests in the VIE, then the fees would not be a variable interest. Next, the GP has to test to determine whether it is the primary beneficiary that consolidates the LP. Under the VIE model, the decision maker (GP in this case) would evaluate whether it is the entity that has both power and benefits.

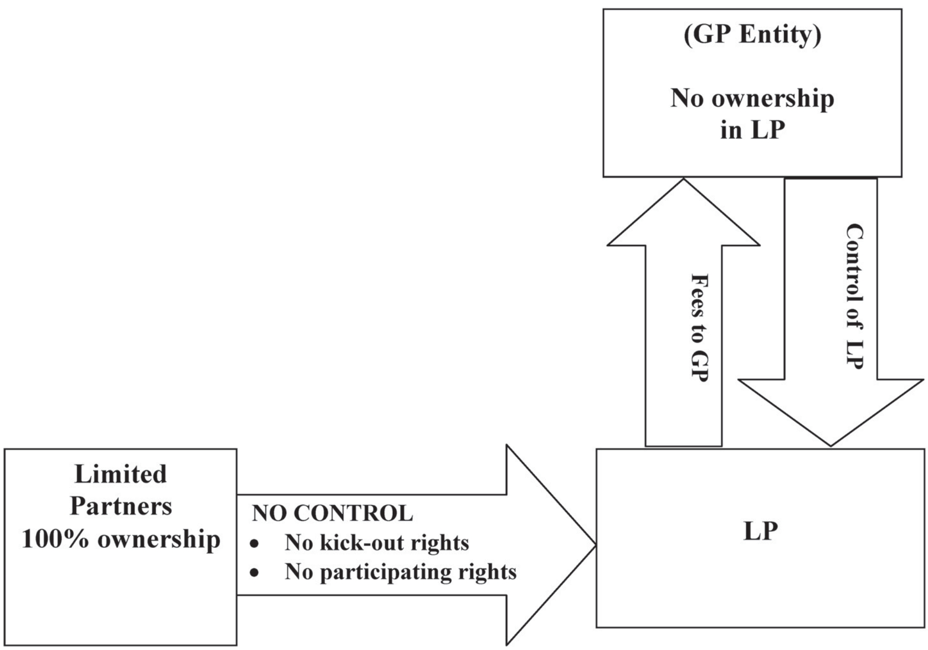
As to the power criterion, the GP must identify which activities of the LP most significantly impact the VIE's (LP's) economic performance and determine whether the

GP has the power to direct those activities. In this case, the activities that most significantly impact the VIE's economic performance are the activities that significantly impact the performance of the managed securities portfolio. In our example, the general partner manages the operations of the VIE. Specifically, the general partner establishes the terms of the VIE, approves the assets to be purchased and sold by the VIE, and administers the VIE by monitoring the assets and ensuring compliance with the VIE's investment policies. Furthermore, the limited partners of the VIE have no voting rights and no other rights that provide them with the power to direct the activities that most significantly impact the VIE's economic performance. As a result, it is apparent that the GP satisfies the power criterion.

Next, the GP must determine whether it satisfies the economic criterion by having the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE. As previously noted, the annual and performance based fees paid to the general partner are both compensation for services provided and commensurate with the level of effort required to provide those services and part of a compensation arrangement that includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length. As a result, the general partner, through its investment in the fund, has the obligation to absorb losses of the VIE that could potentially be significant to the VIE and the right to receive benefits from the VIE that could potentially be significant to the VIE. On the basis of the specific facts and circumstances presented, the GP would be the primary beneficiary.

## EXAMPLE 2:

Same facts as Example 1, except for the fact that the GP has no ownership in the LP.



**Conclusion:**

The GP would not consolidate the LP and in fact, no entity would consolidate the LP. Recall that fees paid to a legal entity's decision maker(s) or service provider(s) are not variable interests if all of the following three conditions are met:

- The fees are compensation for services provided and are commensurate with the level of effort required to provide those services. **YES-GIVEN**
- The decision maker or service provider does not hold other interests in the VIE that individually, or in the aggregate, would absorb more than an insignificant amount of the VIE's expected losses or receive more than an insignificant amount of the VIE's expected residual returns. **YES- GIVEN**
- The service arrangement includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length. **YES- GIVEN**

In this second example, the GP does not hold any interests in the limited partnership. Therefore, it satisfies all three of the conditions noted above. The result is that the GP does not hold any variable interests in the LP (VIE). Because the GP holds no variable interests in the LP, the GP cannot consolidate the LP.

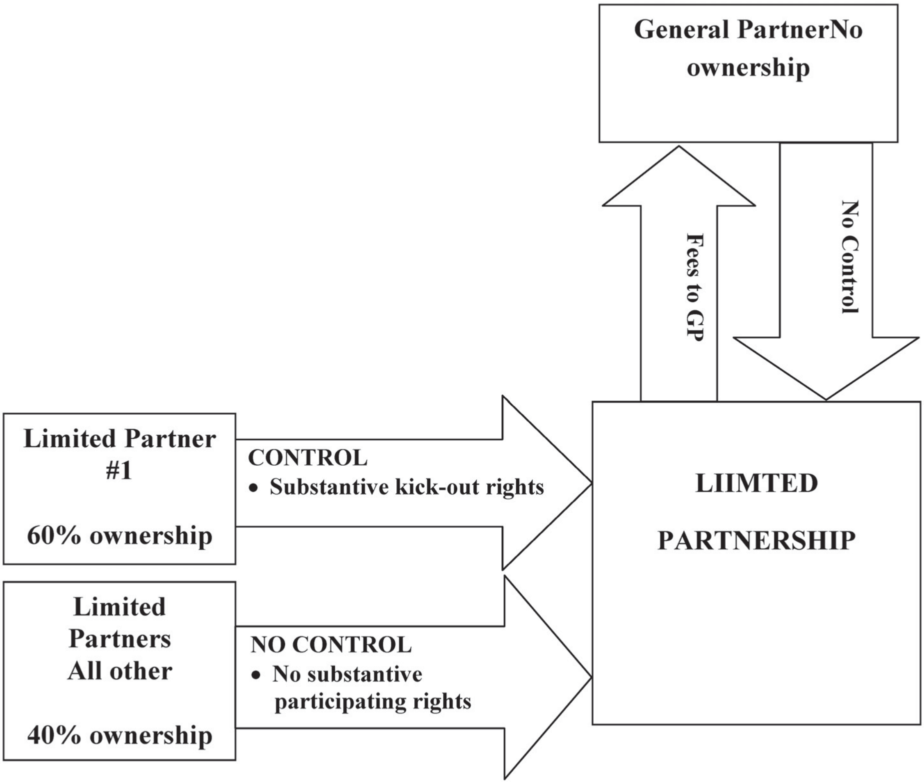
Recall that under the voting interest entity model, a limited partner consolidates an LP only if there is a single limited partner that holds the majority of kick-out rights (more than 50 percent) and there are no substantive participating rights held by non-controlling limited partners that block the single limited partner from exercising its kick-out rights. In this example, there is no single limited partner that has kick-out rights because it has been stated in the example that no limited partners hold kick-out or participating rights. Thus, there is no consolidation using the voting interest entity model.

As to the VIE model, there is no limited partner who satisfies the power criterion or economic criterion. In fact, it has been clearly stated in the example that the limited partners have no control or power over the management of the LP. The conclusion in this case is that no entity consolidates the LP.

> **COMMENT:** In reviewing Examples 1 and 2, it should be clearer to the reader that the new rules found in ASU 2015-02 make it unlikely that a GP will consolidate an LP in situations in which the GP holds no LP interests. As long as the GP compensation (fixed and variable) is commensurate with the services provided, the GP holds no variable interests in the LP and will not have to test to determine whether the GP is the primary beneficiary that consolidates the LP.

## EXAMPLE 3:

Same facts as Example 1, except that the GP has no ownership in the LP, the limited partners have substantive kick-out rights under which they can terminate the GP without cause, and one limited partner (#1) holds 60 percent of the limited partnership interest and 60 percent of the kick-out rights. Additionally, the other 40 percent is held by numerous limited partners that have no substantive participating rights that can block the 60 percent limited partner.



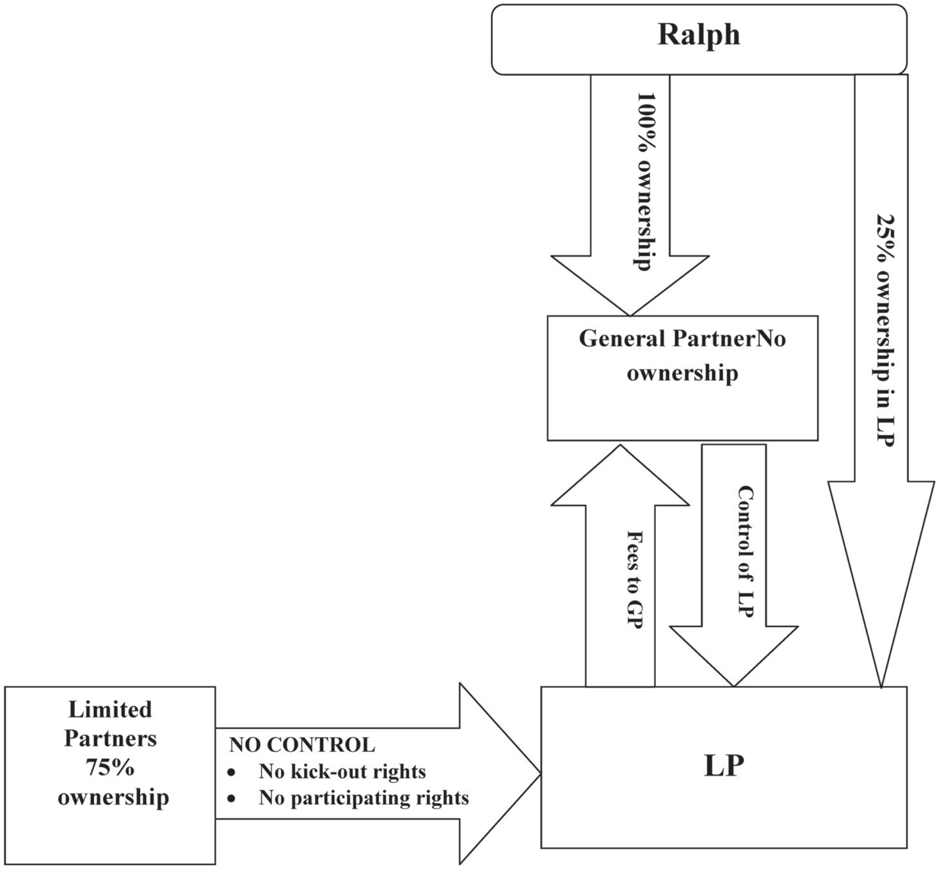

**Conclusion:**

Because one limited partner holds, through its ownership interest, more than 50 percent of the kick-out rights, that one limited partner consolidates the LP using the voting interest entity model. Under that model, a limited partner consolidates the LP provided that the limited partner a) holds more than 50 percent of the kick-out rights of the LP and, b) the other noncontrolling limited partners (40 percent) do not hold any substantive participating rights that could block the controlling limited partner's rights under the kick-out rights.

With respect to the consideration of related parties, under the ASU, in evaluating the three conditions to determine whether fees paid to a decision maker or service provider are a variable interest, any interest in the LP held by a related party of the decision maker or service provider should be considered in the analysis. The term *related parties* includes traditional related parties, as identified in ASC 850, Related Party Disclosures, and certain de facto agents or principals of the variable interest holder. As a result, if a related party holds an interest in the VIE (LP), that interest is deemed to be held by the GP.

## EXAMPLE 4:

Same facts as Example 1, except that the GP has no ownership and the GP's owner, Ralph, has a 25 percent interest in the limited partnership.




**Conclusion:**

The GP would consolidate the limited partnership. In this example, the GP does hold an interest in the limited partnership. The 25 percent limited partnership interest held by GP's owner, Ralph, is assigned to the GP under the related-party rules. Because only two of the three conditions are satisfied, the fees paid to the decision maker (GP), are considered a variable interest. Furthermore, the LP is a VIE because there are no kick-out rights or participating rights held by the limited partners.

Now that GP has a variable interest and the LP is a VIE, GP now must test the LP to determine whether GP is the primary beneficiary that consolidates LP. In this example, the GP does satisfy the power criterion because it is the only one that has the power to direct the LP's activities. The limited partners do not hold any kick-out rights or participating rights that could result in the limited partners participating in the operations of the LP. With respect to the economic criterion, because the GP has a 25 percent ownership in the LP (through Ralph's interest), GP does have the obligation to absorb losses of the LP or the right to receive benefits from the LP. The result is that GP satisfies both the power criterion and economic criterion and is considered the primary beneficiary that consolidates the LP under the VIE consolidation model.

## STUDY QUESTIONS

**10.** Each of the following identifies an area of change with respect to the amendments of ASU 2015-02, ***except:***

- **a.** Evaluating fees paid to a decision maker or a service provider as a variable interest
- **b.** The effect of fee arrangements on the primary beneficiary determination
- **c.** Primary beneficiary determination
- **d.** The effect of related parties on the primary beneficiary determination

**11.** Which of the following rights represents the ability to block actions through which an entity exercises the power to direct the activities of a VIE that most significantly impact the VIE's economic performance?

- **a.** Participating rights
- **b.** Kick-out rights
- **c.** Protective rights
- **d.** Withdrawal rights

# ¶ 512 CHANGE 3: THE EFFECT OF FEE ARRANGEMENTS ON THE PRIMARY BENEFICIARY DETERMINATION

## EXISTING GAAP

Under current GAAP a decision maker or service provider (reporting entity) is determined to be the primary beneficiary of a VIE that consolidates the VIE if it has a controlling financial interest, by having both power and benefits. Under current GAAP, if a fee paid to a decision maker (such as an asset management fee), is determined to be a variable interest in a VIE, the decision maker must include the fee in its primary beneficiary determination and could consolidate the VIE by satisfying both the power criterion and economic criterion through the fees paid to the decision maker.

## NEW RULES PER ASU 2015-02

The amendments in the ASU specify that some fees paid to a decision maker are excluded from the evaluation of whether the decision maker is the primary beneficiary of a VIE. As a result, the amendments make it less likely for a decision maker to meet the economics criterion solely on the basis of a fee arrangement. In performing the primary beneficiary test, fees paid to a reporting entity (decision maker or service provider) other than those included in arrangements that expose a reporting entity to risk of loss that meet both of the following conditions should be excluded:

- The fees are compensation for services provided and are commensurate with the level of effort required to provide those services
- The service arrangement includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length

An arrangement that is designed in a manner such that the fee is inconsistent with the reporting entity's role or the type of service would not meet those conditions above. To assess whether a fee meets these conditions, a reporting entity may need to analyze similar arrangements among parties outside the relationship being evaluated. However, a fee would not presumptively fail those conditions if similar service arrangements relate to a unique or new service, or the fee arrangement reflects a change in what is considered customary for the services. In addition, the magnitude of a fee, in isolation, would not cause an arrangement to fail those conditions.

Furthermore, fees or payments in connection with agreements that expose a reporting entity (the decision maker or service provider) to risk of loss in the VIE should not be eligible for this evaluation. These types of fees include, but are not limited to, the following:

- Those related to guarantees of the value of the assets or liabilities of a VIE
- Obligations to fund operating losses
- Payments associated with written put options on the assets of the VIE
- Similar obligations such as some liquidity commitments or agreements (explicit or implicit) that protect holders of other interests from suffering losses in the VIE

# ¶ 513 CHANGE 4: THE EFFECT OF RELATED PARTIES ON THE PRIMARY BENEFICIARY DETERMINATION

## EXISTING GAAP

Under the VIE consolidation model, in instances in which no single party has a controlling financial interest in a VIE, current GAAP requires interests held by a reporting entity's related parties to be treated as though they belong to the reporting entity when evaluating whether a related party group has the characteristics of a primary beneficiary, to consolidate the VIE.

## NEW RULES PER ASU 2015-02

The fourth primary change made by ASU 2015-02 to the consolidation rules involves considering the effect of related parties on the determination of the primary beneficiary under the variable interest rules. The amendments in ASU 2015-02 reduce the application of the related party guidance for VIEs on the basis of the following three changes:

- For single decision makers, related-party relationships must be considered indirectly on a proportionate basis, rather than in their entirety.
- After the assessment above is performed, related-party relationships should be considered in their entirety for entities that are under common control only if that common control group has the characteristics of a primary beneficiary. That is, the common control group collectively has a controlling financial interest.
- If the second assessment is not applicable, but substantially all of the activities of the VIE are conducted on behalf of a single variable interest holder (excluding the decision maker) in a related party group that has the characteristics of a primary beneficiary, that single variable interest holder must consolidate the VIE as the primary beneficiary.

The ASU does not amend the related-party guidance for situations in which power is shared between two or more entities that hold variable interests in a VIE.

# ¶ 514 CHANGE 5: CERTAIN INVESTMENT FUNDS

## EXISTING GAAP

ASU 2010-10, *Consolidation (Topic 810): Amendments for Certain Investment Funds,* indefinitely deferred the effective date of the VIE consolidation requirements for investment companies.

## NEW RULES PER ASU 2015-02

ASU 2015-02 rescinded the indefinite deferral included in ASU 2010-10. Additionally, the ASU provides a scope exception from ASC 810 consolidation rules for reporting entities with interests in legal entities that are required to comply with or operate in accordance with requirements similar to those in Rule 2a-7 of the Investment Company Act of 1940 for registered money market funds. As a result, a reporting entity should not consolidate a legal entity that is required to comply with or operate in accordance with requirements that are similar to those included in Rule 2a-7 of the Investment Company Act of 1940 for registered money market funds.

A legal entity that is not required to comply with Rule 2a-7 qualifies for this exception if it is similar in its purpose and design, including the risks that the legal entity was designed to create and pass through to its investors, as compared with a legal entity required to comply with Rule 2a-7. It is important to note that a reporting entity subject to this scope exception is required to disclose any explicit arrangements to provide financial support to legal entities that are required to comply with or operate in accordance with requirements that are similar to those included in Rule 2a-7, as well as any instances of such support provided for the periods presented in the performance statement. For purposes of applying this disclosure requirement, the types of support that should be considered include, but are not limited to, any of the following:

- Capital contributions (except pari passu investments)
- Standby letters of credit
- Guarantees of principal and interest on debt investments held by the legal entity
- Agreements to purchase financial assets for amounts greater than fair value (e.g., at amortized cost or par value when the financial assets experience significant credit deterioration)
- Waivers of fees, including management fees

The FASB noted in its Basis for Conclusions section of ASU 2015-02 that the consolidation guidance in ASC 810 will not apply to a reporting entity's interest in an entity that is required to comply with or operate in accordance with requirements that are similar to those included in Rule 2a-7 of the Investment Company Act of 1940 for registered money market funds. Previously, such funds were exempt from application of the ASC 810 consolidation rules under the indefinite deferral provision found in FAS 167. In ASU 2015-02, the FASB removed the indefinite deferral of FAS 167 and provided a permanent exemption for certain money market funds covered under Rule 2a-7 of the Investment Company Act of 1940.

The FASB concluded that consolidation does not produce more meaningful financial reporting than nonconsolidated results. Factors that the FASB considered in making its exemption include:

- Input from respondents indicated that consolidation of money market funds negatively impacts the ability to analyze financial statements to understand a fund manager's compensation and to distinguish between a fund manager's assets and liabilities and those of the consolidated money market fund.
- Consolidation could be distortive due to the regulated nature of registered money market funds, including the portfolio quality, maturity, and diversification of the investments held by the money market funds, in its decision to provide a scope exception.

In conjunction with its decision to provide a scope exception, the FASB decided that the exemption should not be limited to registered money market funds that are required to comply with Rule 2a-7, but that the exemption should also apply to other funds that operate in a manner similar to registered money market funds that are required to comply with that Rule. This decision is consistent with the conclusion for the indefinite deferral of Statement 167 for certain money market funds. However, the FASB decided to require fund sponsors of money market funds meeting this scope exception to disclose explicit arrangements to provide financial support to the money market funds they manage as well as any instances of financial support provided for the periods presented in the performance statement. Disclosing that information benefits users of financial information and presents minimal costs to preparers of financial information.

## ¶ 515 ASU 2015-02 TRANSITIONS

As previously noted, the ASU is effective for public business entities, for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2015. For all other entities, the ASU is effective for fiscal years beginning after December 15, 2016, and for interim periods within fiscal years beginning after December 15, 2017.

If a reporting entity is required to consolidate a legal entity as a result of the initial application of the ASU, the initial measurement of the assets, liabilities, and noncontrolling interests of the legal entity depends on whether the determination of their carrying amounts is practicable. To that end, *carrying amounts* refers to the amounts at which the assets, liabilities, and noncontrolling interests would have been carried in the consolidated financial statements if the requirements of the ASU had been effective when the reporting entity first met the conditions to consolidate the legal entity. If determining the carrying amounts is practicable, the reporting entity should initially measure the assets, liabilities, and noncontrolling interests of the legal entity at their carrying amounts. However, if determining the carrying amounts is not practicable, the assets, liabilities, and noncontrolling interests of the legal entity should be measured at fair value at the date the ASU first applies.

Any difference between the net amount added to the statement of financial position of the reporting entity and the amount of any previously recognized interest in the newly consolidated legal entity should be recognized as a cumulative-effect adjustment to retained earnings. A reporting entity should also describe the transition method(s) applied and disclose the amount and classification in its statement of financial position of the consolidated assets or liabilities by the transition method(s) applied. In addition, a reporting entity that is required to consolidate a legal entity as a result of the initial application of the ASU may elect the fair value option provided by the Fair Value Option Subsections of Subtopic 825-10 on financial instruments, but only if the reporting entity elects the option for all financial assets and financial liabilities of that legal entity that are eligible for this option under those Fair Value Option Subsections. This election is required to be made on a legal entity by legal entity basis. Along with the disclosures required in those Fair Value Option Subsections, the reporting entity is also required to disclose all of the following:

- Management's reasons for electing the fair value option for a particular legal entity or group of legal entities
- The reasons for different elections if the fair value option is elected for some legal entities and not others
- Quantitative information by line item in the statement of financial position indicating the related effect on the cumulative-effect adjustment to retained earnings of electing the fair value option for a legal entity

Furthermore, if a reporting entity is required to *deconsolidate* a legal entity as a result of the initial application of this ASU, the initial measurement of any retained interest in the deconsolidated former subsidiary depends on whether the determination of its carrying amount is practicable. In this context, carrying amount refers to the amount at which any retained interest would have been carried in the reporting entity's financial statements ASU had been effective when the reporting entity became involved with the legal entity or no longer met the conditions to consolidate the legal entity.

Any difference between the net amount removed from the statement of financial position of the reporting entity and the amount of any retained interest in the newly deconsolidated legal entity should be recognized as a cumulative-effect adjustment to retained earnings. Additionally, a reporting entity shall disclose the amount of any cumulative-effect adjustment related to deconsolidation separately from any cumulative-effect adjustment related to consolidation of entities.

The determinations of whether a legal entity is a VIE and which reporting entity, if any, should consolidate the legal entity should be made as of the date the reporting entity became involved with the legal entity or, if events have occurred requiring reconsideration of whether the legal entity is a VIE and which reporting entity, if any, should consolidate the legal entity, as of the most recent date at which the ASU would have required consideration. If, at transition, it is not practicable for a reporting entity to obtain the information necessary to make the determinations as of the date the reporting entity became involved with a legal entity or at the most recent reconsideration date, the reporting entity should make the determinations as of the date on which the ASU is first applied.

If the determinations of whether a legal entity is a VIE and whether the VIE should be consolidated, then the consolidating entity should measure the assets, liabilities, and noncontrolling interests of the legal entity at fair value as of the date on which the ASU is first applied.

With respect to transition method, the ASU may be applied retrospectively in previously issued financial statements for one or more years with a cumulative-effect adjustment to retained earnings as of the beginning of the first year restated. Early adoption, including adoption in an interim period, is also permitted. If an entity early adopts the ASU in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. In addition, an entity is required to provide certain disclosures in the period the entity adopts the ASU.

## STUDY QUESTION

**12.** Company Z is a decision maker for Company Y and receives management fees from Y for its services. Under ASU 2015-02, fees paid to Company Z by Company Y are not variable interests if certain conditions are met. Which of the following is one of the conditions?

- **a. a.** Substantially all of the fees are at or above the same level of seniority as other operating liabilities of the entity that arise in the normal course of the entity's activities.
- **b. b.** The total amount of anticipated fees are insignificant relative to the total amount of the VIE's anticipated economic performance.
- **c. c.** The fees are compensation for services provided and are commensurate with the level of effort required to provide those services.
- **d. d.** The anticipated fees are expected to absorb an insignificant amount of the variability associated with the entity's anticipated economic performance.

**CPE NOTE:** When you have completed your study and review of chapters 4-5, which comprise Module 2, you may wish to take the Final Exam for this Module. Go to **CCHGroup.com/PrintCPE** to take this Final Exam online.

# MODULE 3: OTHER CURRENT DEVELOPMENTS—CHAPTER 6: GAAP for Terrorism and Natural Disasters

## ¶ 601 WELCOME

This chapter provides an overview of the accounting and reporting requirements with respect to costs incurred related to terrorism and natural disasters. This includes a discussion of the disclosure requirements, the treatment of insurance recoveries, as well as the related income statement presentation and certain tax consequences.

## ¶ 602 LEARNING OBJECTIVES

Upon completion of this chapter, you will be able to:

- Identify the accounting and disclosure requirements related to certain risks and uncertainties and those related to terrorism and natural disasters
- Recognize how certain insurance recoveries should be accounted for in an entity's financial statements
- Differentiate between GAAP and tax reporting requirements of costs incurred related to terrorism and natural disasters

## ¶ 603 INTRODUCTION

In April 2013, Boston was the victim of one of the U.S.'s worst terrorist attacks yet, with three individuals dead and more than 260 persons wounded. More than 300 businesses in the Boylston Street, Downtown Boston area were shut down for more than a week as investigators sorted through the rubble and debris left behind by the two bombs that exploded. Unfortunately, the effects of any terrorist attack are not limited to the immediate act that was perpetrated and extend into the lives of many individuals and businesses.

Prior to the Boston attack, there have been several large natural disasters such as Hurricanes Katrina and Sandy, and ongoing tornados and earthquakes. The purpose of this chapter is to address some of the GAAP issues that may have to be considered as a result of gains and losses related to terrorism and acts of God. Some of these issues were addressed going as far back as the September 11th attack in New York. Others are now being brought to the forefront as the United States realizes that terrorism is no longer an isolated 9/11 attack, but now is an ongoing risk that is part of the fabric of the United States. GAAP issues pertaining to terrorism are now becoming relevant. As for natural disasters, they are ongoing and are likely to recur in the future.

In this section, the following issues related to gains and losses involving terrorism and natural disasters are addressed:

- Disclosure issues-risks and uncertainties (terrorism versus acts of God and the GAAP exception)
- Presentation of gains and losses from terrorism and acts of God
- Dealing with insurance including:

- Presentation of business interruption insurance
- Dealing with involuntary conversions for GAAP
- Dealing with gain contingencies and insurance recoveries

## ¶ 604 DISCLOSURE CONSIDERATIONS

ASC 275, *Risks and Uncertainties,* requires that reporting entities make disclosures in their financial statements about the risks and uncertainties existing as of the date of those statements in the following areas:

- Nature of operations
- Use of estimates in the preparation of financial statements
- Certain significant estimates
- Current vulnerability due to certain concentrations

However, ASC 275's disclosure requirements do not encompass risks and uncertainties that might be associated with any of the following:

- Management or key personnel
- Proposed changes in governmental regulations
- Proposed changes in accounting principles
- Deficiencies in the internal control structure
- The possible effects of acts of God, war, or sudden catastrophes

ASC 275 notes that the vulnerability from concentrations arises because an entity is exposed to risk of loss greater than it would have had if it had mitigated its risk through diversification. As a result, financial statements are required to disclose the concentrations if, based on information known to management before the financial statements are issued or are available to be issued, all of the following criteria are met:

- The concentration exists at the date of the financial statements.
- The concentration makes the entity vulnerable to the risk of a near-term severe impact.
- It is at least reasonably possible that the events that could cause the severe impact will occur in the near term.

In order for there to be a concentration that exposes an entity to a near-term severe impact, it must be at least reasonably possible that such a severe impact will occur in the near term (within one year). ASC 275 defines *near term*, and *severe impact* as the following:

**Near term:** A period of time not to exceed one year from the date of the financial statements

**Severe impact:** A significant financially disruptive effect on the normal functioning of an entity. Severe impact is a higher threshold than material. Matters that are important enough to influence a user's decisions are deemed to be material, yet they may not be so significant as to disrupt the normal functioning of the entity

The question is whether the potential risk of a terrorist attack results is a current vulnerability due to a terrorist attack. The same question applies to an act of God. The answer is that GAAP has not addressed terrorist attacks in the capacity of whether such an attack results in a disclosure of the current vulnerability due to a terrorist attack. GAAP also does not specifically address the disclosures as they relate to acts of God or even war.

**EXAMPLE:** Company X is a restaurant in downtown New York City. Because of its location, there is a concentration (terrorist attack) that exposes X to a near-term severe impact. Further, it is reasonably possible that a terrorist attack will occur in the near term (within the next year) and it would have a severe impact on X's business. The primary question is, does the concentration of terrorism risk result in a required disclosure under ASC 275?

On its face, the answer is yes. However, ASC 275 states that disclosure requirements do not apply to risks and uncertainties involving "the possible effects of acts of God, war, or sudden catastrophes." A terrorist attack is not an act of God, and may or may not be an act of war, but it would appear to fall into the category of a sudden catastrophe. Although ASC 275 does not define the term *catastrophe* the dictionary definition is "an event causing great and often sudden damage or suffering; a disaster."

**COMMENT:** The author believes a terrorist attack would be considered a sudden catastrophe. Therefore, the author believes that regardless of where a business is located (downtown Manhattan, Boston), there is no disclosure requirement pertaining to a concentration of risk or uncertainty of a terrorist attack. The same conclusion would be reached if Company X is located on the ocean and subject to the risk of a flood or hurricane. No disclosure would be required under the "possible effects of acts of God, war, or sudden catastrophes" exception.

## ¶ 605 LOSSESS FROM TERRORISM OR ACTS OF GOD

Losses from terrorist attacks and acts of God can be significant and can include physical damage to premises, lost revenue and profits from business shutdown, additional consulting fees for psychotherapists and medical care for employees, relocation costs, and employee expenses to carry employees during a shutdown. The 9/11 and Boston terrorist attacks and the Katrina storm resulted in businesses having significant losses that, in some cases, were not covered by insurance. In preparing financial statements, companies with losses from terrorism and/or acts of God have asked the question as to whether such losses (or in limited cases gains) qualified for extraordinary treatment, to be shown net of tax below the line.

Through a series of Emerging Issues Task Force consensus opinions (EITFs) and practice aids, the FASB has noted that gains or losses from terrorist attacks and most acts of God do not qualify for extraordinary treatment because they do not satisfy the unusual nature and infrequency of occurrence criteria. Although the "unusual nature" criterion may be met, the "infrequency of occurrence" criterion is not satisfied because it is reasonable to expect another terrorist attack or act of God to recur in the foreseeable future, taking into account the environment in which the entity operates. In addition, the magnitude of any loss has no impact on whether the loss qualifies for extraordinary treatment.

In 2015, the FASB issued ASU 2015-01, *Income Statement—Extraordinary and Unusual Items (Subtopic 225-20): Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items*. This ASU eliminates all transactions from extraordinary treatment effective for years beginning after 2015. As a result, the debate as to whether a gain or loss from a terrorist attack qualifies for extraordinary treatment becomes moot beginning in 2016.

## ¶ 606 INSURANCE RECOVERIES FROM TERRORIST ATTACKS

With respect to insurance recoveries, the primary question relates to how insurance recoveries of losses and costs incurred as a result of a natural disaster, terrorist act, or act of God be classified in the statement of operations, and when those recoveries should be recognized. GAAP prescribes that any insurance recoveries of losses and costs incurred should be classified in a manner consistent with the related losses within the income from continuing operations. In addition, an asset (i.e. receivable) relating to the insurance recovery should be recognized only when realization of the claim for recovery of the loss recognized in the financial statements is deemed probable (Under ASC 410, if a claim is the subject of litigation, a rebuttable presumption exists that realization of the claim is not probable). Furthermore, a gain should not be recognized until any contingencies relating to the insurance claim have been resolved.

> **COMMENT:** In accounting for insurance payments to cover losses, entities should follow the guidance in ASCs 210-20, 225-20, 225-30, 410-30, 605-40, and 815. FASB ASC 605-40 clarifies the accounting for involuntary conversions of nonmonetary assets (such as property or equipment) to monetary assets (such as insurance proceeds). It requires that a gain or loss be recognized when a nonmonetary asset is involuntarily converted to monetary assets even though an enterprise reinvests or is obligated to reinvest the monetary assets in replacement nonmonetary assets.

FASB ASC 605-40-45-1 prescribes that gain or loss resulting from an involuntary conversion of a nonmonetary asset to monetary assets is required to be classified in accordance with the provisions of Subtopic 225-20 (Extraordinary and Unusual Items). That guidance generally requires that an asset relating to the insurance recovery should be recognized only when realization of the claim for recovery of a loss recognized in the financial statements is deemed probable (as that term is used in FASB ASC 450). In addition, under FASB ASC 450-30-25-1, a gain (that is, a recovery of a loss not yet recognized in the financial statements or an amount recovered in excess of a loss recognized in the financial statements) should not be recognized until any contingencies relating to the insurance claim have been resolved. It is important to note that in some circumstances, losses and costs might be recognized in the statement of operations in a different (earlier) period than the related recovery.

An additional consideration relates to FASB ASC 225-30, which prescribes that entities may choose how to classify such recoveries in the statement of operations, provided that classification does not conflict with existing GAAP requirements. One issue to consider is that an entity is not allowed to record a receivable due from the insurance company for the insurance proceeds from a recovery until realization of the amount of insurance is probable. The reason is because the receivable is considered a gain contingency until the amount of the insurance to be received is settled with the insurance company. What that means is that there could be a fire or other calamity that occurs in the middle of a year but is not settled with the insurance company by year end. The entity is not allowed to record a receivable for the estimated insurance receivable until the company has settled the claim with the insurance company. Recording a "best estimate" as a receivable is not allowed because to do so would result in the company recording a gain contingency, which is not allowed under GAAP.

> **EXAMPLE:** Company X's equipment was heavily damaged in April 2013 from the Boston terrorist act. The company maintains insurance on the equipment that provides for recovery of its replacement value. The equipment has a net book value of $1,000 and an estimated replacement value of $1,500 as of April 2013. Prior to its December 31, 2013 year end, the company files a claim with its insurer for recovery of $1,500. Based on discussions with the insurer, the company concludes that it is probable that the insurer will settle the claim for at least $1,200. However, as of December 31, 2013, the insurer has communicated to the company that the amount of final settlement is subject to verification of the identity of the equipment damaged and receipt of additional market data regarding its value.

**Conclusion:** Because the insurance claim has not been resolved, a gain on the insurance claim cannot be recognized in the company's December 31, 2013 year end income statement. The company should record a claim receivable limited to the $1,000 net book value of the damaged asset because it is probable that there will be a recovery of the loss. The book value should be credited for $1,000 as the equipment is removed. Any remaining recovery beyond $1,000 should be recognized as a gain only when the insurance claim (contingency) has been resolved; that is, when the identity of the damaged equipment and the market data have been finalized to the satisfaction of the insurance company.

> **EXAMPLE:** Company X owns and operates a retail store in downtown Boston and maintains insurance to cover business interruption losses. Under the policy, the Company receives compensation for lost profits in the event of a business interruption, including a terrorist attack. In April 2013, the company's store is damaged from the terrorist attack. As of September 30, 2013, the company has filed a claim with its insurer to recover its estimated lost profit through September 30, 2013. The company has not previously filed a claim under its insurance policy and is uncertain of the final settlement amount. As a result, the company believes there could be a dispute regarding the scope of terrorism coverage under the policy. The parties have not agreed on a settlement as of the date that the company issues its financial statements for the period ended September 30, 2013.

**Conclusion:** Company X should not recognize a gain because contingencies related to the recovery remain unresolved. The company should recognize a gain when those contingencies are resolved by settlement of the claim with the insurance company.

## STUDY QUESTION

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**1.** How should a loss incurred as a result of a terrorist attack be classified?

- **a.** As an extraordinary item
- **b.** As part of income from discontinued operations
- **c.** As part of income from continuing operations
- **d.** As part of retained earnings

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# ¶ 607 INVOLUNTARY CONVERSIONS UNDER GAAP

For tax purposes, the Code Sec. 1033 provides a special rule to deal with disasters under the involuntary conversion rules. Code Sec. 1033 states the following:

- If property is damaged due to a condemnation, theft, seizure, or destruction, and a taxpayer receives insurance proceeds, the gain or loss from the involuntary conversion is not taxable if reinvested in qualified replacement property within a period of time.
- The gain from receipt of insurance proceeds is non-taxable to the extent that the insurance proceeds are used to purchase qualifying replacement property (e.g., property that is similar to, or related to in use to, the property that was lost or taken) within a two-year period that ends two years after the close of the first tax year in which any part of the gain on the conversion is realized (three years for certain condemned property).
- In lieu of recording a gain, the insurance proceeds reduce the basis of the replacement property.

However, the non-recognition of gain rules found in Code Sec. 1033 do not apply to GAAP. Therefore, for GAAP purposes, an involuntary conversion is treated as a sale of the converted property and a gain or loss is recognized on the income statement.

Deferred income taxes must be recorded on the basis difference for GAAP and tax purposes. For tax purposes, the basis of the replacement property is lower than GAAP because of the reduction in the tax basis for the non-recognition of the gain. Furthermore, ASC 605-40-25 prescribes the following:

> *"An involuntary conversion of a nonmonetary asset to monetary assets (e.g., cash) and the subsequent reinvestment of the monetary assets is not the equivalent to an exchange transaction between an entity and another entity. The conversion of a nonmonetary asset to monetary assets is a monetary transaction, whether the conversion is voluntary or involuntary, and such a conversion differs from exchange transactions that involve only nonmonetary assets. To the extent the cost of a nonmonetary asset differs from the amount of monetary assets received, the transaction results in a gain or loss that shall be recognized."*

GAAP for involuntary conversions, on the other hand, requires the following:

- The transaction must be recorded as a sale of the asset when the asset (building, etc.) is converted to a monetary asset (i.e., when the entity receives cash or records a receivable from the insurance company).
- A gain or loss on the transaction is recorded when the entity receives cash or records a receivable for the insurance amount that is settled with the insurance company.

However, it can take an extensive amount of time to settle with the insurance company and that timeline can extend over one or more reporting periods. In such a situation, an entity is precluded from recording a receivable for the insurance settlement and a gain or loss on the transaction. Further, until the transaction is settled and a gain or loss is recognized, the entity cannot remove the underlying fixed asset from its records.

**EXAMPLE:** Company X, a calendar year end filer, has a fire on September 30, 20X1 that damages its plant, making it inoperable. The plant's carrying book value at the date of the fire was $900,000 (Cost of $15million less accumulated depreciation of $600,000). At December 31, 20X1, the company is still negotiating with the insurance company and has received an advance in the amount of $100,000 to start repairing the facility. The company expects to receive approximately $500,000 in total from the insurance company but has not settled on that amount at December 31, 20X1. At December 31, 20X1, the company has spent about $200,000 for miscellaneous improvements to secure the property. No new renovations were started until 20X2. In addition, at December 31, 20X1, the company estimates that the fair value of the damaged building is $500,000, the amount it expects to receive from the insurance company.

**Conclusion:** Because Company X has not settled with the insurance company, it is precluded from recording a receivable and a gain and loss as if the property was sold. As a result, the following has to be recorded at December 31, 20X1:

- Insurance proceeds received in advance ($100,000) should be recorded in a deposit account as a liability.
- The $200,000 spent on repairs to date should be recorded as either a repair and maintenance expense, or as construction in progress (CIP), if it is part of the new construction.
- The building should be written down to $500,000 (its estimated fair value) with an impairment loss.

| Entries: December 31, 20X1: | dr | cr |
|---|---|---|
| Cash | 100,000 | |
| Deposit liability- insurance proceeds | | 100,000 |
| Construction in progress | 200,000 | |
| Cash | | 200,000 |
| Impairment loss | 400,000 | |
| Plant | | 400,000 |
| [$900,000 -$500,000] | | |

Assume further that in March 20X2, X settles with the insurance company for $525,000 and receives a check for $425,000 ($525,000 less $100,000 advance received in 20X1). A gain or loss on the transaction should be recorded as follows:

| | |
|---|---|
| Insurance proceeds | $525,000 |
| Basis: | |
| Cost (1) | 1,100,000 |
| Accumulated depreciation | (600,000) |
| Book value | 500,000 |
| Gain on transaction | $25,000 |

(1) Original cost $1.5 M less impairment loss $(400,000) = $1.1 million.

| Entries: March 20X2: | dr | cr |
|---|---|---|
| Cash | 425,000 | |
| Deposit liability- insurance proceeds | 100,000 | |
| Building | | 1,100,000 |
| AD- building | 600,000 | |
| Gain on transaction | | 25,000 |

**COMMENT:** Because of the timing of settling the insurance proceeds, an entity will likely have to record an impairment loss in one period, and then record a gain on the transaction representing a sale in the following period once the insurance proceeds are settled. The result is a mismatch of revenue and expense in that the impairment loss results in a lower basis and thus, a higher gain in the subsequent period. Because GAAP does not allow an entity to estimate the insurance proceeds and record the receivable prior to settlement, there is a distortion of revenue and expense among periods. To date, the FASB has not focused on this issue.

**EXAMPLE:** Assume that at December 31, 20X1, the fair value of the building is estimated to be $2million, which is the insurance proceeds that the company expects to receive in 20X2, even though it has not been settled at December 31, 20X1. All other facts are the same as the previous example. In this situation, there would be *no write down* of the building for impairment. Under ASC 360, *Impairments*, an impairment of a fixed asset (building in this case), exists if the undiscounted future cash flows from its use (and sale) are less than its carrying amount. In this case, the estimated future undiscounted cash flows consist of the insurance proceeds that are expected to be $2million, which exceeds the carrying amount of $900,000. Thus, there is no impairment and no write-down of the building at the end of 20X1.

**Conclusion:** The result is as follows:

| Entries: December 31, 20X1: | dr | cr |
|---|---|---|
| Cash | 100,000 | |
| Deposit liability- insurance proceeds | | 100,000 |
| Construction in progress | 200,000 | |
| Cash | | 200,000 |
| Impairment loss | 0 | |
| Plant | | 0 |

Assuming that in March 20X2, X settles with the insurance company for $2,000,000 and receives a check for $1,900,000 ($1,900,000 less $100,000 advance received in 20X1). A gain or loss on the transaction should be recorded as follows:

| | |
|---|---|
| Insurance proceeds | $2,000,000 |
| Basis: | |
| Cost (1) | 1,500,000 |
| Accumulated depreciation | (600,000) |
| Book value | 900,000 |
| Gain on transaction | $1,100,000 |

| Entries: March 20X2: | dr | cr |
|---|---|---|
| Cash | 1,900,000 | |
| Deposit liability- insurance proceeds | 100,000 | |
| Building | | 1,500,000 |
| AD- building | 600,000 | |
| Gain on transaction | | 1,100,000 |

## STUDY QUESTION

**2.** With respect to insurance recoveries, how should an insurance receivable be handled?

- **a.** It should be booked as a gain contingency.
- **b.** It should be recorded only when realization is probable.
- **c.** It should not be recorded and should be accounted for on a cash basis.
- **d.** It should be recorded once a best estimate of the amount that might be recovered is known.

# ¶ 608 BUSINESS INTERRUPTION INSURANCE RECOVERIES

The governing authority for business interruption insurance recoveries is found in ASC 225-30, *Income Statement-Business Interruption Insurance*, which deals with business interruption insurance, and ASC 605, *Revenue Recognition*, for insurance proceeds related to property damage. In other areas, ASC 410, *Asset Retirement and Environmental Obligations* and ASC 605 provide that any insurance recoveries are netted against the related loss on the same income statement line.

An entity may choose how to classify business interruption insurance recoveries in the statement of operations, as long as that classification is not contrary to existing GAAP. With respect to property insurance recoveries, ASC 605 provides that any insurance recoveries are netted against the related loss on the same income statement line. Specifically, ASC 605 states that a gain or loss should be recognized on the difference between the carrying amount of the asset and the amount of monetary assets received (insurance recovery received) in the period of the involuntary conversion. As a result, the insurance recoveries are netted against the related loss (the carrying amount of the insured asset) and shown in the other income section of the income statement.

Business interruption insurance differs from other types of insurance coverage in that it protects the prospective earnings or profits of the insured entity. It provides coverage if business operations are suspended due to loss of use of property and equipment resulting from a covered cause of loss. Business interruption insurance coverage usually provides for reimbursement of certain costs and losses incurred during the reasonable period of time to rebuild, repair, or replace the damaged property. Types of costs typically covered include the following:

- Gross margin that was “lost” or not earned due to the suspension of normal operations
- A portion of fixed charges and expenses in relation to that lost gross margin
- Other expenses incurred to reduce the loss from business interruption, such as rental of a temporary facility and equipment, use of subcontractors, etc.

ASC 605 applies only to recoveries of certain types of losses and costs that have been recognized in the income statement. On the other hand, a portion of recoveries from business interruption insurance represents a reimbursement of “lost margin” rather than a recovery of losses or other costs incurred. As a result, there are no direct costs recorded on the income statement to which the insurance recovery relates.

While an entity may choose how to classify business interruption insurance recoveries in the statement of operations, as long as that classification is not contrary to existing GAAP, the following information should be disclosed in the notes to financial statements in the period(s) in which the insurance recoveries are recognized:

- The nature of the event resulting in the business interruption losses.
- The aggregate amount of business interruption recoveries recognized during the period and the line item(s) in the statement of operations in which those recoveries are classified.

**COMMENT:** ASC 225 gives companies latitude in presenting a business interruption insurance recovery in the income statement. Because the underlying losses may not be recorded, such as lost revenue, there may not be a particular line item(s) to which the recovery relates. One approach to display would be to present the insurance recovery in the lines to which the “lost items” related. Note that although ASC 225 applies to business interruption insurance recoveries, the same concept applies to other insurance recoveries, including property insurance recoveries.

**EXAMPLE:** Assume there is a fire in a building. The building is condemned and the owner recovers $250,000 for lost rents and another $500,000 for property damage while the property is being repaired. Other information follows:

| | |
|---|---|
| Rent revenue | $2,000,000 |
| Operating expenses | (900,000) |
| Insurance recovery ($250,000 + $500,000) | 750,000 |
| Net amounts | $1,850,000 |

Assume the lost rents recovery is calculated as follows:

| | |
|---|---|
| Lost rents | $400,000 |
| Saved utilities and other direct costs | (150,000) |
| Business interruption insurance recovery-lost rents | $250,000 |

Assume the book value of the building (without land) that is condemned is $200,000 so that there is a gain on that portion of the transaction of $300,000 as follows:

| | |
|---|---|
| Property insurance proceeds | $500,000 |
| Book value of real estate | (200,000) |
| Gain on building condemnation | $300,000 |

The net income to be presented is as follows:

| | |
|---|---|
| Rent revenue | $2,000,000 |
| Operating expenses | (900,000) |
| Business interruption insurance recovery | 250,000 |
| Gain on building condemnation | 300,000 |
| Net income | $1,650,000 |

**Conclusion:** With respect to the $250,000 business interruption insurance, ASC 225 permits a company to present it in any way an entity chooses on its income statement. The following are two suggested presentation formats. Option 1 is to categorize the recovery in those sections of the income statement to which the "lost items" relate. In this case, the $250,000 recovery would be split into two sections: $400,000 presented as a credit to rental income, and the other $150,000 presented as an increase to operating expenses.

**Allocation of business interruption insurance**

| | Initial amounts | Allocation of the recovery | Income statement presentation |
|---|---|---|---|
| Rent revenue | $2,000,000 | $400,000 | $2,400,000 |
| Operating expenses | (900,000) | (150,000) | (1,050,000) |
| Business interruption insurance recovery | 250,000 | (250,000) | 0 |
| Net income | $1,350,000 | $ 0 | $1,350,000 |

The income statement presentation would look like this:

**X Real Estate Company**
**Statement of Income**
**For the Year Ended December 31, 20X1**

| | |
|---|---|
| Rent revenue | $2,400,000 |
| Operating expenses | (1,050,000) |
| Other income: | |
| ***Gain on condemnation of building*** | ***300,000*** |
| Net income | $1,650,000 |

Option 2 is to present the business interruption insurance recovery as an other income item as follows:

| X Real Estate Company<br>Statement of Income<br>For the Year Ended December 31, 20X1 | |
|---|---|
| Rent revenue | $2,000,000 |
| Operating expenses | (900,000) |
| Net operating income | 1,100,000 |
| Other income: | |
| ***Business interruption insurance recovery*** | ***250,000*** |
| ***Gain on condemnation of building*** | ***300,000*** |
| Net income | $1,650,000 |

For tax purposes, the $500,000 of property insurance proceeds would be credited to the building asset, resulting in a $300,000 basis difference, which would be a temporary difference for deferred income tax purposes as follows:

| | GAAP | Tax purposes | Temporary difference |
|---|---|---|---|
| Book value-building | $200,000 | $200,000 | |
| Entry to record sale of real estate condemned | (200,000) | 0 | |
| Entry to record reduction of basis for Code Sec.1033 | 0 | (500,000) | |
| Basis before capitalization of construction costs | $ 0 | $(300,000) | $(300,000) |

Assuming that the Company's federal and state tax rate is 40%, deferred income taxes would be recorded as follows:

| Entry: | dr | cr |
|---|---|---|
| Income tax expense-deferred federal/state (1) | 120,000 | |
| Deferred income taxes | | 120,000 |
| (1): $300,000 x 40% = $120,000 | | |

The following is an example of a disclosure that would apply to the above:

**Note X: Insurance Recovery**

In 20X1, the Company incurred a fire at its apartment building located at 120 Main Street, Nowhere, Massachusetts, which resulted in the building being condemned.

Under its insurance policy, the Company received recovery of costs to reconstruct the building into its condition immediately prior to the fire, and business interruption insurance.

The Company received $500,000 as an insurance settlement to reconstruct the building. The insurance recovery, less the carrying amount of the building, resulted in a gain of $300,000 which is presented in the Other Income section of the statement of income. In 20X1, the Company started the reconstruction the building and capitalized $270,000 as part of Construction in Progress at year end.

In addition to receiving the $500,000 insurance settlement, under its business interruption insurance policy, the Company received recovery of rental revenue lost during the construction period, net of certain related costs. The total amount of insurance received was $250,000 which is presented in the Other Income section of the income statement.

> **COMMENT:** In the previous example, the difference between the carrying amount of the building for GAAP and tax purposes results in a temporary difference that creates deferred income taxes. The difference is a byproduct of the basis being reduced by the $500,000 of insurance proceeds for tax purposes under the involuntary conversion rules in Code Sec. 1033, while being recorded as part of a gain for GAAP. When the entity reconstructs the building, the costs would be capitalized for both GAAP and tax purposes.

So what will happen if the company does not spend the $500,000 insurance proceeds within the required two-year (or three-year, in some cases) period required in Code Sec. 1033? That Code section requires that the entire amount of the $500,000 insurance proceeds be spent on qualified replacement property, including reconstruction of the condemned building, within a two- or three-year qualified period, depending on the circumstances. If a portion of those funds is not spent on qualified replacement property within the qualified period, the shortfall is taxable and the deferred income taxes on that portion of the temporary difference set up for the deferred gain would be reversed.

## STUDY QUESTION

**3.** According to ASC 225, an entity may choose how to classify business interruption insurance recoveries in the statement of operations________.

- **a.** Without any restrictions
- **b.** As long as the recovery is insignificant
- **c.** As long as that classification is not contrary to existing GAAP
- **d.** As long as the amount is characterized as unusual

# MODULE 3: OTHER CURRENT DEVELOPMENTS—CHAPTER 7: Recent ASUs: Going Concern, Debt Issuance Costs, and Intangibles

## ¶ 701 WELCOME

This chapter reviews some recent ASUs related to going concern assessment by management, debt issuance costs, internal-use software, and identifiable intangible assets in a private company business combination.

## ¶ 702 LEARNING OBJECTIVES

Upon completion of this chapter, you will be able to:

- Explain changes made to going concern assessment by ASU 2014-15
- Identify one of the criteria that must be met to treat a hosting arrangement as internal-use software
- Identify how to account for intangible assets under ASU 2014-18's accounting alternative

## ¶ 703 RECENTLY ISSUED ASUs

Following is a summary of recently issued ASUs.

**Recently Issued ASUs**
**2014 through 2016**

| ASU No. | Description |
|---|---|
| 2014-01 | *Investments—Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects (a consensus of the FASB Emerging Issues Task Force)* |
| 2014-02 | *Intangibles—Goodwill and Other (Topic 350): Accounting for Goodwill (a consensus of the Private Company Council)* |
| 2014-03 | *Derivatives and Hedging (Topic 815): Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps—Simplified Hedge Accounting Approach (a consensus of the Private Company Council)* |
| 2014-04 | *Receivables—Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure (a consensus of the FASB Emerging Issues Task Force)* |
| 2014-05 | *Service Concession Arrangements (Topic 853) (a consensus of the FASB Emerging Issues Task Force)* |
| 2014-06 | *Technical Corrections and Improvements Related to Glossary Terms* |
| 2014-07 | *Consolidation (Topic 810): Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements (a consensus of the PCC)* |
| 2014-08 | *Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360): Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity* |
| 2014-09 | *Revenue from Contracts with Customers (Top 606)* |
| 2014-10 | *Development Stage Entities* |

**Recently Issued ASUs**
**2014 through 2016**

| ASU No. | Description |
|---|---|
| 2014-11 | *Transfers and Servicing (Topic 860): Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures* |
| 2014-12 | *Compensation—Stock Compensation (Topic 718): Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period (a consensus of the FASB Emerging Issues Task Force)* |
| 2014-13 | *Consolidation (Topic 810): Measuring the Financial Assets and the Financial Liabilities of a Consolidated Collateralized Financing Entity (a consensus of the FASB Emerging Issues Task Force)* |
| 2014-14 | *Receivables- Troubled Debt Restructurings by Creditors (Subtopic 310-40): Classification of Certain Government-Guaranteed Mortgage Loans upon Foreclosure (a consensus of the FASB Emerging Issues Task Force)* |
| 2014-15 | *Presentation of Financial Statements-Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern* |
| 2014-16 | *Derivatives and Hedging (Topic 815): Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share Is More Akin to Debt or to Equity (a consensus of the FASB Emerging Issues Task Force)* |
| 2014-17 | *Business Combinations (Topic 805): Pushdown Accounting (a consensus of the FASB Emerging Issues Task Force)* |
| 2014-18 | *Business Combinations (Topic 805): Accounting for Identifiable Intangible Assets in a Business Combination (a consensus of the Private Company Council)* |
| 2015-01 | *Income Statement—Extraordinary and Unusual Items (Subtopic 225-20): Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items* |
| 2015-02 | *Consolidation (Topic 810): Amendments to the Consolidation Analysis* |
| 2015-03 | *Interest—Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs* |
| 2015-04 | *Compensation—Retirement Benefits (Topic 715): Practical Expedient for the Measurement Date of an Employer's Defined Benefit Obligation and Plan Assets* |
| 2015-05 | *Intangibles—Goodwill and Other—Internal-Use Software (Subtopic 350-40) Customer's Accounting for Fees Paid in a Cloud Computing Arrangement* |
| 2015-06 | *Earnings Per Share (Topic 260): Effects on Historical Earnings per Unit of Master Limited Partnership Dropdown Transactions (a consensus of the FASB Emerging Issues Task Force)* |
| 2015-07 | *Fair Value Measurement (Topic 820): Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent) (a consensus of the FASB Emerging Issues* |
| 2015-08 | *Business Combinations (Topic 805): Pushdown Accounting—Amendments to SEC Paragraphs Pursuant to Staff Accounting Bulletin No. 115 (SEC Update)* |
| 2015-09 | *Financial Services—Insurance (Topic 944): Disclosures about Short-Duration Contracts* |
| 2015-10 | *Technical Corrections and Improvements* |
| 2015-11 | *Inventory (Topic 330): Simplifying the Measurement of Inventory* |

**Recently Issued ASUs**
**2014 through 2016**

| ASU No. | Description |
|---|---|
| 2015-12 | *Plan Accounting: Defined Benefit Pension Plans (Topic 960), Defined Contribution Pension Plans (Topic 962), Health and Welfare Benefit Plans (Topic 965): (Part I) Fully Benefit-Responsive Investment Contracts, (Part II) Plan Investment Disclosures, (Part III) Measurement Date Practical Expedient (consensuses of the FASB Emerging Issues Task Force)* |
| 2015-13 | *Derivatives and Hedging (Topic 815): Application of the Normal Purchases and Normal Sales Scope Exception to Certain Electricity Contracts within Nodal Energy Markets (a consensus of the FASB Emerging Issues Task Force)* |
| 2015-14 | *Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date* |
| 2015-15 | *Interest—Imputation of Interest (Subtopic 835-30): Presentation and Subsequent Measurement of Debt Issuance Costs Associated with Line-of-Credit Arrangements—Amendments to SEC Paragraphs Pursuant to Staff Announcement at June 18, 2015 EITF Meeting (SEC Update)* |
| 2015-16 | *Business Combinations (Topic 805): Simplifying the Accounting for Measurement-Period Adjustments* |
| 2015-17 | *Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes* |
| 2016-01 | *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities* |
| 2016-02 | *Leases (Topic 842)* |
| 2016-03 | *Intangibles—Goodwill and Other (Topic 350), Business Combinations (Topic 805), Consolidation (Topic 810), Derivatives and Hedging (Topic 815): Effective Date and Transition Guidance (a consensus of the Private Company Council)* |
| 2016-04 | *Liabilities—Extinguishments of Liabilities (Subtopic 405-20): Recognition of Breakage for Certain Prepaid Stored-Value Products (a consensus of the Emerging Issues Task Force)* |
| 2016-05 | *Derivatives and Hedging (Topic 815): Effect of Derivative Contract Novations on Existing Hedge Accounting Relationships (a consensus of the Emerging Issues Task Force)* |
| 2016-06 | *Derivatives and Hedging (Topic 815): Contingent Put and Call Options in Debt Instruments (a consensus of the Emerging Issues Task Force)* |
| 2016-07 | *Investments—Equity Method and Joint Ventures (Topic 323): Simplifying the Transition to the Equity Method of Accounting* |
| 2016-08 | *Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)* |
| 2016-09 | *Compensation—Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting* |
| 2016-10 | *Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing* |
| 2016-11 | *Revenue Recognition (Topic 605) and Derivatives and Hedging (Topic 815): Rescission of SEC Guidance Because of Accounting Standards Updates 2014-09 and 2014-16 Pursuant to Staff Announcements at the March 3, 2016 EITF Meeting (SEC Update)* |
| 2016-12 | *Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients* |

# ¶ 704 GOING CONCERN ASSESSMENT BY MANAGEMENT- ASU 2014-15

This section addresses ASU 2014-15, *Presentation of Financial Statements—Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern.* ASU 2014-15 requires management to perform a going concern assessment of an entity.

With the introduction of ASU 2014-15, now *both* management and the auditor must perform their own separate going-concern assessments of the same entity. This section addresses the interrelation of the new GAAP rules in ASU 2014-15 with the auditing standards found in AU-C 570.

## Background

For years, the rules for going concern have been found in auditing literature within AU-C Section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (formerly SAS No. 59), which requires an auditor to assess whether an entity has the ability to continue as a going concern for a reasonable period of time (usually one year from the balance sheet date.) Because going concern is a GAAP issue, it belongs within accounting literature, in addition to auditing standards.

In 2015, Audit Analytics issued a report in which it performed a 15-year study of going- concern opinions. The report, which samples financial statements through 2014, identifies the following trends:

- 2014 going-concern report modifications were at the lowest level over a 15-year period:

| Year | Going-concern opinions |
|---|---|
| 2014 | 2,233 |
| 2013 | 2,403 |
| 2012 | 2,565 |
| 2011 | 2,670 |
| 2010 | 2,988 |
| 2009 | 3,102 |
| 2008 | 3,355 |

**Source:** Audit Analytics

- 15.8 percent of auditor opinions filed in 2014 contained a going-concern report modification. (The highest percentage was 21.1 percent in 2008, and lowest was 14.2 percent in 2000.)
- Going-concern report modifications peaked at 3,355 in 2008 and dropped to 2,233 in 2014.

## Recovery from a Going-Concern Report Modification

Only a small percentage (ranging from five percent to nine percent) of companies that had going-concern report modifications rebounded with a clean opinion in the subsequent year. The following table shows the details:

**Number of Clean Opinions in Subsequent Year to Going-Concern Report Modification**

| Current year | # going concerns prior year | # clean opinions current year, going concern prior year | % recovery in subsequent year |
|---|---|---|---|
| 2014 | 2,403 | 200 | 8.3% |
| 2013 | 2,565 | 188 | 7.3% |
| 2012 | 2,670 | 144 | 5.4% |
| 2011 | 2,988 | 208 | 7.0% |
| 2010 | 3,102 | 276 | 8.9% |
| 2009 | 3,355 | 265 | 7.9% |
| 2008 | 3,309 | 200 | 6.0% |
| 2007 | 2,878 | 253 | 8.8% |

**Source:** Audit Analytics, as modified by Author.

**OBSERVATION:** The previous table illustrates a key point with respect to going-concern report modifications. If such a report modification is made, it can be the "kiss of death" for a company in the subsequent years. A very low percentage of companies subsequently survive a going-concern report modification.

## FASB Issues ASU 2014-15

In August 2014, the FASB issued ASU 2014-15, which provides guidance about *management's responsibility* to evaluate an entity's ability to continue as a going concern and to provide related disclosures. Previously, no such guidance existed in GAAP.

ASU 2014-15 is effective for the annual period ending after December 15, 2016, and for annual periods and interim periods thereafter. Early application is permitted.

The objective of ASU 2014-15 is to provide guidance for evaluating whether there is substantial doubt about an entity's ability to continue as a going concern and about related footnote disclosures.

ASU 2014-15 does the following:

- Requires *management to make an evaluation of going concern* every reporting period, including interim periods.
- Defines the term *substantial doubt* about an entity's ability to continue as a going concern (substantial doubt) 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 (or within one year after the date that the financial statements are available to be issued when applicable).*

  **NOTE:** The term "probable" is used consistently with its use in Topic 450 on contingencies.
- Provides that management should consider the mitigating effect of management's plans only to the extent it is probable the plans will be effectively implemented and mitigate the conditions or events giving rise to substantial doubt.
- Requires certain disclosures when substantial doubt is alleviated as a result of consideration of management's plans

- Requires an explicit statement in the notes that there is substantial doubt and other disclosures when substantial doubt is not alleviated
- Requires an evaluation for a period of one year after the date that the financial are issued (or available to be issued if a nonpublic entity).

## Auditing Standards Board Clarifies its Going-Concern Rules

After the issuance of ASU 2014-15, there were certain inconsistencies between the GAAP and auditing rules for dealing with going concern. In particular, the one-year period of time for evaluating going concern was different as follows:

- AU-C 570 uses a *reasonable period of time* as the period for which an auditor should evaluate going concern. Generally, in practice, that period is one year from the balance sheet date.
- ASU 2014-15 uses a one-year period from the date the financial statements are issued or available to be issued.

Thus, after the FASB issued ASU 2014-15, the GAAP going-concern period extended several months beyond the one-year period used by auditors under AU-C 570.

In response, in January 2015, the Auditing Standards Board (ASB) issued an interpretation to address conflicting issues related to GAAP's recently issued ASU 2014-15 and going-concern rules found in AU-C 570. The purpose of this audit interpretation is to clarify how AU-C 570's requirements for an auditor addressing going concern interrelate with the new GAAP rules found in ASU 2014-15. The auditing interpretation brings the auditing rules for dealing with going concern in parity with the new GAAP rules found in ASU 2014-15.

The auditing interpretation states the following:

- When an applicable financial reporting framework (such as GAAP) includes a definition of *substantial doubt* about an entity's ability to continue as a going concern, that definition would be used by the auditor when applying AU-C section 570. For example, if an entity is required to comply with, or has elected to adopt, ASU 2014-15, the definition of substantial doubt about an entity's ability to continue as a going concern found in GAAP would be used by the auditor.
- When the applicable financial reporting framework (such as GAAP) requires management to evaluate whether there are conditions and events that raise substantial doubt for a period of time *greater than one year* from the date of the financial statements, the auditor's assessment of management's going concern evaluation would be *for the same period of time as required by the applicable financial reporting framework* (such as GAAP). For example, if an entity is required to comply with, or has elected to adopt, ASU 2014-15, the auditor's assessment of management's going concern evaluation would need to be for the same period of time as required by ASU 2014-15 (that is, one year after the date that the financial statements are issued or available to be issued).
- When the applicable financial reporting framework (such as GAAP) provides disclosure requirements related to management's evaluation of substantial doubt, the auditor's assessment of the financial statement effects under AU-C section 570 would be based on the disclosure requirements of the applicable financial reporting framework (such as GAAP).

**OBSERVATION:** The period of time that has been used for auditors previously (one year from the balance sheet date) is extended to be one year from the date the financial statements are either issued (public entities) or available to be issued (nonpublic entities). This change adds a few months to the going concern assessment period for an auditor. It also means that it is important that the auditor conclude his or her audit and ensure that the financial statements are issued so that the one-year period commences. The later the financial statements are issued, the later the one- year going-concern period is extended.

## Going Concern in a Review Engagement

In connection with a review engagement, Paragraph .65 of AR-C 90, SSARS No. 21 states:

> *The accountant should consider whether, during the performance of review procedures, evidence or information came to the accountant's attention indicating that there could be an uncertainty about an entity's ability to continue as going concern for a reasonable period of time.*

SSARS No. 21 defines a *reasonable period of time* to be:

> *the same period of time required of management to assess going concern when specified by the applicable financial reporting framework.*

For a GAAP framework, the reasonable period of time is one year from the date the financial statements are available to be issued (one year from the review report date).

> **NOTE:** Under SSARS No. 21, for a compilation or review engagement on GAAP financial statements, the accountant should consider whether an uncertainty exists using the same one-year window that GAAP uses under ASU 2014-15. That window for a nonpublic entity is one year from the date the financial statements are available to be issued.

For a non-GAAP framework (such as tax basis), if that non-GAAP framework does not specify a period of time for management's assessment, a reasonable period of time is one year from the date of the financial statements being reviewed (which is one year from the balance sheet date).

The result of the previous analysis is that the one-year going concern assessment period is now the same among GAAP, audit and review engagements.

## STUDY QUESTION

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**1.** Prior to the issuance of ASU 2014-15, the going concern assessment was done by __________.

- **a.** The auditor
- **b.** Management
- **c.** Board of directors
- **d.** No assessment is done

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# ¶ 705 FEES PAID IN A CLOUD COMPUTING ARRANGEMENT-ASU 2015-05

ASU 2015-05, *Intangibles – Goodwill and Other—Internal-Use Software (Subtopic 350-40): Customer's Accounting for Fees Paid in a Cloud Computing Arrangement* was issued in April 2005 as part of the FASB's Simplification Initiative. The objective of the Simplification Initiative is to identify, evaluate, and improve areas of GAAP for which cost and complexity can be reduced while maintaining or improving the usefulness of the information provided to users of financial statements. The objective of ASU 2015-05 is to provide guidance to customers about whether a cloud computing arrangement includes a software license.

## Background

Currently, GAAP does not include specific guidance about a customer's accounting for fees paid in a cloud computing arrangement. Examples of cloud computing arrangements include:

- Software as a service
- Platform as a service
- Infrastructure as a service
- Other similar hosting arrangements

The FASB received input from stakeholders that the absence of explicit guidance has resulted in some diversity in practice and has created unnecessary costs and complexity to evaluate the accounting for those fees. As a result of input, the FASB added guidance to Subtopic 350-40, *Intangibles—Goodwill and Other—Internal-Use Software,* to assist entities in evaluating the accounting for fees paid by a customer in a cloud computing arrangement.

The larger question is whether customer fees paid in a cloud computing arrangement represent a license to use software or fees for a service contract. ASC 350-40-05-2, *Intangibles—Goodwill and Other—Internal-Use Software*, defines internal-use software as having *both* of the following characteristics:

- The software is acquired, internally developed, or modified solely to meet the entity's internal needs.
- During the software's development or modification, no substantive plan exists or is being developed to market the software externally.

ASC 350-40-35-4 states that internal-use software licensed or acquired is amortized on a straight-line basis unless another systematic or rational basis is more representative of the software's use.

With respect to cloud services, the FASB's existing guidance is limited and found in ASC 985-605-55-121 through 55-123, *Software-Revenue Recognition*; however, that guidance pertains to revenue received by cloud service providers to determine whether an arrangement includes the sale or license of software. It does not address the accounting for cloud services fees paid from the customer's perspective.

ASU 2015-05 provides guidance to customers about whether a cloud computing arrangement is a license for internal use, or whether it is a service contract:

- If a cloud computing arrangement includes a software license, then the customer should account for the software license element of the arrangement consistent with the licensing of internal-use software, which is generally capitalized and amortized.
- If a cloud computing arrangement does not include a software license, the customer should account for the arrangement as a service contract.

ASU 2015-05 does not change GAAP for a customer's accounting for service contracts. In addition, the guidance in ASU 2015-05 supersedes ASU 350-40-25-16, *Intangibles—Goodwill and Other—Internal-Use Software.* Consequently, all software licenses within the scope of Subtopic 350-40 will be accounted for consistently with other licenses of intangible assets.

## Rules

The scope of internal-use software found in ASC 350-40-15-4 does not apply to software that a customer obtains access to in a hosting arrangement if it does not meet the following two criteria:

- The customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty.
- It is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software.

Hosting arrangements that do not meet both of these criteria are considered *service contracts* and do not constitute a purchase of, or convey a license to, software.

> **NOTE:** In determining the two criteria above, the FASB followed the guidance found in ASC 985-605, *Software*, with respect to revenue recognition by software vendors. Those two criteria are: (1) the customer has the contractual right to take *possession of the software* at any time during the hosting period *without significant penalty*, and (2) it is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software.

The term *without significant penalty* contains two distinct concepts:

- The ability to take delivery of the software without incurring significant cost, or
- The ability to use the software separately without a significant diminution in utility or value.
- ASU 2015-05 supersedes the following paragraph found in ASC 350-40-25-16:

  *Entities often license internal-use software from third parties. Though Subtopic 840-10 excludes licensing agreements from its scope, entities shall analogize to that Subtopic when determining the asset acquired in a software licensing arrangement.*

  > **NOTE:** The ASU states that some cloud computing arrangements include one or more licenses to software as well as a promise to provide services, in which case the customer should allocate the contract consideration between the license(s) and the service element(s).

## Effective Date

ASU 2015-05 is effective as follows:

**Public Business Entities.** For public business entities, ASU 2015-05 is effective for financial statements issued for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years

**Other Entities.** For all other entities, ASU 2015-05 is effective for financial statements issued for fiscal years beginning after December 15, 2015, and interim periods within fiscal years beginning after December 15, 2016.

Early application is permitted for all entities.

## STUDY QUESTION

**2.** Ralph is a CPA and controller for Company K. K has a cloud arrangement with an outside vendor under which certain software functions are run and held on the vendor's cloud. Ralph is evaluating how K should account for the costs of the cloud arrangement which are paid monthly. The cloud arrangement does not include a software license. How should the cost be accounted for?

**a.** As internal-use software
**b.** As a service contract
**c.** As a prepaid asset
**d.** Split with a portion expensed and a portion capitalized as a fixed asset

# ¶ 706 SIMPLIFYING THE PRESENTATION OF DEBT ISSUANCE COSTS - ASU 2015-03

ASU 2015-03, *Interest—Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs* was issued in April 2015 as part of the FASB's Simplification Initiative. The objective of the Simplification Initiative is to identify, evaluate, and improve areas of generally accepted accounting principles (GAAP) for which cost and complexity can be reduced while maintaining or improving the usefulness of the information provided to users of financial statements.

## Background

Debt issuance costs are generally considered to be specific third-party incremental costs that are directly attributable to issuing a debt instrument, either in the form of issuing bonds or closing a bank or private loan. Such costs may include:

- Legal fees
- Commissions or financing fees
- Appraisal costs
- Accounting and auditing fees
- Points
- Title insurance
- Any other costs incurred in order to complete specific financing

Debt issuance costs generally *exclude* internal general and administrative costs and overhead of the borrowing entity.

Under existing GAAP prior to the effective date of ASU 2015-03, deferred issuance costs are capitalized as an asset on the balance sheet, and amortized to interest expense using the effective interest method.

## Rules

ASU 2015-03 does *not* apply to the amortization of premium and discount of assets and liabilities that are reported at fair value, or the debt issuance costs of liabilities that are reported at fair value.

The following elements shall be reported in the balance sheet as a direct deduction from the face amount of a note:

- The discount or premium resulting from the determination of present value in cash or noncash transactions
- Debt issuance costs related to a note (NEW)

**NOTE:** The ASU states that similar to a discount or premium resulting from the determination of present value in cash or noncash transactions, debt issuance costs are not an asset or liability separable from the note that gives rise to it.

The discount, premium, or debt issuance costs shall *not* be classified on the balance sheet as a deferred charge or deferred credit. Amortization of discount or premium shall be reported on the income statement as *interest expense* in the case of liabilities or as *interest income* in the case of assets. Amortization of debt issuance costs shall be reported on the income statement as *interest expense*.

An entity shall disclose the following on the financial statements or in the notes to the statements:

- A description of a note (receivable or payable) which shall include the *effective interest rate*
- The face amount of the note

## Effective Date

ASU 2015-03 is effective as follows:

**Public Business Entities.** For public business entities, ASU 2015-03 is effective for financial statements issued for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years

**Other Entities.** For all other entities, ASU 2015-03 is effective for financial statements issued for fiscal years beginning after December 15, 2015, and interim periods within fiscal years beginning after December 15, 2016.

Early application is permitted for financial statements that have not been previously issued.

## STUDY QUESTION

**3.** Company Z has debt issuance costs related to a $5 million loan. How should Z present the debt issuance costs on its balance sheet in accordance with ASU 2015-03?

**a.** Nowhere, as the costs should be expensed as incurred

**b.** As an asset

**c.** Netted against the debt

**d.** As a contra- equity account

# ¶ 707 ACCOUNTING FOR IDENTIFIABLE INTANGIBLE ASSETS IN A BUSINESS COMBINATION – ASU 2014-18

ASU No. 2014-18, *Business Combinations (Topic 805): Accounting for Identifiable Intangible Assets in a Business Combination (a consensus of the Private Company Council)* was issued in December 2014 to offer an accounting alternative for private companies to elect *not* to allocate a portion of the acquisition price to certain intangibles other than goodwill.

## Background

The Private Company Council (PCC) added this issue to its agenda in response to feedback from some private company stakeholders indicating that the benefits of the current accounting for identifiable intangible assets acquired in a business combination may not justify the related costs. By providing an accounting alternative, this ASU reduces the cost and complexity associated with the measurement of certain identifiable intangible assets without significantly diminishing decision-useful information to users of private company financial statements.

## Rules

The ASU, at an entity's election, applies to all entities except for public business entities and not-for-profit entities as defined in the Master Glossary of the FASB Accounting Standards Codification®.

The accounting alternative applies when an entity within the scope of this ASU is required to recognize or otherwise consider the fair value of intangible assets as a result of any one of the following transactions (in-scope transactions):

- Applying the acquisition method under Topic 805 on business combinations
- Assessing the nature of the difference between the carrying amount of an investment and the amount of underlying equity in net assets of an investee when applying the equity method under Topic 323 on investments—equity method and joint ventures
- Adopting fresh-start reporting under Topic 852 on reorganizations

An entity within the scope of ASU 2014-18 that elects to apply the ASU is subject to all of the recognition requirements within the accounting alternative. The accounting alternative, when elected, should be applied to all in-scope transactions entered into after the effective date.

An entity that elects the accounting alternative to a business combination should no longer recognize goodwill separately from the following:

- Customer-related intangible assets unless they are capable of being sold or licensed independently from the other assets of the business
- Noncompetition agreements

An entity that elects the accounting alternative in ASU 2014-18 must adopt the private company alternative to amortize goodwill (over a maximum of 10 years straight line) as described in ASU 2014-02, *Intangibles—Goodwill and Other (Topic 350): Accounting for Goodwill*. However, an entity that elects the accounting alternative in Update 2014-02 is not required to adopt the amendments in ASU 2014-18.

## Effective Date

The decision to adopt the accounting alternative in this ASU must be made upon the occurrence of the first transaction within the scope of this accounting alternative in fiscal years beginning after December 15, 2015, and the effective date of adoption depends on the timing of that first in-scope transaction. Early application is permitted for any interim and annual financial statements that have not yet been made available for issuance.

# MODULE 3: OTHER CURRENT DEVELOPMENTS—CHAPTER 8: The Gradual Demise of Company Pension Plans

## ¶ 801 WELCOME

This chapter provides an overview of information and statistics that suggest that company defined benefit pension plans are on the decline. This includes an analysis of the significant unfunded liabilities with respect to various pension plans, both from the governmental and nongovernmental standpoint. This chapter also discusses how pension plans can influence their total pension liability based on changes in assumptions used in the pension liability calculation.

## ¶ 802 LEARNING OBJECTIVES

Upon completion of this chapter, you will be able to:

- Recognize statistics related to unfunded liabilities prevalent across defined pension plans
- Differentiate between expected rates of return of U.S. pension plans versus those plans in other countries
- Recognize key requirements prescribed by GASB Statement No. 68
- Differentiate between the various color zones used to assess pension plan health
- Recognize the different types of retirement plans used by nongovernmental employees
- Identify the governmental organization responsible for ensuring payment to pension plan participants

## ¶ 803 INTRODUCTION

Over the past two decades, the costs of maintaining defined benefit pension plans resulted in companies either freezing or eliminating defined benefit plans and replacing them with defined contribution plans or 401(k) plans. Defined contribution or 401(k) plans offer companies the opportunity to provide their employees with a retirement benefit, usually at a much lower cost, and with far greater flexibility for several reasons. With a defined contribution or 401(k) plan, a company can more accurately measure the amount of its pension cost because it is based on the amount contributed to the plan, as compared with the amount of the ultimate benefit paid as in the case of a defined benefit plan. In most defined contribution or 401(k) plans, a company can structure its contributions to be discretionary, thereby allowing it to reduce its pension contribution during weaker business cycles, and increase it during stronger cycles. And finally, with 401(k) plans, investment risk is shifted from the company to the employees as each employee is responsible for managing his or her investments.

Now, the next dramatic crisis in the U.S. markets may be the continued deterioration of U.S. defined benefit pension plans. Plans sponsored by corporate, as well as state and local pensions, are grossly underfunded. The primary reason is one based on simple math: more benefits are being paid out of the plans than net assets going into those plans. For example, in January 2016, William Mercer announced that U.S. pension plan funded status for the S&P 1500 had improved by about $100 billion. In general, a higher discount rate reduced liabilities enough to offset longer actuarial lives of plan participants and declining stock market values. The result is that on December 31, 2015, the pension deficit for the S&P 1500 was $(404) billion, while the deficit was $(504) billion at the end of 2014. Although 2015 had a $100 billion improvement in funded status, the trend does not paint a positive picture for U.S. pension plans.

Any intellectually honest debate must acknowledge that pension liabilities are growing faster than the underlying pension assets and on a long-term basis. Even in years in which the stock market is increasing significantly, those asset value increases cannot offset the continued increases in pension liabilities. These conclusions are true for all defined benefit plans including single and multi-employer plans.

Nevertheless, even with the introduction of 401(k) plans, many companies have retained their existing defined benefit plans by either freezing them or continuing to fund them for certain key employee groups such as those in upper management. Before addressing these plans, let's take a look at a snapshot of where U.S. defined benefit plans fall as of 2015 regardless of what is published:

**Funded Status - All U.S. Pension Plans**

| **Type of Plan** | **Unfunded Liabilities 2015** Low | High | **% Funded Status** |
|---|---|---|---|
| U.S. Corporate Plans: | | | |
| Multi-employer (union) plans | $400 billion | $500 billion | 46-81% |
| Single-employer plans | 500 billion | 700 billion | 50-75% |
| Public-state and local plans (1) | 5 trillion | 7 trillion | 42-60% |
| Estimated total shortfalls | $5.9 trillion | $8.2 trillion | |

(1) Data is based on several recent studies: The range of funded status and percentages varies due to the discount rates used and other assumptions.
**Sources:** *Public Section Pensions: How Well Funded Are They Really*? Andrew G. Biggs, *State Budget Solutions*, July 2012, adjusted to 2015 and other publications.

In looking at the table above, collectively there is a $5.9 trillion to $8.2 trillion unfunded pension liability across all sectors of private and public entities. The range exists because the "true" numbers require one to choose assumptions such as discount rates, expected rates of return, and other variants that significantly affect the unfunded liability. Most commentators believe that the real unfunded liability is closer to the upper amount of $8 trillion due primarily to the fact that sponsors tend to use assumptions that understate pension liabilities. Regardless of whether the shortfall is $5.9 trillion or $8.2 trillion, the numbers are astronomical to the point that the plan sponsors (private or public) are in such a dire hole that there is no real way to get out without renegotiating pension contracts, which is typically impossible.

Defined benefit plans are being squeezed into extinction by the combination of stricter GAAP and accelerated funding required by the Pension Protection Act of 2006 (PPA), all wrapped within a volatile marketplace. In essence, a large portion of the risk associated with whether a pension plan is underfunded or overfunded is outside the control of the sponsor company. In general, the sponsor company cannot control the key factors that drive the funded status of the plan, such as the fair value of the assets and the discount rate, both essentially driven by macro-market forces.

As of 2016, entities that have defined benefit pension plans face an uphill battle in trying to manage their underlying businesses and comply with funding requirements of their pension plans. Because the PPA requires more extensive funding of pension plans, companies with underfunded pension plans must reallocate critical cash flow resources from their core business operations to fund those plans. It is easy to see why few companies are adopting new defined benefit plans and are instead offering either contributory or noncontributory 401(k) plans where the market risk does not rest with the sponsor company.

Most of the underfunded defined benefit pension plans exist within more traditional older manufacturing firms with large workforces and strong unions that previously negotiated generous retirement benefits. Examples are the airlines and automakers, which cannot shed their benefit obligations and are challenged to compete with newer and benefit-lighter companies and foreign companies that do not offer such benefits. One example is where, prior to their bankruptcy filing, older airlines such as United and U.S. Airways had been burdened with large defined benefit plan obligations that newer rivals, such as Jet Blue and Southwest, do not have. In addition to pension plans, many of the same companies have post-retirement benefit plans, most of which are grossly underfunded as compared with pension plans because post-retirement benefit plans are not subject to the funding requirements under ERISA. As a result, most companies fund such post-retirement benefits on a pay-as-you-go basis.

## ¶ 804 GAAP RULES FOR DEFINED BENEFIT PLANS - ASC 715

The accounting for defined benefit plans is prescribed within ASC 715, *Retirement Benefits Compensation*. ASC 715 requires companies to record on their balance sheets the funded status of a defined benefit plan, measured as the difference between the fair value of plan assets and the pension benefit obligation. In issuing ASC 715, the FASB's goal was to provide greater transparency to pension accounting by requiring companies to place the funded status of their pension plans on their balance sheet. Under ASC 715, related to the balance sheet, an accrual (liability) is recorded for pension cost. Refer to the example below.

Assume the following for the year:

| | |
|---|---|
| Service cost | $200 |
| Interest cost | 100 |
| Expected return on plan assets | (50) |
| Amortization of prior service cost | 0 |
| Amortization of (gain) or loss | 0 |
| Net periodic benefit cost | $250 |

| | | |
|---|---|---|
| Entry: | | |
| Net periodic pension cost (income statement) | 250 | |
| Liability for pension benefits | | 250 |

An additional liability or asset is also recorded on the balance sheet for the funded status, measured as the difference between the fair value of the plan assets and the projected benefit obligation (PBO):

| | |
|---|---|
| Fair value of plan assets | $100,000 |
| Projected benefit obligation (PBO) | (110,000) |
| Funded status of plan (under) over | $(10,000) |
| Liability balance (after $250 entry) | $8,000 |
| Additional liability recorded | 2,000 |
| Adjusted liability on balance sheet | $10,000 |

It is important to note that a portion of the liability relates to gains or losses and prior service costs or credits that arise during the period, but that are not recognized as components of net periodic benefit cost of the period. Examples include gains or losses, prior service costs or credits, and transition assets or obligations remaining from the initial application, which are recorded as part of other comprehensive income and accumulated other comprehensive income on the balance sheet, net of the related tax effect.

# ¶ 805 SINGLE-EMPLOYER PLANS

For the past decade, a significant number of single-employer defined benefit plans have been underfunded. In the 1990s, many companies rode a wave of overfunded status due to record returns in the stock market coupled with the use of unrealistic plan assumptions. In the late 1990s, the tide turned and many plans shifted to underfunded status. Most of the shift was driven by the push toward requiring companies to use lower discount rates in valuing their benefit obligations along with softer stock market returns. There is also the fact that retirees are living longer than expected, thereby putting pressure on employers to fund benefits over an extended period of time. Following is a table that compares the funded status of the S&P 1500 between 2015 and 2014.

**S&P 1500 Funded Status**

| | 2014 | 2015 |
|---|---|---|
| Fair value of plan assets | $1.886 trillion | $1.800 trillion |
| Pension obligations | 2.390 trillion | 2.204 trillion |
| Funded status | $(504) billion | $(404) billion |
| % funded status (assets as percentage of liabilities) | 79% | 82% |
| Source: William Mercer, January 2016 | | |

Despite volatile equity markets, the funded status improved from $(504) billion in 2014 to $(404) billion in 2015. In addition, the total fair value of assets declined by about five percent (from $1.886 trillion in 2014 to $1.800 trillion in 2015) as the overall U.S. equity markets declined and pension obligations decreased from $2.390 trillion to $2.204 trillion. The liability decrease was due, in part, to the change in two conflicting elements:

- The liability decreased because there was an increase in the discount rate from about 3.81 percent in 2014 to 4.24 percent in 2015. That rate change was reflective of an increase in the rate of high-quality corporate bonds. As the discount rate increases, the liability decreases to account for a lower present value of pension obligations.
- The liability increased because there was an increase in the liability to reflect a change in the longevity assumptions as plan participants are expected to live longer.

What happened in 2015 represents the continued battle that all defined benefit plans have. As retirees live longer, plans have pressure to drive the increase in asset values to pay for those additional benefit liabilities. Only higher interest rates can help reduce those liabilities to offset the increase in the longer retirement periods.

As previously noted, ASC 715 requires that the underfunded status of a defined benefit plan be recorded as a liability on the balance sheet. A hypothetical combined balance sheet of the S&P 1500 on December 31, 2015 would look like this:

| S&P 1500 Companies<br>Aggregate Balance Sheets<br>December 31, 2015 | (in billions $) |
|---|---|
| ASSETS: | |
| ***Deferred tax asset*** | ***162*** |
| LIABILITIES AND EQUITY: | |
| ***Liability for pension benefit*** | ***404*** |
| Common stock | XX |
| APIC | XX |
| Retained earnings | XX |
| ***Accumulated other comprehensive income (net of taxes)*** | ***(242)*** |
| Total stockholders' equity | XX |
| DIT asset: $404B x 40% = $162B | |
| Accumulated other comprehensive income: $(404)B less DIT asset $162B = $(242)B. | |

On December 31, 2015, S&P 1500 companies were required to record an aggregate liability for the $(404) billion funded status shortfall. Most of the offset (debit) was recorded to accumulated other comprehensive income (equity), net of the tax effect. That $(404) billion of additional liabilities places a strain on those public companies when one takes into account that there is a corresponding reduction in stockholders' equity. Consider what happens to the debt-equity ratio of the various S&P 1500 companies when the debt numerator is increased by $(404) billion while the denominator is reduced by $(242) billion, net of the tax effect of $162 billion.

## STUDY QUESTIONS

**1.** Which of the following statements is correct with respect to defined benefit pension plans?

- **a.** A company can more accurately measure the amount of its pension cost.
- **b.** A company can structure its contributions to be discretionary.
- **c.** Investment risk is shifted from the company to the employee.
- **d.** The amount of its pension cost is based on the amount of the ultimate benefit paid.

**2.** Which of the following is a result of ASC 715?

- **a.** It changes the rules for defined contribution pension plans.
- **b.** It requires companies with defined benefit plans to record on their balance sheets a portion of the plan liabilities.
- **c.** It introduces greater transparency of plan disclosures.
- **d.** It addresses whether post-retirement health benefit plans should be consolidated.

## ¶ 806 UNDERFUNDED MULTI-EMPLOYER PENSION PLANS AND THE LOADED PISTOL

Not only are single-employer plans in trouble, but the next U.S. taxpayer bailout may involve pension plans; namely multi-employer pension plans, mostly involving union employees. A multi-employer plan is a pension or other postretirement benefit plan which has the following characteristics:

- There are two or more unrelated employers that contribute, usually pursuant to one or more collective bargaining agreements.
- Assets contributed by one particular employer may be used to provide benefits to employees of other participating employers since assets contributed by an employer are not segregated in a separate account or restricted to provide benefits only to employees of that employer.
- Employers are *jointly and severally liable* for the plan obligations so that a shortfall in the plan may have to be funded by any and all of the employers.
- The plan usually has a withdrawal or exit fee if an employer seeks to withdraw from the plan.

One of the most pervasive issues related to multi-employer plans is that employers are jointly liable for the plan liabilities. That means if one company fails to pay its obligations, the remainder employers must pay the shortfall. It is sometimes referred to as the "last man standing" principle. If there are five employers in a multi-employer plan and four are defunct, the fifth remaining employer is liable for the entire underfunded status of the plan.

Related to this subject, Credit Suisse published a report entitled, *Crawling Out of the Shadows,* in which it evaluated the pension data of 1,354 pension plans of large and small to medium-cap U.S. companies. Although the report is four years old, the conclusions reached are still relevant in 2016, and demonstrate chronic problems that exist with multi-employer pension plans. The results were staggering and are noted below.

- Multi-employer plans cover approximately 10 million U.S. workers (seven percent of the workforce), and have been partially insured by the Pension Benefit Guarantee Corporation (PBGC).
- Multi-employer plans were $428 billion underfunded (46 percent funded) with most of the underfunding belonging to companies outside the S&P 500.

  - Based on the most recent Form 5500 filings, multi-employer plans reported an unfunded liability of only $(101) billion as compared with Credit Suisse's reconstructed liability of $(428) billion.

  - The underfunding was heavily weighted in the construction, transports, supermarkets, and mining industries.
- Companies could continue to be adversely affected by the extreme underfunding by increased contribution requirements, difficult labor negotiations, higher withdrawal liabilities, and weaker credit ratings.
- Using the Form 5500 filings, multi-employer plans played games with the actuarial computations of plan funded status, using an average expected rate of return on assets of 7.5 percent, which is significantly higher than the actual return on investments and significantly higher than the rate for high-quality corporate bonds, which is the required rate.
- The pension shortfalls affected not only large cap companies, but also mid- to small-cap ones.

Credit Suisse recomputed the funded status of 1,354 of a total of 1,459 multi-employer plans that are insured by the PBGC using fair value instead of actuarial value. In addition, the discount rate used to compute the pension liabilities was 4.7 percent (return on high-grade corporate bonds), instead of 7.5 percent used in the actuarial computations. Refer to the results of the recomputed analysis below.

**Funded Status of Multi-Employer Plans**
**(Based on 1,354 sample)**

| | In billions | |
|---|---|---|
| | Reported Actuarial Basis (Form 5500) | Recomputed by Credit Suisse |
| Assets | $426 | $360 |
| Liabilities | (527) | (788) |
| Net position | $(101) | $(428) |
| % funded-per sampled plans | 81% | 46% |
| Estimated net position of all U.S. multi-employer plans | | **$(454)** |

**Source:** Credit Suisse

When Credit Suisse recalculated the funded status of the selected multi-employer plans, the above-noted chart illustrates that the true funded status was a negative $(428) billion instead of the reported $(101) billion. Moreover, the percentage funded status was actually 46 percent and not the reported 81 percent.

The Pension Protection Act of 2006 established zones for evaluating the funded status of pension plans, using the following system:

| **Color Zone** | **% Funded** | **Additional contributions** |
|---|---|---|
| Green (Healthy) | > 80% funded | None |
| Yellow (Endangered) | 65-80% *or*<br>the plan has an accumulated funding deficiency or is expected to have one during any of the next six years | *Funding Improvement Plan* required:<br>• Must increase future contributions and/or reduce future pension benefit accruals to improve the plan's health, and<br>• Funded status must improve by one third within 10 years. |
| Orange (Seriously Endangered) | 65-80% *and*<br>the plan has an accumulated funding deficiency or is expected to have one during any of the next six years | *Funding Improvement Plan* required:<br>• Must increase future contributions and/or reduce future pension benefit accruals to improve the plan's health, and<br>• Funded status must improve by one-fifth within 15 years. |
| Red (Critical) | < 65% funded | *Rehabilitation Plan* required:<br>• Must increase future contributions and/or reduce future pension benefit accruals to improve plan's health<br>• Can also cut previously earned "adjustable" benefits (e.g., early retirement)<br>• Plan must emerge from critical condition within 10 years. |

**Source:** Credit Suisse

Credit Suisse reported that the top 10 multi-employer plans were significantly underfunded as compared with the reported funded status in their Form 5500 filings:

**Top 10 Largest Multi-Employer Pension Plans**
**Funded Status**

| | Reported % funded (Form 5500) | Recomputed % funded (Credit Suisse) |
|---|---|---|
| Central States, Southeast and Southwest Areas Pension Plan | 63% | 39% |
| Western Conference of Teamsters Pension Plan | 89% | 56% |
| Central Pension Fund of the IUOE & Participating Employers | 86% | 45% |
| Participating Employers National Electrical Benefit Fund | 86% | 47% |
| Boilermaker-Blacksmith National Pension Trust | 80% | 44% |
| 1199 SEIU Health Care Employees Pension Fund | 100% | 50% |
| I.A.M. National Pension Plan | 108% | 58% |
| New England Teamsters & Trucking Industry Pension | 52% | 25% |
| Plumbers And Pipefitters National Pension Fund | 68% | 37% |
| Bakery & Confectionery Union & Industry International Pension Fund | 87% | 46% |

**Source:** Credit Suisse based on Form 5500 Filings

**Funded Status By Percentage**

| % Funded | Zone | Per Form 5500 Filings | Recomputed (Credit Suisse) | % of plans |
|---|---|---|---|---|
| > 100% | (Green) Healthy | 218 | 21 | 4% |
| 90-100% | | 256 | 9 | |
| 80-90% | | 378 | 29 | |
| 65-80% | (Yellow and Orange) Endangered or Seriously Endangered | 309 | 114 | 8% |
| 55-65% | < 65% Red (Critical) Zone | 116 | 246 | 88% |
| 45-55% | | 50 | 425 | |
| 35-45% | | 13 | 371 | |
| 25-35% | | 4 | 112 | |
| < 25% | | 8 | 25 | |
| Rounding | | 2 | 2 | |
| | | 1,354 | 1,354 | |

**Source:** Credit Suisse

**COMMENT:** The previous chart illustrates that once the pension plan status of the sample plans was recomputed at fair value by Credit Suisse, only four percent of plans were in the Green Zone (healthy), while 88 percent were in the Red Zone (critical).

The reader may recall the battle between Hostess brands and its unions, and the attempts for management and the unions to settle on a new contract. What most people did not realize at that time is that there was no way that a deal could be struck under any circumstances. Hostess had 12 unions, 372 pieces of collective bargaining agreements, and 42 multi-employer plans involving 18,500 employees. Approximately one-third of the multi-employer plans to which Hostess contributed were among the most underfunded plans in the United States. This included the Bakers union which had $22 million of the total $100 million of annual contributions to pension plans. The Baker's union pension plan had a significant underfunded status. See summary below:

| | | |
|---|---|---|
| Assets | $4 billion | |
| Liabilities | (7 billion) | |
| Unfunded status | $(3 billion) | |
| Plan activity: | | |
| Contributions received annually | $155 million | (15% paid by Hostess) |
| Benefits paid out annually | (550 million) | |
| Annual shortfall | $(395 million) | |
| Participants in plan: | | |
| Current retirees | 70% | |
| Current workers | 30% | |
| Conclusion: 30% of current workers pay for the benefits of 70% retirees. | | |

With Hostess funding 15 percent of the contributions to the Baker's union pension plan, coupled with the annual shortfall in funding, there was no way that Hostess could continue to stay in the Baker's pension plan. Under the multi-employer plans, Hostess was jointly and severally liable for any unfunded plan status, which potentially exposed Hostess to the entire $3 billion shortfall. Moreover, if Hostess withdrew from the various pension plans, it would have been exposed to a $2 billion pension withdrawal liability.

The result was that Hostess filed Chapter 11 and used the protection of the bankruptcy code to shed most of its pension obligations. In Chapter 11, Hostess saved $22 million per year in contributions to the Baker's pension plan and terminated all single-and multi-employer plans. This resulted in Hostess eliminating $2 billion of withdrawal liabilities for 42 multi-employer plans and shifting the burden of its single employer plans (2,300 employees) on to the PBGC. In addition, it also shifted the burden of its multi-employer plans (covering 16,000 employees) onto other employers and a portion to the PBGC. Those other employers included Kraft Foods, Safeway Stores, Kroger, and BBU, among others, and eliminated its private equity owners' potential exposure to the unfunded pension liabilities, as those owners were deemed passive investors.

> **COMMENT:** In recent years, private-equity funds have effectively used bankruptcy to eliminate pension withdrawal liabilities in cases involving Friendly's Ice Cream, Eddie Bauer, Hostess (discussed above), and Delphi Automotive.

## ¶ 807 THE PENSION PLAN ASSUMPTIONS MANIPULATION GAME

As can be noted, defined benefit plans are underfunded based on use of distorted assumed rates of return. For more than a decade, companies and their actuaries have artificially underreported pension liabilities by using a discount rate that is inflated. If a company wishes to manipulate its funded status, all it has to do is change three fundamental assumptions used in the calculation of the pension liability. This includes:

- The discount rate used to present value the pension liability
- The expected rate of return on assets which reduces pension cost
- The compensation growth rate

The general rule is that the higher the discount rate and expected rates of return, the lower the pension liability and the lower the pension cost. In addition, the lower the compensation growth rate, the lower the pension liability and lower the cost. Therefore, if you want to understate pension liabilities and pension cost, you use a higher discount rate, a higher expected rate of return, and a lower compensation growth rate.

The discount rate is used to compute the present value of the projected benefit obligation. Several of the components of the pension cost used to record the current accrual to the pension liability are measured based on either the discount rate or expected rate. This includes the service cost, interest cost, and the expected return on plan assets. The service cost reflects a compensation growth rate so that if that rate is reduced, the service cost is recorded to pension cost and the corresponding pension liability is reduced. Refer to the following table:

| Component of Net Periodic Cost Recorded to Pension Liability | Definition | Rate Used |
|---|---|---|
| Service cost | Amount by which the pension obligation increases as a result of employee service during the current year<br>Compensation growth rate is reflected in the service cost.<br>Benefits x discount rate | Discount Rate (DR) |
| Interest cost | Amount by which the benefit obligation increases due to passage of time<br>Beginning PBO x discount rate | Discount Rate (DR) |
| Expected return on plan assets | Expected amount of returns generated by plan assets during the accounting period.<br>Determined based on historical returns<br>Beginning FV of assets x Expected Rate of Return | Expected Rate of Return (ERR) |
| Amortization of prior service cost | The portion of cost related to plan adoption or amendment | NA |
| Amortization of (gain) or loss | Changes in assumptions, actual versus expected return on plan assets, etc. | NA |
| Net periodic benefit cost (current year accrual) | | |

The following is a T account that illustrates the effect of these three rates on the projected benefit obligation (PBO):

**PROJECTED BENEFIT OBLIGATION (PBO)**

| | | | |
|---|---|---|---|
| | | Beginning PBO balance | XX |
| Expected return on plan assets [Beg FV-assets x ERR] | XX | Service cost accrual [Benefits x DR]* | XX |
| | | Interest [Beg PBO x DR] | XX |
| | | = ENDING PBO BALANCE | XX |

ERR = expected rate of return
DR = discount rate
* includes compensation growth rate

Therefore, the way to minimize the pension liability is summarized below:

| Component of Cost | Action | Impact on PBO |
|---|---|---|
| Service cost | Use higher discount rate<br><br>Use lower compensation increase assumption | Lower Liability |
| Interest cost | Use higher discount rate | Lower Liability |
| Expected Rate of Return on Assets | Use higher expected rate of return | Lower Liability |
| **OVERALL IMPACT** | | **LOWER PBO LIABILITY** |

The discount rate is used to present value the benefits and compute the pension liability, referred to as the projected benefit obligation. The expected (long-term) rate of return is used to compute a portion of annual pension cost and actually reduces total pension cost. ASC 715 defines the discount rate as the rate used to measure the projected benefit obligation, and the service and interest cost components of net periodic pension cost. ASC 715 further states that the discount rate should reflect the rate at which the pension benefits could be effectively settled. This is the rate of return needed on a bond investment made today to fund future benefit obligations. Additionally, the discount rate is determined at the measurement date and an employer may use the current rates of return on high-quality fixed-income investments currently available whose cash flows match the timing and amount of expected benefit payments. The rate of return on high-quality fixed-income investments consists of the rate of return on AA and AAA corporate bonds, with maturities that match the pension obligation payouts. Typically, rates of return- on AA bond funds with maturities ranging from 10-20 years are used. Examples of funds include Merrill Lynch U.S. Corporate AA 15 years +fund, Merrill Lynch U.S. Corporate AA/AAA 10 years fund, and Citigroup Pension Liability Index Fund.

The determination of the assumed discount rates is separate from the determination of the expected return on plan assets whenever the actual portfolio of plan assets differs from the hypothetical portfolio of high-quality fixed income investments (AA and AAA rated corporate bonds).

ASC 715 notes that the objective of selecting a discount rate is to measure the single amount that, if invested at the measurement date in a portfolio of high-quality debt instruments, would provide the future cash flows necessary to pay the pension benefit obligations when due. Theoretically, that single amount would equal the current market value of a portfolio of high-quality zero coupon bonds whose maturity dates and amounts would be the same as the timing and amount of the expected future benefit payments. Because cash inflows would equal cash outflows in timing and amount, there would be no reinvestment risk in the yields to maturity of the portfolio.

However, in other than a zero coupon portfolio, such as a portfolio of long-term debt instruments that pay semiannual interest payments or whose maturities do not extend far enough into the future to meet expected benefit payments, the assumed discount rates (the yield to maturity) need to incorporate expected reinvestment rates available in the future. Those rates shall be extrapolated from the existing yield curve at the measurement date. Assumed discount rates shall be reevaluated at each measurement date. If the general level of interest rates rises or declines, the assumed discount rates shall change in a similar manner.

On the other hand, expected (long-term) rate of return is the interest rate used to compute the expected return on plan assets, which is a reduction in pension cost. ASC 715 prescribes that the expected rate of return should reflect the average rate of earnings expected on the funds invested or to be invested to provide for the benefits included in the projected benefit obligation. In addition, appropriate consideration should be given to the returns being earned by the plan assets in the fund and the rates of return expected to be available for reinvestment.

As previously noted, GAAP requires the discount rate used to compute the projected benefit obligation to be based on the current rate of return on *high-quality fixed-income investments* consisting of the rate of return (yield) ranging between AA- and AAA-rated corporate bonds. Because AA-rated bonds have a higher yield, typically most companies use a higher AA-rate, which minimizes the pension benefit obligation. The following table compares the average discount rate used by SEC companies with the range of yields that was being generated for AA- and AAA-rated bonds in the same year.

**Annual Discount Rates Versus Bond Returns**

| End of the Year | Discount Rate Used for Pension Funds (a) | Returns on AA and AAA- Rated Bonds (c) |
|---|---|---|
| 2015 | 4.22% | 3.9% (b) |
| 2014 | 3.81% | 3.7% (b) |
| 2013 | 4.83% | 4.6% (b) |
| 2012 | 4.02% | 3.6% |
| 2011 | 4.79% | 4.4% |
| 2010 | 5.44% | 5.5% |
| 2009 | 5.82% | 5.7% |
| 2008 | 6.35% | 5.8% |

(a) Milliman 100 Pension Funding Index
(b) Moody's AAA Bond Yield December of each respective year
(c) Blend of rates based on Merrill Lynch AA 15-year, AA/AAA 10-year, and Citigroup bond index funds

**COMMENT:** In the previous table, the discount rate used in 2009 to 2010 was relatively close to the range of rates actually generated on AA and AAA-rated corporate bonds. Then, in 2011 and 2012, there was a spread in which the discount rate used was slightly higher than the rate of return on bonds Similarly, the discount rates for 2014 (3.81 percent) and 2015 (4.22 percent) were higher than the rates of return for bonds of 3.7 percent and 3.9 percent, respectively.

For those companies that used a higher discount rate, the incentive is obvious in that the higher rate results in a lower liability. While one might conclude that a small elevation in the discount rate (4.22 percent versus 3.9 percent) is insignificant, that small increase in the discount rate has a significant effect on the amount of the liability. The general rule is that for every one percent increase in the discount rate, the pension liability drops by about 15 percent. If the rate increase is only .32 percent (4.22 percent versus 3.9 percent), the result is a potential reduction in the liability of about five percent. A company with a $1 billion pension liability can reduce that amount by $50 million with a corresponding reduction in pension cost. So now the reader can understand that if a company can increase its discount rate by a small fraction, it can significantly understate the pension liability.

The discount rate used to measure pension liabilities is supposed to be the rate that would be generated if the entity hypothetically purchased a risk-free asset at the measurement date, and generated enough investment return to fund future pension payouts. Because pension obligations are guaranteed, the liability is risk-free so that, in theory, the investment purchased at the measurement date should also be a risk-free asset. If the risk-free rate were the valid rate, the rate of the 10-year U.S. Treasury bonds would be used which would result in rates as follows:

| Date | U.S. Treasury Bond Rate 10 years |
|---|---|
| December 31, 2015 | 2.27% |
| December 31, 2014 | 2.17% |
| December 31, 2013 | 3.03% |
| December 31, 2012 | 1.91% |
| December 31, 2011 | 1.97% |
| December 31, 2010 | 3.39% |
| December 31, 2009 | 3.73% |

The reason cited by the FASB and others as to why a risk-free discount rate is not used to compute the pension liability is because there is risk that exists between maturities. That is, it is virtually impossible to match maturities of U.S. Treasury bonds with the cash requirements to fund pension obligations. Therefore, as each investment were to mature, there would be risk associated with being able to repurchase the investments at the same interest rates. Thus, the investments required to be purchased at the measurement date could not be purchased without having some interest-rate risk. Consequently, using a risk-free discount rate would not be realistic because an entity would not have the ability to purchase U.S. Treasury bonds with maturities that identically match the due dates of the pension obligation payments.

To recap, the expected rate of return is the interest rate used to compute the expected return on plan assets, which is a reduction in pension cost. ASC 715 states that "the expected rate of return must reflect the average rate of earnings expected on the funds invested or to be invested to provide for the benefits included in the projected benefit obligation." In determining the expected rate of return, consideration must be given to the mix of actual investments and their returns. Companies have an incentive to keep the expected rate of return as high as possible. The higher the rate, the higher the expected return on plan assets, which reduces the PBO and pension cost.

**Comparison of ERR to Actual Rate of Return, By Year**

| End of the Year | Expected Rate of Return (ERR) Used for Pension Funds | Actual Rate of Return |
|---|---|---|
| 2015 | 7.5% | 1.9% |
| 2014 | 7.5% | 9.9% |
| 2013 | 7.5% | 11.2% |
| 2012 | 7.5% | 11.7% |
| 2011 | 7.8% | 5.9% |
| 2010 | 8.0% | 12.8% |
| 2009 | 8.1% | 14.0% |
| 2008 | 8.1% | (18.8)% |
| 2000 to 2014 average (a) | | 6.0% |

**Source:** Milliman 100 Pension Funding Index, *2014 Corporate Pension Funding Study,* December 2015

(a) Published average return for 2000 to 2012, adjusted by the author to reflect the effect of 2013-2015

Notice from the table above that the average ERR used by U.S. pension funds was about 7.5 percent in 2015 while the actual return for that year was only 1.9 percent. That would suggest that the expected rate of return was actually too low. Moreover, even though the average ERR for 2015 was 7.5 percent, more than 50 percent of the entities used an ERR of eight percent to nine percent.

Based on ASC 715, the ERR must be the rate of return that the plan expects to earn over a long period of time, taking into account the mix of investments in the plan on the measurement date. Although the ERR used in 2015 was around 7.5 percent, one must look closer to reach a conclusion that the 7.5 percent rate might actually be too high, not too low. The actual rate of return on assets for the U.S. plans was only six percent from 2000 to 2015, well below 7.5 percent and the 2015 rate of return of 1.9 percent was reflective of a deterioration in the U.S. stock market. Furthermore, in order to justify a 7.5 percent expected (long-term) rate of return, an entity would have to have a heavy weighting of investments in equities and higher-risk investments.

From one survey, it appears that the typical investment mix followed by most of the major U.S. pension plans in 2015 was:

| | |
|---|---|
| Equities | 40% |
| Fixed income (bonds, etc.) | 40% |
| Other investments | 20% |
| | 100% |

**Source:** Milliman 100 Pension Funding Index, *2015 Corporate Pension Funding Study*

That means a company that uses an expected ERR of eight percent to nine percent is assuming that the long-term return that will be generated on a long-term basis will be eight percent to nine percent based on the 40 percent/40 percent/20 percent blend of assets.

A survey of expected rates of return used by pension plans in other countries indicates that U.S. companies use ERRs that are significantly higher than other countries. Consider the following list based on 2015 data:

**Expected Rates of Return By Country**

| Country | ERR Used in 2015 Pension Plans |
|---|---|
| Canada | 5.57% |
| Germany | 3.92% |
| Japan | 2.69% |
| Netherlands | 3.22% |
| Switzerland | 2.75% |
| UK | 5.74% |
| **United States** | **6.99%** |

**Source:** *2015 Global Survey of Accounting Assumptions for Defined Benefit Plans*, Towers Watson

What the above table shows is that U.S. pension plans are using expected rates of return that are significantly higher than those used by any other major country. A higher expected rate of return reduces the pension liability as previously noted.

As previously stated, if a company wishes to manipulate the funded status of its pension plan, all it has to do is change *three fundamental assumptions* used in the calculation of the pension liability. The last assumption that can be altered is the compensation growth rate. When a company computes the service cost component of total pension cost, it must reflect into the computation any growth in compensation that affects the pension payout. If a company wants to keep its pension benefit obligation down, one way is to reduce the growth rate of compensation that is reflected in the computation of the service cost component of pension cost that is recorded as part of the pension liability.

On average, companies include an average salary increase of about two to five percent per year in the computation of the service cost component. If, instead, the assumption only reflects a one percent increase, the service cost component and, in turn, pension liability would be reduced. Although it is impossible to truly estimate the compensation growth rate over a long period of time, in general, a rate of two to five percent is consistent with what most companies should be using in their pension computations.

> **COMMENT:** Because the assumptions reflected in the compensation of pension liabilities of a defined benefit plan are quite subjective and can dramatically change the overall outcome, it is imperative that any stakeholder in a pension plan evaluate the key assumptions used in measuring the pension liability and funded status.

GAAP requires that a company disclose the discount rate, expected rate of return, and compensation growth rate. Using 2015 market information, those rates should be in the following ranges:

| **Assumption** | **Typical Range of Acceptable Rate** |
|---|---|
| Discount rate | 3.5% to 4.0% |
| Expected return on assets | Not greater than 7% |
| Compensation growth rate | 2 to 5% |

If a company's disclosure of its pension plan assumptions deviates from those noted in the above table, there is a question as to whether appropriate pension plan assumptions have been followed.

It is clear that some companies are manipulating the discount rate and expected rate of return to keep the PBO down. If this is the case, why are pension liabilities increasing? Companies may be trying to keep pension liabilities down by keeping both the discount rate and expected rate of return high, but that action is simply not enough. A key reason for the increase in pension liabilities is that life expectancy is increasing. The longer the life expectancy of pension retirees, the greater the benefits that will have to be paid out and, in turn, have to be present-valued to compute the PBO. Life expectancy at birth has risen from about 65 years in 1950 to more than 76 years now. Life expectancy will surpass 90 years by year 2100.

Using a recent actuarial table, a future male retiree who is currently age 50 will live until 81, while in 1996, that same male would have been expected to live until age 77. That means there are an additional four years of pension benefits to be paid to that one employee, and that additional cost must be reflected in the pension liability, on a present value basis. That trend is likely to continue. Consequently, regardless of the growth of pension assets, defined benefit pension plans are going to be a challenge to fully fund. The math of having too many pensioners living too long makes it virtually impossible for companies to be able to keep their defined benefit pension plans solvent.

Pension plan trustees are concerned that lower interest rates, coupled with pensioners living longer, will bankrupt their defined benefit plans. And the truth is that they could be correct. The good news is that in the next few years, when the Federal Reserve likely stops artificially pushing rates down, the effects of the Fed's quantitative easing (e.g., printing money) may translate into higher inflation and interest rates. If that happens, the underfunded status of many of the U.S. pension plans could be reversed in one swoop simply because the discount rate increases. Consider that if interest rates rise significantly, so will expected rates of return and discount rates. With higher rates, pension liabilities will be reduced so that the funded status may become positive. Until interest rates rise, it will be virtually impossible for most pension plans with an unfunded status to reverse themselves.

## STUDY QUESTIONS

**3.** Which of the following identifies a conclusion reached with respect to the Credit Suisse report on multi-employer plans?

- **a.** Multi-employer plans continue to be overfunded due to a strong stock market.
- **b.** Multi-employer plans are slightly underfunded by about 10 percent.
- **c.** Multi-employer plans are grossly underfunded at about 46 percent.
- **d.** Multi-employer plans became overfunded in recent years due to significant changes in actuarial assumptions.

**4.** Which color zone does a pension plan fall into as defined by the Pension Protection Act if it is 86 percent funded?

- **a.** Yellow
- **b.** Green
- **c.** Orange
- **d.** Red

**5.** Which of the following is a way in which an entity can reduce the pension liability of its defined benefit pension plan?

- **a.** Use a higher discount rate
- **b.** Use a higher compensation growth rate
- **c.** Use a higher actual rate of return
- **d.** Use a lower expected rate of return

**6.** Which of the following is an example of an investment which can be used as the discount rate for measuring the projected benefit obligation?

- **a.** Rate of a U.S. Treasury instrument
- **b.** Rate for a AA-rated corporate bond
- **c.** Rate for a junk bond
- **d.** Rate for an overnight repo

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## ¶ 808 STATE PENSION PLANS- AN ACCIDENT WAITING TO HAPPEN

The state pension plan saga continues and the story does not get any better. According to a report from State Budget Solutions, issued in November 2014, state employee retirement plans are in big trouble. The report notes that through 2013 plan years, all 50 state plans are underfunded by a total of $4.7 trillion, have a funded ratio of 36 percent, and have a shortfall averaging $15,000 per capita. The breakout of the funded status all 50 state plans is as follows:

| | |
|---|---|
| Total assets | $2.7 trillion |
| Plan liabilities | (7.4) trillion |
| Shortfall- underfunded | $(4.7) trillion |

The numbers are far worse than the previous year's numbers of $4.1 trillion underfunded with a funded status of 39 percent. The report measured pension liabilities by market valuation using a 15-year Treasury rate of 2.74 percent instead of expected rates of return used by pensions that are in the seven to nine percent range. Using the states' own erroneous assumptions, the unfunded liabilities were only $1 trillion instead of $4.7 trillion. A summary of the worst states follows:

**Largest Shortfalls-State Pension Plans**

| State | Actuarial Assets | Market Liability* | Funding Ratio | Unfunded Liability | Unfunded Liability Per Capita |
|---|---|---|---|---|---|
| Alabama | $29,419,597 | $94,436,581 | 31% | $65,016,984 | $13,450 |
| Alaska | $9,830,274 | $39,700,280 | 25% | $29,870,006 | $40,639 |
| Arizona | $31,866,927 | $90,652,039 | 35% | $58,785,112 | $8,871 |
| Arkansas | $21,504,868 | $61,485,975 | 35% | $39,981,107 | $13,512 |
| California | $476,133,354 | $1,230,182,696 | 39% | $754,049,342 | $19,671 |
| Illinois | $95,040,320 | $426,619,820 | 22% | $331,579,500 | $25,740 |
| New York | $238,027,500 | $545,959,988 | 44% | $307,932,488 | $15,670 |
| Texas | $190,832,179 | $486,932,011 | 39% | $296,099,832 | $11,196 |
| Ohio | $152,370,215 | $441,974,046 | 34% | $289,603,831 | $25,028 |
| New Jersey | $86,122,541 | $286,272,593 | 30% | $200,150,052 | $22,491 |
| Florida | $131,680,615 | $315,080,836 | 42% | $183,400,221 | $9,380 |
| Pennsylvania | $85,215,151 | $267,049,559 | 32% | $181,834,408 | $14,235 |

**Largest Shortfalls-State Pension Plans**

| State | Actuarial Assets | Market Liability* | Funding Ratio | Unfunded Liability | Unfunded Liability Per Capita |
|---|---|---|---|---|---|
| Michigan | $57,209,849 | $193,562,650 | 30% | $136,352,801 | $13,779 |
| Massachusetts | $42,974,758 | $147,019,968 | 29% | $104,045,210 | $15,545 |
| **ALL 50 STATES** | **$2,679,831,466** | **$7,416,319,293** | **36%** | **$4,736,487,827** | **$15,052** |

* Market value based on use of 15-year Treasury rate of 2.734%
**Source:** State Budget Solutions, November 2014

In June 2012, GASB issued Statement 68, Accounting and Financial Reporting for Pensions, to make some changes to the pension rules for public pension plans. The rules were effective in fiscal years beginning after June 15, 2014. GASB 68 made the following changes to public pension plans:

- It requires governments that participate in defined benefit pension plans to report in their statement of financial position the funded status (projected benefit obligation less the fair value of assets).
- It requires immediate recognition of annual service cost and interest on the pension liability and immediate recognition of the effect on the net pension liability of changes in benefit terms.

  - Other components of pension expense will be recognized over a closed period that is determined by the average remaining service period of the plan members (both current and former employees, including retirees).
- Discount rate: GASB 68 provides for use of a blended discount rate to compute the present value of the projected benefit obligation. The discount rate is a blend of expected rate of return and yield on tax-exempt 20-year bonds. The discount rate is computed by using a long-term expected rate of return for that portion of the plan assets that is expected to be secured by plan assets. For example, if 60 percent of the pension liability is expected to be funded by plan assets, 60 percent of the expected rate of return should be used to compute the discount rate.
- Use a yield or index rate on tax-exempt 20-year, AA-or-higher rated municipal bonds for that portion of the pension liability that is not expected to be secured by plan assets. For example, if 40 percent of the pension liability is expected not to be funded by plan assets, 40 percent of the yield on tax-exempt bonds should be used to compute the discount rate.
- It requires employers to present more extensive disclosures and required supplementary information.

**COMMENT:** The changes that GASB 68 made have a significant effect not only on state and local governments, but also on any institutions (colleges and universities) that participate in state pension plans. Such institutions have to record their share of the state pension plan liability.

As to the two discount rates, under GASB 68, the overall discount rate declines because of the use of the two rates. To the extent that the plan has assets to fund the PBO, the higher expected rate of return will be used. The excess PBO, for which there is not expected to have plan assets to pay for the benefits, a lower rate based on the 20-year AA or higher rated municipal bond will be used.

**EXAMPLE:** Assume the Town of Brokesville has a funded status of 50 percent (fair value of assets/PBO). Also assume the current rate on 20-year AA-rated municipal bonds is 3.5 percent and that the expected rate of return on plan assets is eight percent based on the existing investment mix. Under GASB 68, 50 percent of the pension liability is discounted using the eight percent expected long-term rate, as that is the portion of the liability for which there will be sufficient pension assets to pay for plan obligations. The remaining 50 percent is discounted using the AA-rated municipal bond rate of 3.5 percent as noted below.

| | | | |
|---|---|---|---|
| 8% | x | 50% = | 4.00% |
| 3.5% | x | 50% = | 1.75% |
| | | Weighted discount rate | 5.75% |

Although a rough calculation, the discount rate (which, under previous GASB rules, would have been based on the expected rate of return of eight percent), declines to about 5.75 percent. That decline of greater than two percent would significantly increase the pension liability, but is far short of the discount rate that should be used based on an AA-rated bond which is about 3.5 percent in the previous example.

## ¶ 809 CAN COMPANIES AFFORD TO OFFER ADEQUATE PENSIONS AND OTHER BENEFITS IN THE FUTURE?

The trend is toward companies offering more modest pension and retirement plans in the future as the cost to maintain them is simply too great. According to the PBGC (Source: PBGC, *2014 Annual Management Report*, November 2014), defined benefit plan terminations were 83 in 2014 as compared with 111 in 2013, compared to only 67 terminations back in 2008. Additionally, the number of employees enrolled in defined benefit plans covered by the PBGC has gradually declined from year to year to about 40 million in 2014. Now, only seven percent of private sector employees are part of defined benefit plans, down from 62 percent in 1980.

A short time ago, the AICPA published the results of a survey conducted of more than 3,000 members in both publicly and privately held companies. The results noted that 74 percent of respondents stated that U.S. companies cannot continue providing employees with pensions that adequately cover their retirement years and 54 percent indicated that the erosion of benefits would hurt recruiting and retention efforts. Furthermore, 57 percent believe rising healthcare costs are the biggest barrier to a company's ability to offer pension benefits and 30 percent stated the pressures to compete in the marketplace outweigh the pressures to provide retirement benefits. Finally, 65 percent of respondents offer 401(k) plans with matching contributions and 59 percent believe that Americans need to educate themselves about retirement savings strategies.

## ¶ 810 WHO PAYS FOR THE FUNDING SHORTFALLS IN PENSION PLANS?

Is it the U.S. Government as part of a bailout, the PBGC, state and local taxpayers, or all three? With $6 to 8 trillion of pension liability shortfalls related to single and multi-employer corporate plans, and state and local plans, it is doubtful that the related sponsors will be able to fund these shortfalls. For corporate plans, the first line of defense in funding deficient pension plans (including multi-employer and single-employer plans) is the PBGC. The PBGC bails out defunct defined benefit pension plans, including single- and multi-employer plans. But who will bail out the PBGC? For the past few years, the PBGC has had negative funding positions and significant exposure for future bailouts. Nevertheless, Congress will likely have to subsidize the PBGC in the next few years.

Part of the problem is that the PBGC only guarantees benefits up to about $13,000 per employee, per year, which is not enough to fund most of the overall shortfalls.

| | September 30 (In billions) | |
|---|---|---|
| PBGC Status: | 2014 | 2015 |
| Assets | $90.0 B | $87.7 B |
| Liabilities | (151.8) B | (164.0) B |
| Net position | $(61.8) B | $(76.3) B |
| Possible exposure | $184 million | $238 million |

**Source:** PBGC, *2015 Annual Management Report*, November 2015

At September 30, 2015, the PBGC had exposure to fund potentially defunct pension plans in the amount of $238 million, consisting of $218 million related to single-employer plans, and $20 billion related to multi-employer plans (*2015 Annual Management Report*, Pension Benefit Guarantee Corporation, November 2015) Those amounts do not reflect future claims that could occur from grossly underfunded plans that are categorized in the red zone. A large portion of the $184 million of possible exposure in 2014 was concentrated in the manufacturing and transportation industries.

On one side, the PBGC is simply not receiving the cash flow needed to function as fewer plans are available to pay it fees. On the other side, companies, in particular those in older established, union-based businesses, have learned how to play the bankruptcy game as a method to eliminate two burdens; one is union contracts and the other is the large underfunded pension obligations. Upon filing bankruptcy, companies can shift a portion of the pension shortfall to PBGC with no recourse. Classic examples of such strategies have previously occurred in the airline industry.

There is no surprise that Congress has been lobbied by the various unions for Congress to approve a bailout of the pension liabilities for multi-employer plans. Since most of the multi-employer plans involve union employees, the union lobbies are extensive. There have been several bills proposed in Congress that would provide for the U.S. taxpayer to fund or guarantee the funding of the multi-employer plan deficits after the PBGC pays its share of the losses. To date, nothing has passed. Similar discussions exist with public plans. In addition, Congress may be required to bail out the PBGC for other shortfalls related to single-employer plans.

Consider a rough computation of the total underfunded obligation that could exist with multi-employer plans along with the PBGC, which could require U.S. taxpayer bailout:

| Multi-employer plans: | (in billions) |
|---|---|
| Funding deficiency $(428) billion x 88% in the Red Zone | $(377) |
| Total potential exposure | $(377) |
| Assets in PBGC | 88 |
| Net exposure to bailout | $(289) |

In looking at the above table, a few observations can be noted. If one considers that portion of the multi-employer plans that is in Red Zone status (88 percent have a funded status of less than 65 percent), the net potential exposure to bail out the plans could be $377 billion. Additionally, the PBGC has only $88 billion of assets as of its 2015 financial statements to pay for $377 billion of potential losses, leaving the PBGC short by about $289 billion. Add to that number any potential shortfall in single-employer plans. The result is that the PBGC has insufficient assets to pay for exposure to losses and may have to be bailed out by Congress.

The largest shortfall of defined benefit pension plans actually rests with state and local pension plans, which have a shortfall of about $5 to $7 trillion. There is simply no way that the state and local governments will be able to fund $5 to 7 trillion. Don't be surprised if state and local municipals seek a bailout of their plans from Congress.

# ¶ 811 TRENDS IN PENSIONS AND COMPENSATION

The recent cutback in defined benefit pension and postretirement plan benefits is part of a larger trend toward a reduction in overall compensation and employee benefits. In general, companies are looking for ways to trim overall compensation costs. Consider these statistics: (*Monthly Labor Review*, Bureau of Labor Statistics, December 2015).

- 25 million people will leave the work force through 2020.
- The average age of a U.S. worker exceeds age 41, with more than 20 percent more than age 55.
- The median age will increase to 43 by 2020, with more than 25 percent expected to be older than age 55. At that time, baby boomers will be between the ages of 56 and 74.

To put the age in perspective, the average age of a U.S. worker was only 34 in 1980. With a soft economy, companies are taking specific action toward reducing employer retirement plan benefits thereby shifting that benefit to employee IRAs. One report stated that total retirement benefits from all U.S. employer retirement plans decreased from 7.8 percent of pay in 2002 to approximately 6 percent in 2015 with a continued downward trend (Watson Wyatt)

Based on the most recently published information, assets in retirement plans of non-governmental employees are approximately at the following levels:

**Assets in Retirement Plans for Non-Governmental Employees**
**2015**

| Plan type | 2015 assets in plans* | 2015 % | 1996 % |
|---|---|---|---|
| IRAs | $7.3 trillion | 44% | 31% |
| 401(k)-defined contribution plans | 6.5 trillion | 39% | 36% |
| Defined benefit plans | 2.8 trillion | 17% | 33% |
| | $16.6 trillion | 100% | 100% |

**Source:** 2015 information: *The U. S. Retirement Market, Investment Research Institute,* December 2015.
1996 information: Flow of Funds Report, Federal Reserve.
* Consists of third quarter 2015 data.

There has been a continued shift from defined benefit plans to 401(k) plans and, in turn from 401(k) plans to individual IRA accounts. This move in assets from corporate-related accounts to individual accounts is a trend because companies have to cut ever-growing employee benefits. As presented in the previous table, the highest percentage of assets in retirement funds lies in IRAs (44 percent) with defined benefit plans having the smallest percentage (17 percent). This shift is profound when compared with the percentages in 1996 when the percentages were equally divided among the three types of plans. Clearly, the shift to IRAs is a prime example of companies having to reduce higher retirement costs from the entity to the individual responsibility.

The same trend is occurring with other employee benefits. With respect to health insurance, companies are being forced to shift more of the financial burden onto employees. A survey published by Mercer Human Resource Consulting asked this question to employers about health care costs:

| How is your company responding to rising health care costs? | |
|---|---|
| Higher co-payments | 64% |
| Increase deductibles | 61% |
| Increase employee contribution to premiums | 60% |
| Health savings accounts/reimbursable plans | 45% |
| Wellness/disease prevention programs | 40% |
| Switch providers for lower rates | 39% |
| Disease-management programs offered | 18% |
| Reduce scope of coverage | 12% |
| Purchase health care jointly with other businesses | 8% |
| Use more contract labor to avoid cost | 7% |

Notice that the first three responses represent a shift in the financial burden to employees. The above survey does not reflect the impact of Obamacare which is likely to further reduce benefits provided by employers.

Unfortunately, regardless of the type of pension plan used by retirees and prospective retirees, there is a significant shortfall in the amount of pension assets as compared with what individuals will require in the future to retire. Consider the following, some of which is provided by the Employee Benefits Research Institute:

- The average employee contributes 6.4 percent of his or her paycheck to a 401(k), much less than 10 percent minimum that is recommended.
- Boomers and Gen Xers have an aggregate retirement income shortfall of $4.3 trillion.
- Shortfall is defined as: Amount needed to retire, less amount in savings and Social Security benefits.

## ¶ 812 NEW DEFINED BENEFIT PLAN MORTALITY TABLES

In October 2014, the Society of Actuaries (SOA) released new mortality tables found in RP-2014 and a new mortality improvement scale referred to as MP-2014. These new tables directly impact company defined benefit plan liabilities. According to SOA, the new mortality tables are based on about 10.5 million life-years of exposure and more than 220,000 deaths, submitted from a total of 123 private and public/federal pension plans.

The mortality assumptions currently used to value most retirement programs in North America were developed from data that are more than 20 years old (UP-94 and RP-2000), which are based on mortality experience with base years of 1987 and 1992, respectively.

The new mortality tables reflect expanded life expectancies which will be reflected in actuarial computations of plan obligations. Life expectancies of 65-year olds in the United States have increased from 84.6 years to 86.6 years for men, and 86.4 years to 88.8 years for woman. For companies with significant defined benefit pension and other post-employment benefit (OPEB) obligations, longer life expectancies will probably significantly increase the plan obligations. An average of two years of future benefit payments will have to be added to the plan obligation liability on sponsor financial statements.

> **COMMENT:** The immediate income statement effect will be minimal as GAAP permits the adoption of the new tables to be amortized into net income over several years.

The new mortality assumptions and longer life expectancies will likely also result in higher contribution requirements, benefit restrictions, lower balance sheet funded status (assets minus liabilities will be lower), higher lump-sum payouts, and higher PBGC variable rate premiums.

One important question is must companies use the new mortality tables in computing plan obligations for GAAP financial statements? Not necessarily. U.S. GAAP does not require a plan sponsor to use a particular mortality table so that sponsors ultimately make the decision as to which assumptions they use in their financial statements to measure a plan's defined benefit obligation and net periodic benefit cost. Instead, plan sponsors make their own decisions with respect to assumptions used for their financial statements as long as they use the "best estimate" available. That said, most plan actuaries, accountants and auditors choose to use the actuary tables, in particular the newly issued RP-2014, because it represents the most recently issued mortality information available.

For pension funding purposes, although the IRS did not include the new RP-2014 information in its tables for 2014 and 2015, the IRS is expected to reflect it in its tables for 2016. Therefore, for GAAP purposes, some companies may try to hold onto the old (and less expensive) actuary tables through 2015 plan years based on the argument that they do not want to use the new tables until the IRS uses them in 2016. For many actuaries, accountants and auditors, they may not want to wait until 2016 and may force their clients to use the new tables starting in 2014 plan years.

In February 2015, the AICPA issued a Technical Practice Aid (TPA) entitled, *Section 3700, Pension Obligations .01 Effect of New Mortality Tables on Nongovernmental Employee Benefit Plans (EBPs) and Nongovernmental Entities That Sponsor EBPs,* to address the applicability of the new mortality tables to sponsors of pension plans. An excerpt is included below.

> **Technical Practice Aid (TPA) entitled, *Section 3700, Pension Obligations .01 Effect of New Mortality Tables on Nongovernmental Employee Benefit Plans (EBPs) and Nongovernmental Entities That Sponsor EBPs***
>
> ***[February 2015]***
>
> **Inquiry:** Nongovernmental EBPs and nongovernmental entities that sponsor EBPs (sponsoring entities) incorporate assumptions about participants' mortality in the calculation of the benefit liability for financial reporting purposes. Professional associations of actuaries occasionally publish updated mortality tables and mortality improvement projection scales (collectively referred to as mortality tables for purposes of this Technical Question and Answer) to reflect changes in mortality conditions based on recent historical trends and data. Established actuarial companies also may develop mortality tables based on other information and assumptions.
>
> ***For financial reporting purposes, how and when should nongovernmental EBPs and nongovernmental sponsoring entities consider these updated mortality tables if their financial statements have not yet been issued at the time the updated mortality tables are published?***
>
> **Reply:** Nongovernmental EBPs and nongovernmental sponsoring entities should consider the specific requirements of generally accepted accounting principles (GAAP), **which require the use of a mortality assumption that reflects the best estimate of the plan's future experience for purposes of estimating the plan's obligation** as of the current measurement date

(that is, the date at which the obligation is presented in the financial statements).

In making this estimate, GAAP requires that all available information through the date the financial statements are available to be issued should be evaluated to determine if the information provides additional evidence about conditions that existed at the balance sheet date.

FASB Accounting Standards Codification (ASC) 855-10-55-1 specifies that information that becomes available after the balance sheet date (but before the financial statements are available to be issued) may be indicative of conditions existing at the balance sheet date when that information is a culmination of conditions that existed over a long period of time.

Updated mortality tables are based on historical trends and data that go back many years; therefore, the existence of updated mortality conditions is not predicated upon the date that the updated mortality tables are published. Management of a nongovernmental EBP or a nongovernmental sponsoring entity should understand and evaluate the reasonableness of the mortality assumption chosen, even when assisted by an actuary acting as a management's specialist, and document its evaluation and the basis for selecting the mortality tables it decided to use for its current financial reporting period. A management's specialist is defined in paragraph .05 of AU-C section 500, *Audit Evidence* (AICPA, Professional Standards), as an individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.

Many defined benefit pension plans present plan obligations as of the beginning of the plan year, as allowed under FASB ASC 960-205-45-1. Although this presentation is before the balance sheet date, it represents a measurement of an amount that is presented in the financial statements that should reflect management's *best estimate* of the plan's mortality and other assumptions. The assumptions used to estimate the plan's obligation should be evaluated based on all available information through the date the financial statements are available to be issued, including determining whether updated mortality conditions existed as of the date the obligation is presented in the financial statements (that is, the beginning of the year).

Auditors are required to evaluate the competence, capabilities, and objectivity of a management's specialist; obtain an understanding of the work of that specialist; and evaluate the appropriateness of that specialist's work as audit evidence for the relevant assertion. Considerations may include evaluating the relevance and reasonableness of significant assumptions and methods used by that specialist. Refer to paragraphs .08 and.A35–.A49 of AU-C section 500 and the "Using the Work of a Specialist" section in chapter 2, "Planning and General Auditing Considerations," of the AICPA Audit and Accounting Guide Employee Benefit Plans, for further guidance. In addition, the auditor is responsible for evaluating subsequent events under AU-C section 560, *Subsequent Events and Subsequently Discovered Facts* (AICPA, Professional Standards). That section requires the auditor to obtain sufficient appropriate audit evidence about whether events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements are appropriately reflected in those financial statements in accordance with the applicable financial reporting framework. [Issue Date: February 2015.]

Although GAAP does allow a plan sponsor to choose its plan assumptions as long as they are the best estimates available, the SEC has been a bit more forceful and letting companies know they expect those companies to use the new mortality tables. In his remarks made in December 2014 during the 2014 AICPA National Conference on Current SEC and PCAOB Developments, the SEC's T. Kirk Crews made the following comments:

> *"Given plan sponsors have historically utilized the SOA's mortality data and that data has been updated, the [SEC] staff does not believe it would be appropriate for a registrant to disregard the SOA's new mortality data in determining their best estimate of mortality. Finally, management should consider the guidance in Subtopic 715-20 and disclose the impact of mortality to the extent it results in a significant change in the benefit obligation."*

Those comments suggest that the SEC expects SEC companies to use the new tables in applying its "best estimate" of mortality assumptions.

It is also interesting to consider the impact of the using the new mortality tables on 2014 pension plans If an entity uses the new mortality tables for 2014, they are adding an average of two years of pension payments in the computation of their pension obligations. That amount is likely to be significant. The following also identifies some of the impacts of the new mortality tables:

- Tower Watson noted that it estimates that the funded status of the 400 largest U.S. company pension plans declined by $72 billion as a result of using the new mortality table assumptions in 2014.

Overall funded status of the top 400 companies declined from 89 percent to 80 percent due to mortality table changes and a decline in interest rates (Longer Lives Hit Companies With Pension Plans Hard—Firms' balance sheets will have to reflect higher costs, Wall Street Journal, February 2015).

As to individual companies, some had more significant impacts on their liabilities than others: (Long lives pinching pension plan funds, Bloomberg News, February 2015)

- General Motors' pension liability increased by $2.2 billion due to mortality table changes, out of an overall increase of $3.6 billion.
- AT&T's pension and retirement-benefit obligations increased by $1.5 billion in 2014.
- Kimberly-Clark's pension obligations increased by about $2.5 billion.
- General Electric estimated that the new mortality assumptions could cause its retiree obligations to increase by $5 billion.
- Dow Chemical Co.'s pension liabilities increased by $750 million stemmed from new mortality table estimates.

In addition to the increases in obligations due to use of the new mortality tables, for 2014 plan years, companies experienced additional pension obligations due to a decline in interest rates. Thus, for 2014, U.S. companies with pension plans incurred sizeable deterioration in their funded status due to a one-two punch created by use of the new mortality tables coupled with a decline in interest rates.

## ¶ 813 U.S. PENSION PLANS ARE MOVING FROM EQUITIES TO BONDS

As previously discussed in the last section, pension liabilities are increasing in part, because interest rates (and thus discount rates) have declined. One reason for the decline is that the AA and AAA-rated bond interest rates have decreased. Moreover, the overall discount rates are declining because sponsors no longer wish to hold such a high percentage of assets in risk equity investments. As a result, the shift is moving toward bonds and, consequently, a lower discount rate. A lower discount rate yields a higher pension obligation. Companies are increasing their holdings in long-term bonds for several reasons. With bonds they can more closely match returns with future pension commitments, bonds offer less risk from the volatility of the stock market, and sponsors are anticipating that bonds will offer a higher interest rates in the future if the Federal Reserve follows up on its warning that it is likely to increase interest rates.

For the first time since 2003, large pension funds hold more bonds than equities. The 50 largest pension plans in the S&P 500 invested 43 percent of their assets in bonds and 37 percent in stocks last year. In 2013, the split was 42 percent in debt and 41 percent in equities the year before, according to a new report from Goldman Sachs Asset Management (Yield Watch: Corporate Pensions Shift to Bonds, CFO Journal, WSJ, April 2015, based on a report issued by Goldman Sachs Asset Management). This is in stark comparison to 2003 where pensions held only 30 percent in bonds versus 61 percent in equities.

## STUDY QUESTIONS

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**7.** The results of an AICPA survey of more than 3,000 of its members in both publicly and privately held companies show that what percent of respondents do not believe that U.S. companies can continue providing employees with pensions that adequately cover their retirement years?

- **a.** 30 percent
- **b.** 54 percent
- **c.** 65 percent
- **d.** 74 percent

**8.** Which of the following is likely to occur based on the new mortality assumptions?

- **a.** There will be lower pension contribution requirements.
- **b.** Funded status will be lower.
- **c.** There will be lower lump-sum payouts.
- **d.** There will be lower PBGC variable rate premiums.

**9.** Recently, sponsors of company pension plans have been shifting more to which of the following types of investments?

- **a.** Bonds
- **b.** Equities
- **c.** Mutual funds
- **d.** Index funds

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**CPE NOTE:** When you have completed your study and review of chapters 6-8, which comprise Module 3, you may wish to take the Final Exam for this Module. Go to **CCHGroup.com/PrintCPE** to take this Final Exam online.

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# ¶ 10,100 Answers to Study Questions

## ¶ 10,101 MODULE 1—CHAPTER 1

**1. a.** ***Incorrect.*** Under existing GAAP, in order for a lease to qualify as a capital lease, the present value of the minimum lease payments must be equal to or exceed 90% or more (and not 10%) of the fair value of the asset.

**b.** ***Incorrect.*** Under existing GAAP, in order for a lease to qualify as a capital lease, the lease term must be *at least 75 percent* of the remaining useful life of the leased asset.

**c.** ***Correct.*** **Under current GAAP, ASC 840, *Leases* divides leases into two categories: operating and capital leases. Under existing GAAP, if there is a bargain purchase at the end of the lease, this is one of the criteria which would define the lease as a capital lease.**

**d.** ***Incorrect.*** Under existing GAAP, if there is a transfer of ownership, the lease qualifies as a capital lease.

**2. a.** ***Correct.*** **The new standard uses the right-of-use model under which a lease obligation is recorded at the present value of cash flows with the recording of a corresponding right-of-use asset.**

**b.** ***Incorrect.*** Operating leases are part of existing GAAP and have nothing to do with the new lease standard.

**c.** ***Incorrect.*** The term "capital lease" is part of existing GAAP and is not used in the new model even though the new model does capitalize assets and liabilities.

**d.** ***Incorrect.*** The concept of "true lease" is found in taxation and not in GAAP.

**3. a.** ***Incorrect.*** The new standard will not require the company to record a lease asset and liability for a short-term lease of 12 months or less. This will be required for lease terms of more than 12 months.

**b.** ***Incorrect.*** The new standard will permit, but not require, that the company record a short-term lease as an operating lease.

**c.** ***Correct.*** **If the lease is 12 months or less, a lessee will be able to elect to record the lease as an operating lease, or will also be allowed to record the lease asset and liability, similar to other leases. In accordance with the right-of-use model, a lessee will recognize assets and liabilities for any leases that have a maximum possible lease term of more than 12 months.**

**d.** ***Incorrect.*** The new standard does address these leases, and gives options as to how to deal with them.

**4. a.** ***Incorrect.*** Total expense (interest and amortization) on the lessee's income statement will be higher, not lower, in the earlier years of new leases.

**b.** ***Incorrect.*** There will be a positive (not negative) shift to cash from operations from cash from financing activities in the statement of cash flows.

**c.** ***Incorrect.*** In most cases, total expense for GAAP will differ from total expense for income tax purposes resulting in deferred income taxes being recorded.

**d.** ***Correct.*** **The lessee's EBITDA may increase as there is a shift from rent expense to interest and amortization expense. Interest and amortization are not deducted in arriving at EBITDA while rent expense under existing operating leases is deducted.**

**5. a.** ***Incorrect.*** The new standard is not likely to expand leases because those leases will have lease obligations that have to be recorded on the lessee's balance sheet.

**b.** ***Incorrect.*** Shorter, not longer, leases will be the trend so that smaller liabilities are recorded on the lessee's balance sheet.

**c.** ***Correct.*** **Tenants in single-tenant buildings with long-term leases may choose to buy because they already have to record lease obligations that are similar to the debt they will have to record in a purchase.**

**d.** ***Incorrect.*** The status quo is not likely to be the case given the enormity of the impact of the new standard on company balance sheets.

**6. a.** ***Incorrect.*** GAAP depreciation under a purchase may be lower, not higher, because the useful life used to depreciate the purchased asset is usually longer than the lease term used to amortize the lease.

**b.** ***Correct.*** **The useful life used to depreciate an asset under a purchase is likely to be longer than the lease term used to amortize a lease, thereby resulting in lower depreciation with a purchase than amortization with a Type A lease.**

**c.** ***Incorrect.*** There is no indication that the amounts will be the same, as the terms used for depreciation will differ than those for amortization,

**d.** ***Incorrect.*** Even if the option periods are included in the lease term, that term will be lower than the useful life of the purchase. Thus, depreciation will always be lower than amortization.

## ¶ 10,102 MODULE 1—CHAPTER 2

**1. a.** ***Incorrect.*** Fair value is not used in inventory valuation.

**b.** ***Correct.*** **For companies using LIFO, market value is defined as replacement cost subject to a ceiling and a floor.**

**c.** ***Incorrect.*** Net realizable value is the ceiling for market but is not market. Market is replacement cost, subject to a ceiling and a floor. The ceiling is defined as net realizable value.

**d.** ***Incorrect.*** Normal profit is not market. Normal profit is merely a reduction made to net realizable value to compute the floor. The floor represents the lowest amount for market.

**2. a.** ***Incorrect.*** Normal profit is not part of the formula for net realizable value. Instead, normal profit is used to adjust net realizable value to a floor in determining lower of cost or market for LIFO and retail inventory methods.

**b.** ***Correct.*** **Costs of completion, disposal and transportation are deducted from estimated selling price to compute net realizable value.**

**c.** ***Incorrect.*** Fixed costs are not part of the formula for net realizable value. Instead, costs that are adjustments represent certain variable costs.

**d.** ***Incorrect.*** Any discounts and allowances are considered disposal (selling) costs and are deducted, not added, to estimated selling price to compute net realizable value.

**3. a.** ***Incorrect.*** Inventory is measured at net realizable value only if cost is higher than net realizable value. If, however, cost is lower than net realizable value, inventory would be measured at cost.

**b. *Correct.* ASU 2015-11 requires FIFO inventory to be measured at lower of cost and net realizable value. However, LIFO inventory is still measured using three possible outcomes.**

**c. *Incorrect.*** Although inventory might be measured initially at cost, the subsequent measurement is not.

**d. *Incorrect.*** The ASU does not use the term "fair value" and instead uses the term "net realizable value."

**4. a. *Incorrect.*** Because the test requires use of net realizable value, it is not possible for J to perform the test on individual items in raw materials basis. In particular, those materials ultimately become part of finished goods inventory so that the test should be performed on total inventory.

**b. *Correct.* The best way to perform the test is to perform it on total inventory that includes raw materials, work-in-process, and finished goods inventory. In doing so, net realizable value can be computed based on the finished goods inventory.**

**c. *Incorrect.*** Because FIFO is used, the previous lower of cost or market method, which uses replacement cost, is no longer available under ASU 2015-11.

**d. *Incorrect.*** Because the test requires use of net realizable value, it is not possible for J to perform the test on individual items in raw materials basis. While performing the test on total inventory would be a reasonable approach, the company should only perform the test on individual items in raw materials if the total inventory approach results in an impairment of inventory.

**5. a. *Incorrect.*** The amendments would have required a revaluation of the LIFO layers which could impact the amount of the LIFO reserve but certainly not an elimination of it.

**b. *Incorrect.*** Existing GAAP already requires use of replacement cost under the existing lower of cost or market computation. The ASU makes no changes to that requirement for LIFO inventories.

**c. *Correct.* One particular criticism of the ASU is that it would result in significant costs particularly for the transition into the ASU due to allocating any previous write-downs to inventory layers.**

**d. *Incorrect.*** Existing GAAP requires use of normal profit in computing the floor amount of market. The ASU requires entities that use LIFO to continue existing practice. Thus, there would not be a new requirement to use normal profit because it is already used in existing GAAP.

# ¶ 10,103 MODULE 1—CHAPTER 3

**1. a. *Incorrect.*** In reviewing the rules in ASC 740, the probable threshold is not used in determining whether a valuation account is required. The probable threshold is used in the contingency rules.

**b. *Incorrect.*** The reasonably possible threshold is not used in determining whether a valuation account is required. Reasonably possible is a term used in the contingency rules, not the valuation account.

**c. *Correct.* ASC 740 uses the more-likely-than-not (more than 50-percent probability) threshold to determine whether a valuation account is required. If it is more like than not that a portion or the entire deferred tax asset will not be realized, a company is required to record a valuation account against the deferred tax asset.**

**d.** ***Incorrect.*** ASC 740 and GAAP, in general, does not use the term "highly likely" as a threshold for determining whether a valuation account is required. ASC 740 specifically uses a different term when addressing this topic.

**2. a.** ***Incorrect.*** Estimated future taxable income should exclude the reversal of temporary differences and carryforwards.

**b.** ***Correct.*** **Tax-planning strategies that a company would implement to utilize an expiring NOL is one example of future income. An example of a tax-planning strategy is switching from a tax-exempt to a taxable investment. This in turn creates future taxable income.**

**c.** ***Incorrect.*** Reversal of existing taxable temporary differences is a source of future income, but it is based on the assumption that taxable income is zero and not that taxable income is greater than book income.

**d.** ***Incorrect.*** A current year tax loss does not create future income.

**3. a.** ***Correct.*** **If the federal rate were to be reduced, all deferred tax assets that were previously recorded at a higher 35 percent tax rate would have to be adjusted downward to reflect the lower tax benefit that would be received in future years.**

**b.** ***Incorrect.*** Deferred tax assets would not be adjusted upward as a result of lowering the corporate tax rate. However, if rates increase, the deferred tax assets should be adjusted upward.

**c.** ***Incorrect.*** There would be an effect on deferred tax assets with respect to the lowering of corporate tax rates. Depending on the change in the corporate tax rate (i.e. adjusted up or down), this would have an effect on the deferred tax assets of companies.

**d.** ***Incorrect.*** A lowering of the corporate tax rate would not have an impact on the valuation account used for deferred tax assets. Depending on the change in the corporate tax rate (i.e. adjusted up or down), this would have an effect on the deferred tax assets of companies, which would be adjusted directly to the deferred tax asset and not the valuation account.

**4. a.** ***Incorrect.*** The classification is not based on the estimated reversal date unless the deferred tax liability does not relate to an asset or liability.

**b.** ***Correct.*** **GAAP requires the classification of the deferred tax liability (or asset) follow the classification of the related asset or liability that caused the temporary difference.**

**c.** ***Incorrect.*** GAAP does not provide for always classifying the deferred tax liability (or asset) as long-term.

**d.** ***Incorrect.*** There is no GAAP requirement that a deferred tax liability or asset always be classified as current.

**5. a.** ***Incorrect.*** This is not the Correct federal tax rate that should be used to record the deferred tax liability. This percent represents the current maximum U.S. federal corporate tax rate.

**b.** ***Incorrect.*** This is not the Correct federal tax rate that should be used to record the deferred tax liability. The 25-percent rate is the rate on taxable income between $50,000 and $75,000.

**c.** ***Correct.*** **The average graduated tax rate on $100,000 of taxable income should be used, which is 22 percent.**

**d.** ***Incorrect.*** This is not the Correct federal tax rate that should be used to record the deferred tax liability. Thirty-four percent is the tax rate on taxable income within the $75,000 and $100,000.

**6. a.** ***Incorrect.*** NOL carryforwards cannot be carried forward indefinitely. They can only be carried forward for 20 years.

**b.** ***Correct.*** **Section 179 deductions can be carried forward indefinitely. This deduction relates to an election to recover all or part of the cost of certain qualifying property, up to a limit, by deducting it in the year the property is placed in service.**

**c.** ***Incorrect.*** Capital loss carryforwards cannot be carried forward indefinitely. They can only be carried forward five years from the loss year.

**d.** ***Incorrect.*** Charitable contributions can only be carried forward five years for that portion that exceeds 10 percent of taxable income, without regard to the deduction for the contribution and other items.

**7. a.** ***Incorrect.*** Pharmaceuticals is an industry that would be adversely affected by a reduction in tax rates. Commercial banks would be another industry that would be adversely affected by a reduction in tax rates.

**b.** ***Incorrect.*** Biotechnology is an industry that would be adversely affected by a reduction in tax rates. Auto components would be another industry that would be adversely affected by a reduction in tax rates

**c.** ***Incorrect.*** Financial companies would be adversely affected by a reduction in tax rates.Computer hardware and software manufacturers would be other industries that would be adversely affected by a reduction in tax rates.

**d.** ***Correct.*** **Oil and gas exploration companies would benefit from a reduction in tax rates. Other winners would include utilities and energy sectors; electric, gas, and water utilities; and transportation companies.**

**8. a.** ***Incorrect.*** The worldwide average top corporate income tax rate is 22.6 percent, not 35 percent. The U.S. corporate tax rate is 35 percent.

**b.** ***Incorrect.*** Europe has the lowest, not highest, top corporate income tax rate. Its average corporate tax rate is 18.6 percent.

**c.** ***Incorrect.*** By region, Africa has the highest, not lowest, top corporate income tax rate. Its highest average tax rate is 29.1 percent.

**d.** ***Correct.*** **The United States has the third highest general top marginal corporate income tax rate in the world. It is only exceeded by Chad and the United Arab Emirates.**

**9. a.** ***Correct.*** **The United Arab Emirates has the highest corporate tax rate. Its tax rate is 55 percent.**

**b.** ***Incorrect.*** Australia does not have the highest corporate tax rate. Its tax rate is 30 percent which is lower than countries such as the United States, India, France, and Japan.

**c.** ***Incorrect.*** The United States does not have the highest corporate tax rate. Its maximum corporate tax rate is 35 percent, which is lower than both Chad and the United Arab Emirates.

**d.** ***Incorrect.*** Switzerland has one of the lowest corporate tax rates at 8.5 percent. Its tax rate is lower than many countries such as Ireland, Sweden, Israel, and Austria.

# ¶ 10,104 MODULE 2—CHAPTER 4

**1. a.** ***Incorrect.*** Under current practice, materiality is not determined by the investor or other third party, but is typically determined by the company or auditor.

**b.** ***Incorrect.*** In practice, materiality is typically determined using an arbitrary threshold such as five percent of income or a percentage of total assets, not a statistical, computed threshold.

**c.** ***Correct.*** **The Report suggests that the materiality threshold should be determined through the eyes of the investor, for whom the financial information is issued. That threshold is based on what will affect investors' decisions.**

**d.** ***Incorrect.*** The Report suggests that both quantitative and qualitative factors should be considered in determining materiality, and it should not be based on an arbitrary quantitative threshold.

**2. a.** ***Incorrect.*** The Study does deal with shelf life of disclosures and does not suggest that such disclosures get replaced after one year. In fact, rarely does the disclosure get removed.

**b.** ***Correct.*** **One key point noted in the Study is that once a disclosure is added to the notes, it is rare that the disclosure is omitted in future financial statements or filings. The result is that excess disclosures accumulate in the notes over several years.**

**c.** ***Incorrect.*** There is no evidence that the disclosure converts to a qualitative version.

**d.** ***Incorrect.*** The Study did state that companies are concerned that an auditor or regulator will require a company to retain a disclosure. However, there is no evidence that a regulator will make a company change a disclosure.

**3. a.** ***Incorrect.*** The business section is identified as one of the possible categories. According to the sample financial statements, the business section would consist of operating and investing transactions.

**b.** ***Incorrect.*** The proposal would include a financing section. According to the sample financial statements, the financing section would include debt and financing transactions.

**c.** ***Incorrect.*** The proposal would include an income tax section that would be reflective of activity related to all income taxes.

**d.** ***Correct.*** **There is no debt section identified. Instead, debt activity would be part of the financing section.**

**4. a.** ***Incorrect.*** The term "cash equivalents" would be eliminated.

**b.** ***Incorrect.*** Although "cash and cash equivalents" is a term used under the current statement of cash flows, the FASB does not recommend that it be continued.

**c.** ***Correct.*** **The FASB wants to eliminate the term "cash equivalents" so that the statement of cash flows reconciles down to cash only.**

**d.** ***Incorrect.*** Cash and short-term investments is not a category recommended by the FASB.

**5. a.** ***Incorrect.*** Collection of receivables increases cash from operating activities which, in turn, affects free cash flow.

**b. *Correct.* Purchasing equipment through long-term debt has no impact on free cash flow. This is considered a capital expenditure.**

**c. *Incorrect.*** Purchasing equipment with accounts payable which is outstanding at year end does, in fact, ultimately result in the cash flow impacting free cash flow. When the accounts payable is paid in the following period, the change in accounts payable is an adjustment to cash from operating activities, thereby affecting free cash flow.

**d. *Incorrect.*** Preferred stock dividend payments are deducted from net income to arrive at free cash flow. Thus the payments directly impact free cash flow.

**6. a. *Incorrect.*** Day's supply in inventory is inventory divided by net sales times 365.

**b. *Incorrect.*** Days payable outstanding consists of accounts payable divided by net sales times 365.

**c. *Correct.* Days in working capital consists of the sum of the working capital components divided by net sales times 365.**

**d. *Incorrect.*** There is no formula for days left in the sales cycle.

**7. a. *Incorrect.*** Companies had more than "very little" excess working capital.

**b. *Correct.* The REL working capital study showed that U.S. companies had about $1 trillion in excess working capital due to inefficient working capital management.**

**c. *Incorrect.*** In 2014, the number of days in payables was higher (46) than the number of days in receivables (36).

**d. *Incorrect.*** Days in working capital decreased from about 39 in 2009 to 33 in 2014.

**8. a. *Incorrect.*** A symptom that exists in companies with poor working capital management techniques is an increase in inventory obsolescence, which suggests excess inventory maintained over current demand for that inventory.

**b. *Incorrect.*** An increase, not a decrease, in past due receivables unveils a weak collection policy.

**c. *Incorrect.*** A poor technique is where the same supplier delivers to different sites based on different terms suggesting the company is not leveraging its collective volume to maximize terms and prices.

**d. *Correct.* A symptom that exists in companies with poor working capital management techniques is that vendors have imposed credit restrictions or sanctions on the company due to past due payments and concern that the company may be a credit risk.**

**9. a. *Incorrect.*** Efficient trade receivable, not trade payables, collection procedures can minimize bad debts.

**b. *Incorrect.*** Efficient inventory management can reduce the amount of obsolescence, not increase it.

**c. *Incorrect.*** Excess cash from efficient cash flow management can be used to pay down debt and, in turn, minimize interest expense, not establish more accounts.

**d. *Correct.* If an entity has efficient working capital management, that entity can use excess cash generated from trade receivable and inventory management to maximize purchase discounts.**

# ¶ 10,105 MODULE 2—CHAPTER 5

**1. a.** ***Incorrect.*** Consolidation occurs if there is more than 50 percent of the voting shares in another entity.

**b.** ***Incorrect.*** The cost method applies if one entity owns less than 20 percent of the voting shares in another entity and the investment is a non-security.

**c.** ***Incorrect.*** The fair value method may be applied if one entity owns less than 20 percent of the voting shares in another entity and the investment is a security. Fair value does not apply if ownership of voting equity exceeds 50 percent.

**d.** ***Correct.*** **If one entity owns between 20-50 percent of the voting shares or where one entity has significant influence over another, the accounting treatment for the investment generally is to use the equity method. Significant influence is assumed at between 20 percent and 50 percent ownership.**

**2. a.** ***Incorrect.*** With respect to an entity that manages, but does not own, another entity, consolidation is unlikely unless that entity has a controlling financial interest in the other entity.

**b.** ***Correct.*** **The general rule for consolidation of entities found in ASC 810 is that consolidation occurs when one entity directly or indirectly has a controlling financial interest in another entity.**

**c.** ***Incorrect.*** Although consolidation can occur at less than 50 percent ownership through one of the consolidation exceptions, the general rule does not state that consolidation occurs at less than 50 percent ownership.

**d.** ***Incorrect.*** Under the VIE rules, consolidation can occur with respect to an off-balance-sheet entity but that entity must first be a VIE.

**3. a.** ***Incorrect.*** The cost method does not apply to the GP's investment in situations in which the GP controls the LP.

**b.** ***Incorrect.*** When a GP controls an LP, recording the fair value is not appropriate.

**c.** ***Incorrect.*** The equity method is not appropriate when a GP controls an LP.

**d.** ***Correct.*** **Existing GAAP provides that when a GP controls an LP, the GP should consolidate the LP, regardless of ownership percentage.**

**4. a.** ***Incorrect.*** An entity that owns less than 20 percent of another entity's voting stock records the investment at cost or fair value. Because there is no common ownership, it is unlikely that combining financial statements would be meaningful.

**b.** ***Incorrect.*** An entity that owns more than 50 percent of another entity's voting stock is required to consolidate and does not have the option to combine financial statements.

**c.** ***Incorrect.*** An off-balance-sheet entity that is a VIE and meets certain criteria to consolidate under FIN 46R is required to consolidate. Therefore, combining financial statements is not an option.

**d.** ***Correct.*** **Two entities with common ownership that do not meet the criteria for consolidation may elect to issue combined financial statements even though such combining is never required. The issue is whether combining is meaningful.**

**5. a.** ***Incorrect.*** An entity is considered a VIE if, by design it has at least one of two conditions. One of those conditions is that the total equity investment at risk is not sufficient to permit it to finance its activities without obtaining additional subordinated financial support provided by any parties. The other condition is that it lacks three characteristics. One of the three characteristics is that they lack the obligation to absorb the expected losses of the entity.

**b.** ***Incorrect.*** An entity is considered a VIE if it has at least one of two conditions. One condition is that it lacks three characteristics. One of the three characteristics is that the holders lack the right (not have the right) to receive expected residual returns of the entity.

**c.** ***Correct.*** **One of the three characteristics is that as a group, the holders of equity investments at risk lack the power to direct the entity's activities.**

**d.** ***Incorrect.*** An entity is considered a VIE if it has at least one of two conditions. One condition is that it lacks three characteristics. Creating the entity at inception is not one of the three characteristics under the VIE model.

**6. a.** ***Correct.*** **ASU 2015-02 states that fees paid to a reporting entity are excluded from the primary beneficiary test if two conditions are met. One is that the fees are compensation for services. The other is that the service arrangement terms, conditions or amounts that are customarily present in similar arrangements.**

**b.** ***Incorrect.*** The fees are excluded in certain cases in which specific conditions are met.

**c.** ***Incorrect.*** The ASU states that the exclusion rule does not reflect fees that are part of arrangements that exposes the entity to risk of loss.

**d.** ***Incorrect.*** Fees paid to a reporting entity include those fees paid to both a decision maker and a service provider.

**7. a.** ***Incorrect.*** Non-substantive participating rights do not overcome the presumption because they do not allow the LP to participate in certain partnership actions.

**b.** ***Incorrect.*** Protective rights only block certain actions and do not impact whether an LP consolidates a limited partnership.

**c.** ***Correct.*** **Substantive participating rights overcome the presumption that the** limited partner **that holds the majority of the kick-out rights shall consolidate the LP. Substantive participating rights allow the non-controlling** limited partner **to effectively participate in certain partnership actions.**

**d.** ***Incorrect.*** Protective rights only block certain actions and do not impact whether a limited partner consolidates an LP even if they are substantive.

**8. a.** ***Incorrect.*** One of the barriers is that the limited partners have the inability (not ability) to obtain the information necessary to exercise the rights. Another barrier is financial penalties or operational barriers associated with dissolving the limited partnership or replacing the general partners that would act as a significant disincentive for dissolution or removal.

**b.** ***Incorrect.*** The absence (not existence) of an adequate number of qualified replacement general partners or the lack of adequate compensation to attract a qualified replacement is a barrier.

**c.** ***Correct.*** **ASU 2015-02 states that one barrier that could make kick-out rights less substantive is if the rights are subject to conditions that make it unlikely they will be exercisable. One example given is if there are conditions that narrowly limit the timing of the exercise.**

**d.** ***Incorrect.*** One barrier is the absence (not existence) of an explicit, reasonable mechanism in the limited partnership's governing documents or in the applicable laws or regulations, by which the limited partners holding the rights can conduct a vote to exercise the rights.

**9. a.** ***Incorrect.*** Typically acquisitions of assets undertaken not in the ordinary course of business are considered protective rights while those undertaken in the ordinary course of business are participating rights.

**b.** ***Incorrect.*** Dispositions of assets undertaken not in the ordinary course of business are protective rights, not those in the ordinary course of business.

**c.** ***Correct.*** **ASU 2015-02 identifies amendments to articles of incorporation or the partnership agreement of an investee as typically being considered protective rights.**

**d.** ***Incorrect.*** Selecting and setting compensation of management is typically a participating right.

**10. a.** ***Incorrect.*** ASU 2015-02 changes existing GAAP by eliminating three of the six conditions for evaluating whether a fee paid to a decision maker or a service provider represents a variable interest.

**b.** ***Incorrect.*** The amendments in the ASU 2015-02 specify that some fees paid to a decision maker or service provider are excluded from the evaluation of the economics criterion (second criterion) if the fees are both customary and commensurate with the level of effort required for the services provided. The ASU amendments make it less likely for a decision maker or service provider to meet the economics criterion solely on the basis of a fee arrangement.

**c.** ***Correct.*** **ASU 2015-02 does not make amendments with respect to the determination of a primary beneficiary. Based on current GAAP, a VIE is consolidated by a primary beneficiary entity if that entity has a controlling financial interest in the VIE through having both the power to direct the activities that most significantly impact the VIE's economic performance, and the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE.**

**d.** ***Incorrect.*** The amendments in ASU 2015-02 reduce the application of the related party guidance for VIEs on the basis of three changes.

**11. a.** ***Correct.*** **Participating rights are those rights that provide an entity the ability to block or participate in the actions through which an entity exercises the power to direct the activities of VIE that most significantly impact the VIE's economic performance. Participating rights do not require the holders of such rights to have the ability to initiate actions.**

**b.** ***Incorrect.*** Kick-out rights represent the ability to remove the entity with the power to direct the activities of a VIE that most significantly impact the VIE's economic performance or to dissolve/liquidate the VIE without cause.

**c.** ***Incorrect.*** Protective rights are the rights designed to protect the interest of the party holding those rights without giving that party a controlling financial interest in the entity to which they relate. For example, these include approval or veto rights granted to other parties that do not affect the activities that most significantly impact the entity's economic performance.

**d.** ***Incorrect.*** Withdrawal rights are the limited partners' unilateral rights to withdraw from the partnership in whole or in part that does not require dissolution or liquidation of the entire limited partnership would not be deemed a kick-out right. The requirement to dissolve or liquidate the entire limited partnership upon the withdrawal of a limited partner shall not be required to be contractual for a withdrawal right to be considered as a potential kick-out right.

**12. a.** ***Incorrect.*** One of the conditions that was eliminated by ASU 2015-02 is that substantially all of the fees are at or above the same level of seniority as other operating liabilities of the entity that arise in the normal course of the entity's activities, such as trade payables.

**b.** ***Incorrect.*** ASU 2015-02 eliminated three conditions, one of which is the total amount of anticipated fees are insignificant relative to the total amount of the VIE's anticipated economic performance.

**c.** ***Correct.*** **One of the three conditions is that the fees are compensation for services provided and are commensurate with the level of effort required to provide those services (e.g., the fees are at an arms-length rate).**

**d.** ***Incorrect.*** One of three conditions eliminated by ASU 2015-02 is that the anticipated fees are expected to absorb an insignificant amount of the variability associated with the entity's anticipated economic performance.

# ¶ 10,106 MODULE 3—CHAPTER 6

**1. a.** ***Incorrect.*** **In general, a loss from a terrorist attack would not be an extraordinary item because the infrequency of occurrence and unusual in nature criteria are not met. The reason is because it is reasonable that such an attack could occur again in the foreseeable future. Moreover, starting in 2016, ASU 2015-01 removed the concept of extraordinary items altogether from GAAP.**

**b.** ***Incorrect.*** There is no authority for presenting such a transaction as part of income from discontinued operations because it has nothing to do with the elimination of a particular operation of an entity.

**c.** ***Correct.*** **Because the criteria for extraordinary treatment (which was eliminated in 2016 with the issuance of ASU 2015-01) are not satisfied, the loss should be presented as part of income from continuing operations.**

**d.** ***Incorrect.*** The loss should be presented on the income statement and not part of retained earnings because there is no authority to present it initially in retained earnings.

**2. a.** ***Incorrect.*** GAAP does not permit that a gain contingency be recorded.

**b.** ***Correct.*** **A receivable related to the insurance recovery should be recorded only when realization of the claim is deemed probable. Also, a gain should not be recognized until any related contingencies have been resolved.**

**c.** ***Incorrect.*** It should be recorded when realization is probable which is well before the cash from the insurance claim is received.

**d.** ***Incorrect.*** Using a best estimate would be tantamount to recording a gain contingency. Recording a receivable related to a gain contingency is not permitted under GAAP.

**3. a.** ***Incorrect.*** There is one specific restriction.

**b.** ***Incorrect.*** The size of the insurance recovery is not an issue in determining its classification.

**c.** ***Correct.*** **An entity may choose how it wants to classify business interruption insurance recoveries in the statement of operations as long as the classification is not contrary to existing GAAP.**

**d.** ***Incorrect.*** There is no requirement that the amount be characterized as unusual or extraordinary.

# ¶ 10,107 MODULE 3—CHAPTER 7

**1. a.** ***Correct.*** **Prior to the FASB issuing ASU 2014-15, the going concern assessment was found only in auditing literature in AU-C 570, and not GAAP.**

**b.** ***Incorrect.*** Prior to the issuance of ASU 2014-15, there was no requirement for management to assess going concern.

**c.** ***Incorrect.*** There has never been a requirement for the board of directors to assess going concern.

**d.** ***Incorrect.*** Auditing standards have required that an auditor perform a going-concern assessment.

***2.*** **a.** ***Incorrect.*** The transaction should be accounted for as internal-use software only if it includes a software license, which it does not.

**b.** ***Correct.*** **If a cloud computing arrangement does not include a software license, the customer should account for the arrangement as a service contract.**

**c.** ***Incorrect.*** At best, the asset is an intangible asset, and not a prepaid one, as there is no evidence to suggest there is a prepaid expense that should be recorded.

**d.** ***Incorrect.*** GAAP does not provide for expensing a portion while capitalizing the remainder.

**3. a.** ***Incorrect.*** Debt issuance costs are capitalized and amortized, and not expensed as incurred.

**b.** ***Incorrect.*** The previous rules required the debt issuance costs to be recorded as an asset and amortized. Under ASU 2015-03, recording those costs as an asset is no longer an option.

**c.** ***Correct.*** **The ASU requires that the debt issuance costs be presented as a net amount against the underlying debt.**

**d.** ***Incorrect.*** The ASU does not permit the costs to be presented as a contra- equity account as they have nothing to do with equity.

# ¶ 10,108 MODULE 3—CHAPTER 8

**1. a.** ***Incorrect.*** With a defined contribution or 401(k) plan, not a defined benefit plan, a company can more accurately measure the amount of its pension cost because it is based on the amount contributed to the plan, and not based on a defined payment amount.

**b.** ***Incorrect.*** A sponsor of a defined benefit plan has fixed, measured contributions required with no discretion to those payments. To the contrary, most defined contribution or 401(k) plans allow a company to structure its contributions to be discretionary, thereby allowing it to reduce its pension contribution during weaker business cycles and increase it during stronger cycles.

**c.** ***Incorrect.*** Investment risk remains with a company that sponsors a defined benefit plan. Alternatively, with 401(k) plans, investment risk shifts from the company to the employee as each employee is responsible for managing his or her investments.

**d.** ***Correct.*** **With defined benefit pension plans, the amount of its pension cost is based on the amount of the ultimate benefit paid, discounted back to the current year.**

**2. a.** ***Incorrect.*** ASC 715 does not apply to defined contribution pension plans but does apply to defined benefit plans.

**b.** ***Incorrect.*** The FASB statement requires a company to record the funded status of the plan on the balance sheet. It does not require that a portion of the plan liability be recorded.

**c.** ***Correct.*** **The Statement introduces greater transparency of plan disclosures on the sponsor's balance sheet by including the entire funded status on the balance sheet.**

**d.** ***Incorrect.*** ASC 715 does not relate to postretirement health benefits. ASC 715 addresses the accounting for retirement plans only.

**3. a.** ***Incorrect.*** Multi-employer plans are underfunded by about $428 billion.

**b.** ***Incorrect.*** Multi-employer plans are significantly underfunded by far greater than 10 percent.

**c.** ***Correct.*** **According to Credit Suisse, multi-employer plans are grossly underfunded at as much as 46 percent, which places them in a critical funded status zone.**

**d.** ***Incorrect.*** Multi-employer plans have been underfunded for several years and continue to be underfunded. There is no evidence that changes in actuarial assumptions contributed to the underfunded status.

**4. a.** ***Incorrect.*** Yellow is between 65 percent and 80 percent funded status. In this funding zone, a funding improvement plan is required.

**b.** ***Correct.*** **Green zone occurs at a funded status of more than 80 percent.**

**c.** ***Incorrect.*** Orange, like yellow, occurs between 65 percent and 80 percent funded status. However, orange is considered a seriously endangered level and the plan has an accumulated funding deficiency or is expected to have one during any of the next six years. Like the yellow status, plans in this zone are required to have a funding improvement plan.

**d.** ***Incorrect.*** Red occurs at less than 65 percent funded status which is far less than 86 percent. The red zone is considered a critical zone and a rehabilitation plan is required.

**5. a.** ***Correct.*** **Use of a higher discount rate results in a lower pension liability being calculated. As the discount rate increases, the present value of the pension liability is decreased. The general rule is that for every one percent increase in the discount rate, the pension liability drops by about 15 percent.**

**b.** ***Incorrect.*** Using a lower, not higher, compensation growth rate results in a lower pension liability because future benefits estimated to be paid will be lower.

**c.** ***Incorrect.*** The actual rate of return does not affect the pension liability calculation.

**d.** ***Incorrect.*** Use of a higher, not lower, expected rate of return results in the periodic pension cost being lower. A lower periodic pension cost results in a lower pension liability accrual.

**6. a.** ***Incorrect.*** The rate of a Treasury instrument is synonymous with a risk-free rate of return. GAAP does not provide for using the risk-free rate of return for measuring the pension obligation.

**b.** ***Correct.*** **The rate used is that of a high-quality fixed-income investment which includes either an AA or AAA-rated corporate bond.**

**c.** ***Incorrect.*** The rate should be that of a high-quality corporate investment, which does not include the rate of a junk bond.

**d.** ***Incorrect.*** An overnight repo is not a high-quality fixed-income investment. It is a short-term investment which does not match the term of the pension liability.

**7. a.** ***Incorrect.*** The results of the AICPA study show that 30 percent believe the pressures to compete in the marketplace outweigh the pressures to provide retirement benefits.

**b.** ***Incorrect.*** The results of the AICPA study show that 54 percent suggested that the erosion of benefits would hurt recruiting and retention efforts.

**c.** ***Incorrect.*** The results of the AICPA study show that 65 percent of respondents offer 401(k) plans with matching contributions.

**d.** ***Correct.*** **The results of the AICPA study show that 74 percent of respondents stated that U.S. companies cannot continue providing employees with pensions that adequately cover their retirement years. Fifty-seven percent believe rising healthcare costs are the biggest obstacle to a company's ability to offer pension benefits.**

**8. a.** ***Incorrect.*** Because the mortality life of both males and females have increased by about two years, pension contribution requirements will be higher to accommodate the longer lives of plan participants.

**b.** ***Correct.*** **Because pension liabilities will be higher, the funded status (assets as a percent of liabilities) will be lower.**

**c.** ***Incorrect.*** Because the liability will be higher due to longer actuarial lives, there will be high lump-sum payout requirements.

**d.** ***Incorrect.*** Higher liabilities will require higher, not lower, PBGC variable rate premiums because those premiums are based on liability amounts.

**9. a.** ***Correct.*** **Recently, companies are beginning to shift their investments to more bonds instead of equity holdings. With bonds, companies can more closely match returns with future pension commitments and bonds offer less risk from volatility of the stock market.**

**b.** ***Incorrect.*** Companies are reducing their investments in equities given the increasing risk of volatility of the stock market. This volatility makes it difficult for sponsors to more closely match returns with future pension commitments.

**c.** ***Incorrect.*** As mutual funds are generally a mix of certain equity investments, these equity instruments are continuing to be reduced in the portfolio of pension plan assets. This is due in part to the increasing volatility of the stock market and difficulty in matching returns to future pension commitments.

**d.** ***Incorrect.*** An index fund is a type of mutual fund with a portfolio constructed to match or track the components of a certain market index, such as the S&P 500. While an index fund provides broad market exposure, the volatility of the stock market makes this a difficult investment for a pension plan sponsor to use when attempting to match returns with future pension commitments.

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***References are to paragraph (¶) numbers.***

## A

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# ¶ 10,301 Final Exam Questions: Module 1

**1.** One key change under the new lease standard is:

**a.** A very small portion of operating leases, but not capital leases, will be brought onto the balance sheet.

**b.** Capital leases, but not operating leases, will be brought onto the balance sheet.

**c.** No leases will be capitalized.

**d.** Most existing operating leases will be brought onto the balance sheet.

**2.** Under the new lease standard, which of the following is true as it relates to the lessee?

**a.** An asset is recognized representing the sum of the lease payments over the lease term.

**b.** An asset is not recognized.

**c.** An asset is recognized representing the lessee's right to use the leased asset for the lease term.

**d.** An asset is recognized only if four criteria are met.

**3.** Which of the following is ***not*** considered part of lease payments under the new lease standard?

**a.** Fixed payments

**b.** Amortization on the underlying leased asset

**c.** Exercise price of a purchase option

**d.** Payments for penalties for terminating the lease

**4.** How will a lessee account for initial direct costs incurred in connection with a lease, under the new lease standard?

**a.** Initial direct costs are included in the lease asset that is recorded at the commencement date.

**b.** Initial direct costs are not part of the lease asset.

**c.** Initial direct costs are expensed as period costs.

**d.** The new lease standard is silent as to how to account for initial direct costs.

**5.** What happens to existing leases on the date of adoption of the new lease standard?

**a.** Existing operating leases are grandfathered but capital leases are not.

**b.** Existing capital leases are grandfathered but operating leases are not.

**c.** The new standard does not grandfather any existing leases.

**d.** Existing leases are phased into the new standard over a four-year period.

**6.** Under the proposed lease standard, which of the following is true?

**a.** Lease terms are likely to shorten to decrease the amount of the lease obligation.

**b.** Lease terms are likely to get longer to reduce the amount of the lease obligation.

**c.** Lease terms are likely to shorten to increase the amount of the lease asset recorded.

**d.** Lease terms are likely to get longer to reduce the amount of the lease asset recorded.

**7.** The new lease standard will likely result in which of the following occurring for existing operating leases?

- **a.** Total lease expense for tax purposes will be greater than total GAAP expense.
- **b.** Total GAAP expense will be greater than lease expense for tax purposes.
- **c.** GAAP and tax expense will be identical.
- **d.** There will be no change in the total expense for GAAP or tax purposes from current practice.

**8.** Under the new lease standard _____:

- **a.** Deferred tax assets will likely be created.
- **b.** Deferred tax assets will likely be reduced.
- **c.** Deferred tax liabilities will likely be created.
- **d.** Deferred tax liabilities will likely be reduced.

**9.** One potential impact from the new lease standard will be that the debt-equity ratio will be _____:

- **a.** Higher
- **b.** Lower
- **c.** The same
- **d.** Either higher or lower depending on several factors

**10.** One potential impact from the proposed lease standard for Type A leases would be that EBITDA would have a/an:

- **a.** Favorable impact because interest would decrease while rental expense would increase
- **b.** Unfavorable impact because depreciation would increase while rental expense would decrease
- **c.** Favorable impact because interest and amortization expense would increase while rental expense would decrease
- **d.** Unfavorable impact because interest, depreciation and rental expense would all increase

**11.** With respect to FIFO inventory, ASU 2015-11 replaces the concept of "market" with which of the following?

- **a.** Replacement cost
- **b.** Fair value
- **c.** Normal profit
- **d.** Net realizable value

**12.** Company K uses the LIFO inventory valuation method and has adopted the amendments of ASU 2015-11. At the end of the year, the Company should measure its inventory based on which of the following?

- **a.** Net realizable value
- **b.** Lower of cost and net realizable value
- **c.** Lower of cost or market
- **d.** Cost

**13.** Company L wrote down its inventory to lower of cost and net realizable value in the previous year, and in the current year, it appears that there is a recovery of the write-down. Based on this fact pattern, which of the following statements is correct with respect to U.S. GAAP?

- **a.** The company is permitted to reverse the previous year's write-down.
- **b.** The company cannot reverse the previous year's write-down under U.S. GAAP.
- **c.** The company is permitted to reverse the previous year's write-down above original cost.
- **d.** The company cannot reverse the previous year's write-down under U.S. GAAP unless it adopts the amendments of ASU 2015-11.

**14.** A company is performing a lower of cost and net realizable value test on its year-end inventory. Which of the following ***would not*** be an appropriate approach to perform the test if the company's inventory has about 1,000 individual items and two major categories of products?

- **a.** Directly on each of the 1,000 individual items
- **b.** To the total inventory in each of the two major categories
- **c.** To the total inventory
- **d.** Only on five percent of the total inventory

**15.** If Company Q is implementing the amendments prescribed by ASU 2015-11, then the company should apply the changes using which of the following transition methods?

- **a.** Retroactively
- **b.** Retrospectively
- **c.** Prospectively
- **d.** Modified Retroactive

**16.** A manufacturer that uses raw materials in its manufacturing process must apply the amendments of the ASU to which of the following?

- **a.** Segments or inventory in total
- **b.** Raw materials
- **c.** Work in process
- **d.** Total replacement cost

**17.** The amendments of ASU 2015-11 amended which of the following ASC topics?

- **a.** ASC 315
- **b.** ASC 840
- **c.** ASC 250
- **d.** ASC 330

**18.** Which one of the following Code sections permits, but does not require, an entity to use lower of cost or market for its inventory valuation?

- **a.** Code Sec. 470
- **b.** Code Sec. 471
- **c.** Code Sec. 845
- **d.** Code Sec. 846

**19.** The amendments of ASU 2015-11 are effective for public business entities for fiscal years beginning after which of the following?

- **a.** December 15, 2016
- **b.** December 15, 2017
- **c.** December 31, 2016
- **d.** December 31, 2017

**20.** The amendments of ASU 2015-11 are effective for nonpublic business entities for fiscal years beginning after which of the following?

- **a.** December 15, 2016
- **b.** December 15, 2017
- **c.** December 31, 2016
- **d.** December 31, 2017

**21.** Which of the following identifies the difference between the book and tax basis of an asset or liability that will result in taxable or deductible amounts in future years when the reported amount is recovered or settled?

- **a.** Temporary difference
- **b.** Permanent difference
- **c.** Tax differential
- **d.** Non-GAAP adjustment

**22.** When deferred tax accounts are adjusted for the effect of a change in tax laws or rates, the effect should be included in which of the following for the period that includes the enactment date?

- **a.** Tax expense
- **b.** Extraordinary items
- **c.** Stockholders' equity
- **d.** Cumulative translation adjustment

**23.** ASC 740 requires a company to recognize which of the following against a deferred income tax asset if, based on the weight of available evidence, it is more likely than not that some portion or the entire deferred tax asset will not be realized?

- **a.** Reserve account
- **b.** Contra asset
- **c.** Valuation account
- **d.** Impairment

**24.** At December 31, 20X4, Company Y has a deferred tax asset due to an unused NOL carryforward. Y has had cumulative losses in years 20X2, 20X3, and 20X4. There are no deferred income tax liabilities at December 31, 20X4. In assessing whether the company will have sufficient future taxable income to absorb the deferred tax asset, how should the three years of cumulative losses be considered?

- **a.** The losses should be considered strong negative evidence in making the assessment.
- **b.** The losses should be disregarded in making the assessment.
- **c.** The losses are only a small factor to be considered in making the assessment.
- **d.** There must be at least five years of cumulative losses to be considered in making the assessment.

**25.** In estimating future taxable income that will absorb deferred tax assets, such estimated future taxable income ______.

**a.** Should exclude any taxable income from reversal of existing deferred income tax liabilities
**b.** Should include all estimated future taxable income that will be generated during the carryforward period
**c.** Should be limited to income estimated over the first five years in the carryforward period
**d.** Should include taxable income from reversal of existing deferred income tax assets

**26.** Company X is a nonpublic entity that has no uncertain tax positions liability. Which of the following is correct?

**a.** X must disclose the number of tax years open for tax examination.
**b.** X must include an abbreviated disclosure of the number of tax years open for examination.
**c.** The exclusion of the disclosure only applies if X is SEC registered and not a nonpublic entity.
**d.** X is not required to disclose the number of tax years open for examination.

**27.** When determining whether a valuation account is required, which of the following identifies positive evidence that would suggest the valuation account is ***not*** required?

**a.** Excess of appreciated asset value over the tax basis of the entity's net assets
**b.** Cumulative losses in recent years
**c.** Unsettled circumstances that can adversely affect future operations
**d.** Carryback period so brief that would limit realization of tax benefits

**28.** Each of the following is an example of a tax-planning strategy that can be used to utilize an NOL, ***except:***

**a.** Changing the character of items from capital gain to ordinary income
**b.** Selling investments including available-for-sale securities to accelerate taxable income
**c.** Switching from tax-exempt to taxable investments
**d.** Changing tax status in order to accelerate taxable income

**29.** Which of the following FASB Interpretations, prior to codification within ASC 740, provided guidance with respect to uncertain tax benefit liabilities?

**a.** FIN 45
**b.** FIN 48
**c.** FIN 19
**d.** FIN 34

**30.** Which of the following corporations would be required to file Schedule UTP within their corporate tax return based on the guidance prescribed by IRS Announcement 2010-75?

- **a.** The corporation has assets of approximately $5 million.
- **b.** A related party to the corporation issued audited financial statements reporting a portion of the corporation's operations for a portion of its tax year.
- **c.** The corporation has approximately $2 million in deferred tax assets.
- **d.** The corporation has assets of less than $7 million.

**31.** According to the *IRS Attention* study, which of the following statements is correct with respect to increased IRS attention of corporate disclosures subsequent to the implementation of FIN 48?

- **a.** There is increased usage of computer algorithms to pull information from EDGAR.
- **b.** The average downloaded 10-K is more than three years old.
- **c.** The IRS attention is strongly driven by firm size, foreign profitability, and NOLs.
- **d.** Cash effective tax rate is the single primary financial statement measure used by the IRS.

**32.** Which of the following financial statement measures appeared to be used more frequently based on results of the *IRS Attention* study?

- **a.** Income from continuing operations
- **b.** Return on stockholders' equity
- **c.** Marginal corporate income tax rate
- **d.** Unrecognized tax benefit liabilities

**33.** Which of the following ASUs issued by the FASB prescribed that deferred income tax assets and liabilities should be presented as noncurrent on an entity's balance sheet?

- **a.** ASU 2015-17
- **b.** ASU 2016-02
- **c.** ASU 2015-11
- **d.** ASU 2016-01

**34.** Based on the Tax Foundation's study entitled *Corporate Income Tax Rates around the World, 2014*, which of the following countries has a 0 percent corporate income tax rate?

- **a.** Spain
- **b.** Bahamas
- **c.** Japan
- **d.** Ireland

**35.** Which of the following can be carried forward five years for that portion that exceeds 10 percent of taxable income?

- **a.** Capital loss
- **b.** Section 179 deduction
- **c.** NOLs
- **d.** Charitable contributions

# ¶ 10,302 FINAL EXAM QUESTIONS: MODULE 2

**36.** One of the 12 recommended principles for a comprehensive business reporting model is that the company must be viewed from the perspective of .

- **a.** All investors in the company's equity
- **b.** All third parties with a range of perspectives considered
- **c.** The current investor in the company's common equity
- **d.** The financial analyst

**37.** One of the 12 recommended principles is that the cash flow statement provides essential information and should .

- **a.** Be prepared using the indirect method
- **b.** Be prepared using the direct method
- **c.** Add a fourth category in addition to operating, investing, and financing activities
- **d.** Reconcile to working capital instead of cash

**38.** One of the 12 recommended principles is that all changes in net assets must be recorded in the:

- **a.** Cash flow statement
- **b.** Statement of changes in stockholders' equity
- **c.** Income statement
- **d.** Statement of changes in net assets available to common shareholders

**39.** IBM's investors complain about the fact that IBM's disclosures keep growing from year to year. Which of the following might be a prime reason why IBM over-discloses in their notes to financial statements?

- **a.** To protect against litigation
- **b.** To save time in removing disclosures from period to period
- **c.** To avoid challenges from over-reactive third parties who seek specific information
- **d.** Because those in charge of governance may be ignorant of accounting and disclosure issues

**40.** Implications of a drastic change in the format of financial statements would include all of the following ***except:***

- **a.** Tax return M-1 reconciliation would differ.
- **b.** Contract formulas for bonuses would have to be rewritten.
- **c.** The cost would be significant.
- **d.** The use of the term cash equivalents would remain intact.

**41.** ASC 230, *Statement of Cash Flows*, requires that non-cash investing and financial activities be disclosed but excluded from the statement of cash flows. Examples of these non-cash activities include all but which of the following?

- **a.** Purchase of equipment by issuance of a note
- **b.** Establishment of capital leases
- **c.** Conversion of debt to equity
- **d.** Payment of stock dividends

**42.** Free cash flow is the amount of cash flow that is free after accounting for:

- **a.** Fixed commitments such as capital expenditures and preferred stock dividends
- **b.** Unrealized gains and losses on securities
- **c.** Variable items such as commissions and other variable costs
- **d.** Other income or expense

**43.** Which of the following would be the logical flow of particular elements in financial statements?

- **a.** Working capital flows to cash.
- **b.** Core earnings flow to working capital.
- **c.** Cash flows to free cash flow.
- **d.** Inventories flow to receivables.

**44.** Four key ratios provide a thorough analysis of working capital. These ratios include all of the following ***except:***

- **a.** Days payables outstanding
- **b.** Days sales in accounts receivable
- **c.** Days in cash flow
- **d.** Days supply in inventory

**45.** How is Days Sales Outstanding (DSO) calculated?

a. $$\frac{Accounts\ receivable + Inventory - Accounts\ payable}{Net\ sales} \times 365$$

b. $$\frac{Inventory}{Net\ sales} \times 365$$

c. $$\frac{Last\ three\ months\ ending\ total\ trade\ receivables}{Net\ sales\ for\ the\ quarter} \times 30$$

d. $$\frac{Last\ three\ months\ ending\ current\ portionoftrade\ receivables}{\text{Current portion of trade receivables}} \times 30$$

**46.** Assume the following:
Days sales outstanding (DSO) is 45 days
Best possible DSO is 30 days
Credit terms are 20 days
Which is the average days delinquent (ADD)?

- **a.** 10 days
- **b.** 15 days
- **c.** Zero
- **d.** 25 days

**47.** Which of the following is true?

- **a.** DSO and ADD always move in the same direction.
- **b.** DSO and ADD always move in different directions.
- **c.** DSO and ADD can move in different directions but only as a result of collections efficiency.
- **d.** None of the above

**48.** Symptoms of inefficiently managed working capital include all of the following ***except***:

- **a.** Bad debts are increasing.
- **b.** Customer service levels are higher than normal.
- **c.** Interest payments to suppliers are increasing.
- **d.** Receivables are growing disproportionately to sales.

**49.** One of the practices that companies can implement to create a long-term working capital management programs:

- **a.** Link cash flow performance and working capital management to compensation structure.
- **b.** Individualize customer and supplier payment terms
- **c.** Automate and eliminate low-volume, high-margin transactions to free up resources.
- **d.** None of the above

**50.** In the computation of the S&P's Core Earnings, items excluded consist of all of the following ***except***:

- **a.** Gains/losses from asset sales
- **b.** Goodwill impairment charges
- **c.** Merger/acquisition related expenses
- **d.** Pension costs

**51.** If a physician practice management entity (PPME) has a controlling financial interest in a physician practice, how should the PPME account for the physician practice?

- **a.** Consolidate it
- **b.** Record it at equity method
- **c.** Record it at cost
- **d.** Make no entry

**52.** In accordance with ASC Subtopic 810-20 and the rules in effect prior to the changes made by ASU 2015-02, there is a presumption that a general partner _____ a limited partnership regardless of the extent of the general partners' ownership interest in the limited partnership.

- **a.** Manages
- **b.** Controls
- **c.** Has significant influence in
- **d.** Materially participates in

**53.** A key aspect of a variable interest entity (VIE) is that it:

- **a.** Is not self-supportive
- **b.** Can finance its activities without additional financial support
- **c.** Is not required to be consolidated
- **d.** Controls a subsidiary

**54.** An example of where combined financial statements may be useful is:

- **a.** A group of unconsolidated entities
- **b.** Tax planning strategies
- **c.** When one entity wishes to augment its balance sheet
- **d.** Where there is a group of unrelated parties that wish to join forces

**55.** If combined financial statements are presented, combining is treated essentially in the same manner as a consolidation with:

- **a.** No intercompany transactions eliminated
- **b.** All intercompany transactions eliminated
- **c.** Selected intercompany transactions eliminated
- **d.** Only equity accounts consolidated with eliminations made

**56.** In accordance with ASU 2015-02, under the voting interest entity model for limited partnerships, a limited partner has a controlling financial interest in a limited partnership if it has more than 50 percent of the limited partnership's _____.

- **a.** Subscription rights
- **b.** Participation rights
- **c.** Kick-out rights
- **d.** Controlling rights

**57.** Which of the following does ASU 2015-02 change with respect to a general partner and a limited partnership?

- **a.** Eliminates the presumption that a general partner should consolidate a limited partnership
- **b.** Now requires that a general partner consolidate a limited partnership in all instances
- **c.** Now precludes a general partner from consolidating a limited partnership in all instances
- **d.** Adds a rule that a general partner consolidate a limited partnership if the general partner holds more than 80 percent of the voting interest in the limited partnership

**58.** Company X is a non-controlling limited partner in a limited partnership. X has noncontrolling rights that allow it to block partnership actions. Such rights are called _____:

- **a.** Participation rights
- **b.** Kick-out rights
- **c.** Blocking rights
- **d.** Protective rights

**59.** Company J has several rights in an investee. J wants to determine whether they are Non-controlling. Which of the following rights of J is considered non-controlling?

- **a.** Selection of board members
- **b.** Name of investee
- **c.** Selection of senior management
- **d.** Right to sell the entity

**60.** One key change made by ASU 2015-02 is that some fees paid to a decision maker _____:

- **a.** Are excluded from the evaluation of whether the decision maker is the primary beneficiary of a VIE
- **b.** Are included in the test as to whether an entity is a VIE
- **c.** Are used in the computation of whether debt is nonrecourse under the VIE rules
- **d.** Are considered equity for purposes of determining if there is a controlling financial interest

**61.** The amendments within ASU 2015-02 are effective for public business entities for fiscal years and for interim periods within those fiscal years beginning after what date?

**a.** December 15, 2015
**b.** December 31, 2015
**c.** December 15, 2016
**d.** December 31, 2016

**62.** The amendments within ASU 2015-02 are effective for nonpublic business entities for fiscal years beginning after what date?

**a.** December 15, 2015
**b.** December 31, 2015
**c.** December 15, 2016
**d.** December 31, 2016

**63.** The amendments within ASU 2015-02 may be applied by an entity using which of the following methods?

**a.** Modified retrospective
**b.** Prospective
**c.** Modified prospective
**d.** Prospective with an adjustment to equity

**64.** Which of the following ASUs endorsed by the FASB and issued by the Private Company Council provided a private company exemption from consolidation under FIN 46R rules?

**a.** ASU 2016-01
**b.** ASU 2014-07
**c.** ASU 2014-09
**d.** ASU 2015-03

**65.** Which of the following conditions was eliminated as a result of ASU 2015-02 for evaluating whether a fee paid to a decision maker or a service provider represented a variable interest?

**a.** Substantially all of the fees are at or above the same level of seniority as other operating liabilities of the entity that arise in the normal course of the entity's activities, such as trade payables.
**b.** The fees are compensation for services provided and are commensurate with the level of effort required to provide those services.
**c.** The decision maker or service provider does not hold other interests in the VIE that individually, or in the aggregate, would absorb more than an insignificant amount of eh VIE's expected losses or receive more than an insignificant amount of the VIE's expected residual returns.
**d.** The service arrangement includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length.

**66.** Which of the following types of rights is a unilateral right to exit from the partnership in whole or in part that does not require dissolution or liquidation of the entire limited partnership would not be deemed a kick-out right?

**a.** Protective rights
**b.** Kick-out rights
**c.** Participating rights
**d.** Withdrawal rights

**67.** Each of the following identifies an exception to the more than 50 percent ownership test consolidation guidance with ASC 810, ***except:***

**a.** Entities controlled by a contract
**b.** Limited partner that controls a general partner
**c.** Miscellaneous transactions involving research and development arrangements
**d.** VIEs

**68.** The amendments in ASU 2015-02 did ***not*** have an effect on which of the following?

**a.** Physician Practice Management Entities
**b.** Variable interest entity model
**c.** General partners that control a limited partnership
**d.** Evaluating fees paid to a decision maker

**69.** With respect to certain investment funds, ASU 2015-02 rescinded the indefinite deferral included within which of the following ASUs?

**a.** ASU 2010-09
**b.** ASU 2010-10
**c.** ASU 2011-15
**d.** ASU 2012-12

**70.** If a decision maker or service provider (reporting entity) concludes that fees received represent a variable interest in a VIE, the reporting entity should evaluate which of the following?

**a.** Whether it is the primary beneficiary of the VIE
**b.** Whether the fees received are at market terms
**c.** Whether the fees received were appropriately approved for payment
**d.** Whether the fees relate to guarantees of assets or liabilities

# ¶ 10,303 FINAL EXAM QUESTIONS: MODULE 3

**71.** The disclosure requirements of ASC 275 require that entities make disclosures in their financial statements about risks and uncertainties arising from which of the following?

- **a.** Certain significant estimates
- **b.** Proposed changes in governmental regulations
- **c.** Deficiencies in internal control structure
- **d.** Possible effects of acts of God, war, or sudden catastrophe

**72.** As a result of the issuance of ASU 2015-01, the FASB effectively eliminated the recognition of which of the following financial statement treatments?

- **a.** Loss contingencies
- **b.** Extraordinary and unusual
- **c.** Gain contingencies
- **d.** Material dispositions

**73.** Which of the following Code sections provides a special rule to deal with disaster under the involuntary conversion rules?

- **a.** Code Sec. 1033
- **b.** Code Sec. 1034
- **c.** Code Sec. 1065
- **d.** Code Sec. 1099

**74.** A company maintains insurance to cover business interruption losses and the company's store is damaged from a terrorist attack. If the company files a claim with the provider but is uncertain of the final settlement, the company should do which of the following?

- **a.** Recognize a gain when those contingencies are resolved by settlement of the claim
- **b.** Recognize a gain for the amount the company anticipates receiving
- **c.** Record a receivable for the total proceeds anticipated to be received from the insurance provider
- **d.** Disclose the uncertainty of the settlement if the proceeds are expected to exceed $500,000

**75.** ASC 605 requires that any insurance recoveries should be:

- **a.** Recorded as other income
- **b.** Netted against the related loss on the same income statement item
- **c.** Recorded as an extraordinary gain
- **d.** Classified as an adjustment to equity

**76.** In accordance with the FASB's ASU 2014-15 related to going concern, management's evaluation of going concern runs for what period of time?

- **a.** One year
- **b.** Six months
- **c.** A reasonable period of time that is no quantified
- **d.** Eighteen months

**77.** Company X has signed a contract and obtains access to software in a hosting arrangement. In accordance with ASU 2015-05, which of the following is one of the criteria that must be met in order for X to treat it as internal-use software?

**a.** X is not permitted to run the software on its own hardware.

**b.** X has the contractual right to take possession of the software without significant penalty.

**c.** X is permitted to take possession of the software by paying a significant penalty.

**d.** X is not permitted to have another party unrelated to the vendor to host the software.

**78.** Which of the following is generally excluded from debt issuance costs?

**a.** Legal fees

**b.** Appraisal costs

**c.** Title insurance

**d.** Internal general and administrative costs

**79.** Company X is a private company that is acquiring the net assets of Company Y. If X elects to use the accounting alternative under ASU 2014-18, which of the following is true?

**a.** X should allocate a portion of acquisition cost to all customer-related intangible assets.

**b.** X should recognize all intangible assets separately from goodwill.

**c.** X should no longer recognize customer-related intangible assets from goodwill, unless those assets are capable of being sold or licensed independently.

**d.** X should not recognize a separate value for goodwill.

**80.** Company W is purchasing the net assets of Company Z. Company W has elected the accounting alternative related to identifiable intangibles in ASU 2014-18. Which of the following should no longer be recognized separately from goodwill?

**a.** Inventory

**b.** Fixed assets

**c.** Noncompetition agreement

**d.** Liabilities

**81.** Which of the following identifies a characteristic of a multi-employer pension plan?

**a.** Many employers are part of one, identical collective bargaining agreement.

**b.** Assets contributed by one particular employer must be used for that employer's employees only.

**c.** Employers are jointly and severely liability for the plan obligations.

**d.** There is no withdrawal or exit fee.

**82.** Which of the following statements can be discerned from the recomputed analysis performed by Credit Suisse of the funded status of pension plans?

**a.** The funded status shortfall of \$(101) billion is distorted and should be about \$(428) billion.

**b.** The funded status shortfall of \$(101) billion fairly represents the funded status of pension plans.

**c.** The funded status shortfall of \$(101) billion really should be a surplus of about \$500 billion.

**d.** The funded status is understated because of the poor stock market performance.

**83.** Hostess was able to achieve which of the following as a result of filing for Chapter 11 protection?

- **a.** It paid a reduced pension withdrawal liability.
- **b.** It shifted the burden of its single employer plans to the unions.
- **c.** It terminated all of its single and multi-employer plans.
- **d.** It shifted the burden of its multi-employer plans to the IRS.

**84.** Which of the following as the average rate of earnings anticipated on the funds invested or to be invested?

- **a.** Actual return
- **b.** Expected rate of return
- **c.** Discounted rate of return
- **d.** Projected rate of return

**85.** Which of the following statements with respect to the expected rates of return used by U. S. pension plans compared to those rates used by other major countries in measuring their pension liabilities is correct?

- **a.** The U.S. rates are significantly higher than those used in other countries.
- **b.** The U.S. rates are the same as those used in other countries.
- **c.** The U.S. rates are slightly lower than those used in other countries.
- **d.** The U.S. rates are significantly lower than those used in other countries.

**86.** Which of the following identifies a change to public pension plans based on the release of GASB Statement 68?

- **a.** Use of a higher expected rate of return
- **b.** Reporting of the funded status of the plans on the statement of financial position
- **c.** Use of a higher discount rate
- **d.** Use of a higher compensation growth rate

**87.** Which of the following organizations is in financial distress and may have to be bailed out by Congress because of its $88 billion in assets and exposure of $377 billion for potential claims?

- **a.** Congressional Budget Office
- **b.** Pension Fund Society of America
- **c.** Pension Benefit Guaranty Corporation
- **d.** Social Security Administration

**88.** Based on several recent studies, the unfunded liabilities for 2015 of total U.S. Corporate and Public pension plans is estimated to be what amount on the high end?

- **a.** $8.2 trillion
- **b.** $5.9 trillion
- **c.** $13.5 trillion
- **d.** $9.6 trillion

**89.** Based on the 2016 William Mercer study of single employer pension plans, the percentage of funded status for 2015 was which of the following?

- **a.** 82 percent
- **b.** 79 percent
- **c.** 65 percent
- **d.** 91 percent

**90.** Which of the following color zones requires that a plan must emerge from critical condition within 10 years and allows the plan to cut previously earned adjustable benefits?

**a.** Yellow

**b.** Red

**c.** Brown

**d.** Orange

**91.** Which of the following color zones requires a funding improvement plan along with a one-fifth improvement in funded status within 15 years?

**a.** Red

**b.** Yellow

**c.** Orange

**d.** Blue

**92.** Based on Credit Suisse's recomputed analysis of the funded status of a sample of 1,354 pension plans, what percentage of plans were in the critical zone?

**a.** 38 percent

**b.** 56 percent

**c.** 88 percent

**d.** 91 percent

**93.** Based on the 2014 Corporate Pension Funding Study from Milliman, which of the following identifies the expected rate of return used by pension plans for the last several years?

**a.** 8.0 percent

**b.** 7.5 percent

**c.** 4.5 percent

**d.** 6.0 percent

**94.** GASB Statement 68 requires the immediate recognition of which of the following on the pension liability?

**a.** Annual service cost

**b.** Changes in fair value of plan assets

**c.** Tax-exempt bond percent returns

**d.** Net investment cost

**95.** Which of the following types of retirement plans currently account for the highest percentage of plan assets for non-governmental employees based on the U.S. Retirement Market analysis by the Investment Research Institute?

**a.** 401(k) defined contribution plans

**b.** IRAs

**c.** Defined benefit plans

**d.** ROTH IRAs

# ¶ 10,400 Answer Sheets

## ¶ 10,401 Top Accounting Issues for 2017 CPE Course: MODULE 1

(10014576-0005)

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## Module 1: Answer Sheet

(10014576-0005)

Please answer the questions by indicating the appropriate letter next to the corresponding number.

| | | | |
|---|---|---|---|
| 1. ______ | 10. ______ | 19. ______ | 28. ______ |
| 2. ______ | 11. ______ | 20. ______ | 29. ______ |
| 3. ______ | 12. ______ | 21. ______ | 30. ______ |
| 4. ______ | 13. ______ | 22. ______ | 31. ______ |
| 5. ______ | 14. ______ | 23. ______ | 32. ______ |
| 6. ______ | 15. ______ | 24. ______ | 33. ______ |
| 7. ______ | 16. ______ | 25. ______ | 34. ______ |
| 8. ______ | 17. ______ | 26. ______ | 35. ______ |
| 9. ______ | 18. ______ | 27. ______ | |

**Please complete the Evaluation Form (located after the Module 3 Answer Sheet) and return it with this Final Exam Answer Sheet to Wolters Kluwer at the address on the previous page. Thank you.**

# ¶ 10,402 Top Accounting Issues for 2017 CPE Course: MODULE 2

(10014577-0005)

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## Module 2: Answer Sheet

(10014577-0005)

Please answer the questions by indicating the appropriate letter next to the corresponding number.

| | | | |
|---|---|---|---|
| 36. ____ | 45. ____ | 54. ____ | 63. ____ |
| 37. ____ | 46. ____ | 55. ____ | 64. ____ |
| 38. ____ | 47. ____ | 56. ____ | 65. ____ |
| 39. ____ | 48. ____ | 57. ____ | 66. ____ |
| 40. ____ | 49. ____ | 58. ____ | 67. ____ |
| 41. ____ | 50. ____ | 59. ____ | 68. ____ |
| 42. ____ | 51. ____ | 60. ____ | 69. ____ |
| 43. ____ | 52. ____ | 61. ____ | 70. ____ |
| 44. ____ | 53. ____ | 62. ____ | |

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# ¶ 10,403 Top Accounting Issues for 2017 CPE Course: MODULE 3

(10014578-0005)

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## Module 3: Answer Sheet

(10014578-0005)

Please answer the questions by indicating the appropriate letter next to the corresponding number.

| | | | | |
|---|---|---|---|---|
| 71. ____ | 76. ____ | 81. ____ | 86. ____ | 91. ____ |
| 72. ____ | 77. ____ | 82. ____ | 87. ____ | 92. ____ |
| 73. ____ | 78. ____ | 83. ____ | 88. ____ | 93. ____ |
| 74. ____ | 79. ____ | 84. ____ | 89. ____ | 94. ____ |
| 75. ____ | 80. ____ | 85. ____ | 90. ____ | 95. ____ |

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# ¶ 10,500 Top Accounting Issues for 2017 CPE Course: Evaluation Form

## (10024493-0004)

Please take a few moments to fill out and submit this evaluation to Wolters Kluwer so that we can better provide you with the type of self-study programs you want and need. Thank you.

**About This Program**

1. Please circle the number that best reflects the extent of your agreement with the following statements:

| | | **Strongly Agree** | | | | **Strongly Disagree** |
|---|---|---|---|---|---|---|
| a. | The Course objectives were met. | 5 | 4 | 3 | 2 | 1 |
| b. | This Course was comprehensive and organized. | 5 | 4 | 3 | 2 | 1 |
| c. | The content was current and technically accurate. | 5 | 4 | 3 | 2 | 1 |
| d. | This Course content was relevant and contributed to achievement of the learning objectives. | 5 | 4 | 3 | 2 | 1 |
| e. | The prerequisite requirements were appropriate. | 5 | 4 | 3 | 2 | 1 |
| f. | This Course was a valuable learning experience. | 5 | 4 | 3 | 2 | 1 |
| g. | The Course completion time was appropriate. | 5 | 4 | 3 | 2 | 1 |

2. What do you consider to be the strong points of this Course?

3. What improvements can we make to this Course?

**THANK YOU FOR TAKING THE TIME TO COMPLETE THIS SURVEY!**

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