ACCOUNTING AND AUDITING UPDATE FOR MANUFACTURERS

October 25, 2016
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• We remain an independent member of the RSM International network globally, which encompasses:
  • 120 countries
  • 760 offices
  • 38,300 people internationally

• This is accelerating our vision to be the first-choice advisor to middle market leaders globally
Your instructors

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ACCOUNTING AND AUDITING UPDATE
Agenda

- Revenue Recognition, ASU 2014-09
- Leases, ASU 2016-02
- Financial Instruments, ASU 2016-13
- Going Concern, ASU 2014-15
- Simplifying Business Combination Accounting, ASU 2014-18
- Simplifying Presentation of Debt Issuance Costs, ASU 2015-03, ASU 2015-15
- Simplifying Measurement of Inventory, ASU 2015-11
- Simplifying Accounting for Measurement Period Adjustments, ASU 2015-16
- Balance Sheet Classification of Deferred Taxes, ASU 2015-17
REVENUE RECOGNITION
What’s changing?

- **Overall model** is based on transferring control instead of transferring risks and rewards of ownership

- **Collectibility** assessment is more complex and the revenue recognition model used when collectibility is not probable could result in delayed revenue recognition (even with respect to nonrefundable cash received)

- **Multiple-element arrangements** are subject to the following new requirements:
  - For separation purposes, must apply incremental criterion focused on whether a promised good or service is separately identifiable from other promised goods or services in the contract
  - For allocation purposes, must allocate discounts and (or) variable consideration to less than all performance obligations in certain circumstances

- **Warranties** are evaluated to determine if they represent a performance obligation to which revenue is allocated

- **Variable consideration** may be recognized earlier in certain circumstances
What’s changing?

• **Significant financing component** guidance is applied to both deferred and advance payments, which may result in the recognition of interest income (deferred payment) or interest expense (advanced payment).

• **Recognition of revenue over time or at a point in time** (i.e., whether control of a performance obligation’s promised goods or services transfers over time or at a point in time) depends on whether one or more of three specific criteria are met.

• **Licenses** are evaluated to determine whether they include a right to use (point in time) or a right to access (over time) intellectual property.

• **Bill-and-hold transaction** criteria are less onerous.

• **Uninstalled materials** guidance may, in certain circumstances, result in recognizing revenue to the extent of their cost upon transfer of control.
What’s changing?

- **Contract modifications** are accounted for under a comprehensive model that provides for different outcomes depending on the facts and circumstances.

- **Balance sheet presentation** requires separate recognition of contract liabilities, accounts receivable and contract assets.

- **Disclosure requirements** are significant and likely involve tracking (and disclosing) a variety of information not historically tracked or disclosed.

- **Costs related to customer contracts** (e.g., costs to obtain or fulfill a customer contract) must be capitalized in certain circumstances.

- **Gains and losses from the derecognition of nonfinancial assets** that are not an output of the entity’s ordinary activities (e.g., real estate sales) are recognized, in large part, based on key aspects of ASC 606.
Background and recent activities

• Final standard issued by the FASB in May 2014
  • ASU 2014-09, Revenue from Contracts with Customers (Topic 606)

• Many changes made to ASC 606 since issuance
  • FASB has issued four final ASUs, some of which made fundamental changes to ASC 606

• More changes are coming
  • FASB has three proposed ASUs outstanding
    • Changes are limited in nature
  • FASB’s Joint Transition Resource Group
    • Continues to meet and discuss issues, which may or may not result in additional changes


Scope

• All revenue-generating contracts with customers are within the scope of ASC 606, except for:
  • Leases
  • Contracts within the scope of ASC 944 (insurance)
  • Various contractual rights or obligations related to financial instruments
  • Guarantees other than warranties
  • Certain nonmonetary exchanges

• No industries are scoped out of ASC 606

• Key aspects of ASC 606 are used to account for the sale of nonfinancial assets that are not an output of the entity’s ordinary activities
  • For example, a bakery’s sale of used delivery trucks or a manufacturer’s sale of a manufacturing facility
Recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.
Key steps

1. Identify the contract with a customer
2. Identify the performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price to the performance obligations
5. Recognize revenue when (or as) each performance obligation is satisfied
Disclosures

• Objective is to help financial statement users understand the nature, amount, timing and uncertainty of the related revenue and cash flows

• Annual and interim disclosures required of public entities
  • Less on an interim basis, but mostly quantitative in nature

• More disclosures required of PBEs and certain nonprofit entities and employee benefit plans
  • However, disclosures for all others are still significant
## Effective date

<table>
<thead>
<tr>
<th>Effective date of ASC 606</th>
<th>Calendar year end entities</th>
<th>June 30 year end entities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public entities, quarter and year beginning...</td>
<td>January 1, 2018</td>
<td>July 1, 2018</td>
</tr>
<tr>
<td>Other entities, year ending...</td>
<td>December 31, 2019</td>
<td>June 30, 2020</td>
</tr>
<tr>
<td><strong>Early adoption of ASC 606</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Allowed for both public entities and other entities...</td>
<td>As early as January 1, 2017</td>
<td>As early as July 1, 2017</td>
</tr>
</tbody>
</table>
Transition methods

- Entities may choose to apply one of the following transition methods:
  - Full retrospective application of ASC 606 to all periods presented
    - One or more of four practical expedients may be elected
  - Modified retrospective application as of the date of initial application of ASC 606
    - Recognition of a cumulative effect adjustment as of the date of initial application (i.e., prior periods are not adjusted)
    - One practical expedient may be elected
    - Disclose the effects on each line item in the financial statements of applying the new guidance in the period of adoption
Background

• In February 2016, the FASB issued Accounting Standards Update (ASU) 2016-02, Leases (*Topic 842*)
  • Upon the effective date of ASU 2016-02, Topic 842 of the FASB’s Accounting Standards Codification (ASC) will replace Topic 840, *Leases* (legacy lease guidance)

• In January 2016, the IASB issued International Financial Reporting Standard (IFRS) 16, *Leases*

• Despite being a joint project, convergence was not achieved with respect to certain key issues
  • For example, under ASU 2016-02 a lessee classifies and accounts for most of its leases as either operating or finance leases, while under IFRS 16 there is a finance lease accounting model for most leases
What does ASU 2016-02 change?

• For lessees
  • Most significant change is to record a lease liability and right-of-use (ROU) asset for most leases
  • Provided on the next slide is an illustrative balance sheet for a lessee with operating leases that predominantly consist of a building lease with a remaining lease term of 15 years
    • After giving effect to ASU 2016-02, the lessee reflects ROU assets and lease liabilities for its operating leases
**What does ASU 2016-02 change?**

<table>
<thead>
<tr>
<th>Assets</th>
<th>Before</th>
<th>After</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash and equivalents</td>
<td>$1,260</td>
<td>$1,260</td>
</tr>
<tr>
<td>Accounts receivable, net</td>
<td>4,590</td>
<td>4,590</td>
</tr>
<tr>
<td>Inventory</td>
<td>5,830</td>
<td>5,830</td>
</tr>
<tr>
<td>Other current assets</td>
<td>680</td>
<td>680</td>
</tr>
<tr>
<td><strong>Total current assets</strong></td>
<td>12,360</td>
<td>12,360</td>
</tr>
<tr>
<td>Noncurrent assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Property and equipment</td>
<td>17,820</td>
<td>17,820</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>(6,780)</td>
<td>(6,780)</td>
</tr>
<tr>
<td><strong>Property and equipment, net</strong></td>
<td>11,040</td>
<td>11,040</td>
</tr>
<tr>
<td>Right-of-use assets</td>
<td>-</td>
<td>12,540</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>1,960</td>
<td>1,960</td>
</tr>
<tr>
<td>Goodwill</td>
<td>1,370</td>
<td>1,370</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>$26,730</td>
<td>$39,270</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities and equity</th>
<th>Before</th>
<th>After</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable and other</td>
<td>$5,250</td>
<td>$5,250</td>
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<tr>
<td>Lease liabilities</td>
<td>-</td>
<td>870</td>
</tr>
<tr>
<td><strong>Total current liabilities</strong></td>
<td>5,250</td>
<td>6,120</td>
</tr>
<tr>
<td>Noncurrent liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Long-term debt</td>
<td>7,560</td>
<td>7,560</td>
</tr>
<tr>
<td>Lease liabilities</td>
<td>-</td>
<td>11,670</td>
</tr>
<tr>
<td>Deferred taxes</td>
<td>1,190</td>
<td>1,190</td>
</tr>
<tr>
<td>Shareholders’ equity</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common stock</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>6,210</td>
<td>6,210</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>6,420</td>
<td>6,420</td>
</tr>
<tr>
<td><strong>Total shareholders’ equity</strong></td>
<td>12,730</td>
<td>12,730</td>
</tr>
<tr>
<td><strong>Total liabilities and equity</strong></td>
<td>$26,730</td>
<td>$39,270</td>
</tr>
</tbody>
</table>

**Current ratio**

- Before: 2.35
- After: 2.02
- Percentage change: (14%)

**Debt-to-equity ratio**

- Before: 1.10
- After: 2.08
- Percentage change: 89%
What does ASU 2016-02 change?

• For lessors
  • Relative to lessees, changes were limited
  • One of the more significant changes is the prospective elimination of the leveraged lease accounting model
  • More discussion to come

• Changes in the following areas will affect both lessees and lessors
  • Definition of a lease
  • Lease classification criteria
  • Definition of initial direct costs
  • Separation of lease and nonlease components
  • Related party leases
  • Accounting for sale-leaseback transactions
  • Presentation and disclosure requirements
Leases overview

1. Determine if contract contains a lease
2. Separate lease and nonlease components
3. Classify the lease
4. Apply the appropriate accounting model
5. Present and disclose leases in financial statements
Scope

• ASC 842 is applicable to all leases except:
  • Leases of intangible assets
  • Leases to explore for or use minerals, oil, natural gas and similar nonregenerative resources
  • Leases of biological assets
  • Leases of inventory
  • Leases of assets under construction
Lessees: Financial statement presentation

• Balance sheet
  • ROU assets and lease liabilities for finance leases and operating leases should be presented as separate line items on the balance sheet or disclosed separately in the notes
    • If not presented separately on the balance sheet, must disclose which balance sheet line items include those assets and liabilities
    • ROU assets and lease liabilities related to finance leases cannot be included in the same balance sheet line items that include the ROU assets and lease liabilities related to operating leases
  • Portion of the lease liabilities that are expected to be paid within 12 months or less (or, if longer, the lessee’s operating cycle) should be classified as current
Lessees: Financial statement presentation

• **Income statement**
  
  • **Finance leases**
    
    • Classify the portion of the lease costs related to the amortization of the ROU asset and the portion related to interest on the lease liability consistent with how similar expenses are classified on the income statement
      
      • For example, classify consistent with how depreciation and interest expense related to the financed purchase of property, plant or equipment are classified
  
  • **Operating leases**
    
    • Include lease costs in the lessee’s income from continuing operations unless it is part of a discontinued operation
Lessees: Financial statement presentation

• **Cash flow statement**
  - **Finance leases**
    - Classify the portion of the lease payment representing repayment of principal as a financing activity
    - Classify the portion of the lease payment representing interest as an operating cash flow (unless some of the interest is capitalized in accordance with other guidance in the ASC)
    - Classify variable lease payments not included in the lease liability as an operating activity
  - **Operating leases**
    - Classify as operating activities (unless some of the payment is capitalized in accordance with other guidance in the ASC)
Lessees: Disclosures

• Extensive qualitative and quantitative disclosures are required

• Examples of information that should be disclosed include:
  • Qualitative discussion of:
    • The nature of an entity’s leases
    • Variable payment arrangements
    • Termination/purchase/renewal options
  • Quantitative information related to:
    • Amortization and interest for finance leases
    • Operating lease costs
Lessees: Disclosures

• Examples of information that should be disclosed include:
  • Quantitative information related to:
    • Variable lease costs
    • Short-term lease costs
    • Maturity analysis of lease liabilities
  • Qualitative and (or) quantitative information related to significant judgments and assumptions used in applying ASC 842, such as those involved in:
    • Determining whether a contract contains a lease
    • Determining/Estimating the standalone prices used to separate lease and nonlease components
ASU 2016-02, Leases (Topic 842)

• Effective Date
  - For fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019 (Calendar 2020), and interim periods within fiscal years beginning after December 15, 2020.
  - Early adoption is permitted
Transition

• Modified retrospective transition
  • Full retrospective adoption is prohibited
  • All comparative periods presented are restated
  • Mechanics of transition and degree of complexity depend on:
    • The classification of the lease under the legacy lease guidance and ASC 842
    • Whether any practical expedients are elected
FINANCIAL INSTRUMENTS: CREDIT LOSSES
Overview of the credit losses standard

• ASU 2016-13, Measurement of Credit Losses on Financial Instruments was issued June 16
  • Creates ASC Topic 326
    • Subtopic 326-20 applies to financial assets measured at amortized cost
    • Subtopic 326-30 applies to Available-for-Sale (“AFS”) debt securities
  • Supersedes impairment guidance in ASC 310 on receivables/loans and ASC 320 on debt securities (amongst other changes)
Effective dates of the credit losses standard

- SEC filers – fiscal years beginning after 12/15/19 (including interim periods) – **2020 for calendar year-end entities ("CYE")**
- Public Business Entities that are not SEC filers – fiscal years beginning after 12/15/20 (including interim periods) – **2021 for CYE**
- All others – fiscal periods beginning after 12/15/20 (interim periods beginning after 12/15/21) – **2021 for CYE**
- Early adoption is permitted for fiscal years beginning after 12/15/18 – **2019 for CYE**
- Adopt through a cumulative effect adjustment to retained earnings
  - Special rules for other-than-temporary impairment ("OTTI"), purchased financial assets with a more-than-insignificant amount of credit deterioration since origination ("PCD assets") and beneficial interests
Applicability of ASC 326-20

• The following are in-scope:
  • Financial assets measured at amortized cost (AC) including:
    • Financing receivables (loans)
    • Held to maturity debt securities
    • Receivables from revenue transactions with customers and other income
    • Reinsurance receivables
    • Receivables related to repo and securities lending agreements
  • Net investment in leases
  • Off-balance-sheet credit exposures
    • Loan commitments
    • Standby letters of credit
    • Financial guarantees/similar instruments
Applicability of ASC 326-20

• The following are out of scope:
  • Financial assets measured at fair value (FV)
    • Available-for-sale securities
    • Other
  • Loans made to participants by defined contribution employee benefit plans
  • Policy loans receivable of an insurance entity
  • Promises to give (pledges receivable) of a not-for-profit entity
  • Loans and receivables between entities under common control
OTHER RECENTLY ISSUED OR EFFECTIVE ASUs
ASU 2014-15 – Disclosure of uncertainties about an entity’s ability to continue as a going concern
ASU 2014-15 – Disclosure of uncertainties about an entity’s ability to continue as a going concern

Disclose
- Principal conditions or events
- Management’s evaluation
- Management’s plans

Conditions or events

Mitigating plans

F/S issued or available for issuance

1 year
ASU 2014-15 – Disclosure of uncertainties about an entity’s ability to continue as a going concern

Disclose
- Principal conditions or events
- Management’s evaluation
- Management’s plans

Footnote: There is substantial doubt about the entity’s ability to continue as a going concern...
ASU 2014-15 – Disclosure of uncertainties about an entity’s ability to continue as a going concern

Effective date for calendar year-ends

- Permitted
- Required

2014 2015 2016
ASU 2014-18 – Accounting for identifiable intangible assets in a business combination

• Provides an accounting alternative for private companies to recognize fewer intangible assets separately in a business combination

• Private companies would no longer be required to separately recognize Non-Competition Agreements (NCA) or Customer-Related Intangibles (CRI) that are not capable of being sold or licensed independently

• CRIs that may still be required to be separately recognized include:
  • Mortgage servicing rights
  • Commodity supply contracts
  • Core deposits
  • Customer information
Pre-existing NCAs and CRIs recognized in prior business combinations would not be impacted.

Alternative also applies to:
- Equity method of accounting
- Fresh-start reporting in a reorganization

If alternative is elected, ASU 2014-02 must also be elected at the same time.
  - ASU 2014-02 provides private companies with a simplified approach to the subsequent accounting for goodwill.
ASU 2014-18 – Accounting for identifiable intangible assets in a business combination

- If alternative is elected, effective date for calendar year-ends is as follows:

  | Permitted if financial statements have not yet been made available for issuance | Required on occurrence of first business combination |
  | 2015 and prior | 2016 and subsequent |
ASU 2015-03 – Simplifying the presentation of debt issuance costs

- Requires that debt issuance costs be presented in the balance sheet as a direct deduction from the carrying amount of the related debt liability (same as debt discounts)
- The recognition and measurement guidance for debt issuance costs are not affected

**Effective date for calendar year-ends**

- Permitted
- Required

2016
ASU 2015-15 – Debt issuance costs associated with line-of-credit arrangements

- ASU 2015-03 requires entities to present debt issuance costs as a direct deduction from the carrying amount of the related debt.
- How should debt issuance costs for line-of-credit arrangements be treated?
ASU 2015-15 – Debt issuance costs associated with line-of-credit arrangements

- ASU 2015-03 requires entities to present debt issuance costs as a direct deduction from the carrying amount of the related debt.
- How should debt issuance costs for line-of-credit arrangements be treated?

**EXISTING**

- No objection if an entity defers and presents these debt issuance costs as an asset and subsequently amortizes these costs over the line-of-credit arrangement’s term.
- ASU 2015-15 was issued to codify this SEC staff announcement in the FASB ASC.
# ASU 2015-11 – Simplifying the measurement of inventory

<table>
<thead>
<tr>
<th>Measurement of Inventory - Existing</th>
<th>Measurement of Inventory - Amended</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lower of:</td>
<td>Lower of:</td>
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<tr>
<td>• Cost or</td>
<td>• Cost or</td>
</tr>
<tr>
<td>• Market</td>
<td>• Net realizable value</td>
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<td></td>
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<td></td>
<td>Estimated selling prices in the</td>
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<td>ordinary course of business, less</td>
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<td>reasonably predictable costs of</td>
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<td></td>
<td>completion, disposal, and</td>
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<tr>
<td></td>
<td>transportation</td>
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<tr>
<td></td>
<td>— FASB ASC Master Glossary</td>
</tr>
</tbody>
</table>

- Net realizable value (ceiling)
- Replacement cost
- Net realizable value less an approximately normal profit margin (floor)
ASU 2015-11 – Simplifying the measurement of inventory

Effective date for calendar year-ends

- Permitted: 2015 and 2016
- Required: 2017
ASU 2015-16 – Simplifying the Accounting for Measurement-Period Adjustments

• If business combination accounting is not complete by the end of the reporting period in which the acquisition occurs, provisional amounts are reported.

• During the measurement period, the acquirer must retrospectively adjust provisional amounts recognized if new information is obtained about facts and circumstances that existed as of the acquisition date.

• Comparative information for prior periods presented must also be revised.
ASU 2015-16 – Simplifying the Accounting for Measurement-Period Adjustments

- If business combination accounting is not complete by the end of the reporting period in which the acquisition occurs, provisional amounts are reported.
- During the measurement period, the acquirer must retrospectively adjust provisional amounts recognized if new information is obtained about facts and circumstances that existed as of the acquisition date.
- Comparative information for prior periods presented must also be revised.

- Eliminates the requirement to retrospectively account for adjustments.
- Requires an acquirer to recognize measurement period adjustments in the reporting period in which the adjustments are determined.
- Must separately present in the income statement or disclose the portion of the amount recorded in current earnings by line item that would have been recorded in previous periods if the adjustment had been recognized at the acquisition date.
ASU 2015-17 – Balance sheet classification of deferred taxes

- Requires an entity to separate deferred tax liabilities and assets into current and noncurrent amounts in a classified balance sheet
ASU 2015-17 – Balance sheet classification of deferred taxes

- Requires an entity to separate deferred tax liabilities and assets into current and noncurrent amounts in a classified balance sheet

EXISTING

- Deferred tax liabilities and assets should be classified as noncurrent in a classified balance sheet

AMENDED

- No offset of deferred tax liabilities and assets attributable to different tax-paying components of the entity or to different tax jurisdictions
ASU 2015-17 – Balance sheet classification of deferred taxes

Effective date for calendar year-ends

Public entities
- Permitted
- Required

Other entities
- Permitted
- Required

2017
2018
QUESTIONS AND CLOSING REMARKS
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I would like to learn more about (check all that apply):

- Economic trends that are affecting my business
- Reducing risk in my business
- Technology helping my business
- Managing my audit needs
- Capitalizing on business opportunities
- Outsourcing or co-sourcing resources for my business
- Tax planning and preparation issues for my business
- Managing my personal wealth
- Managing M&A transactions

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QUESTIONS AND ANSWERS?
Address your questions

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Click the “Ask a Question” button, type your question in the open area and click “Ask Question to Submit.”
Before we conclude

Make plans to join us for our next webcast:

The finance function as a strategic business partner

• Thursday, November 17, 2016
• 2 pm EST | 1 pm CST | Noon MST | 11 am PST
• 60 minutes
• Up to 1.0 CPE credit
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