QUARTERLY ACCOUNTING UPDATE WEBCAST – FALL 2019

Oct. 17, 2019
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RECENT FASB ACTIVITY
Recently proposed FASB guidance

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## Effective date changes: Leases

<table>
<thead>
<tr>
<th>ASC 842: Leases</th>
<th>Effective date before pending changes</th>
<th>Effective date after pending changes</th>
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<tbody>
<tr>
<td>Public business entities (PBEs), not-for-profit entities that have issued, or are conduit bond obligors for, securities that are traded, listed or quoted on an exchange or an over-the-counter market and employee benefit plans that file or furnish financial statements to the SEC</td>
<td>Fiscal years beginning after Dec. 15, 2018, including interim periods within those fiscal years</td>
<td>Fiscal years beginning after Dec. 15, 2018, including interim periods within those fiscal years</td>
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<tr>
<td>All other entities</td>
<td>Fiscal years beginning after Dec. 15, 2019 and interim periods within fiscal years beginning after Dec. 15, 2020</td>
<td>Fiscal years beginning after Dec. 15, 2020 and interim periods within fiscal years beginning after Dec. 15, 2021</td>
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IFRS 16 continues to be effective for annual reporting periods beginning on or after Jan. 1, 2019
## Effective date changes: Hedging simplification amendments

<table>
<thead>
<tr>
<th>Hedging simplification amendments</th>
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<tr>
<td>PBEs</td>
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## Effective date changes: Credit losses

<table>
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<tr>
<th>ASC 326: Credit losses</th>
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<tr>
<td>PBEs that are SEC filers, except for smaller reporting companies (SRCs)</td>
<td>Fiscal years beginning after Dec. 15, 2019, and interim periods within those fiscal years</td>
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IFRS 9 continues to be effective for annual reporting periods beginning on or after Jan. 1, 2018.
## Effective date changes: Insurance targeted improvement amendments

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<th>Insurance targeted improvement amendments</th>
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Simplifying the classification of debt in a classified balance sheet (current versus noncurrent)

• Introduces an overarching principle for determining debt classification which would replace the current fact-specific guidance

• An entity would classify debt as noncurrent if either of the following criteria is met as of the balance sheet date:
  - The liability is contractually due to be settled more than one year after the balance sheet date
  - The entity has a contractual right to defer settlement of the liability for at least one year after the balance sheet date
One exception is that the borrower would continue to classify its debt as noncurrent when a debt covenant violation has been waived, subject to certain conditions:

- Applies to all waivers except those that result in a troubled debt restructuring or those that are accounted for as a debt extinguishment.
- Retains and clarifies the probability assessment related to subsequent covenant violations.
- Requires an entity to separately present in the balance sheet liabilities that are classified as noncurrent as a result of this exception.
Simplifying the classification of debt in a classified balance sheet (current versus noncurrent) (cont.)

• May shift classification of certain debt arrangements between noncurrent liabilities and current liabilities:
  - Short-term debt that is refinanced on a long-term basis after the balance sheet date, but before the financial statements are issued, would no longer be classified as noncurrent
  - A subsequent refinancing of short-term debt with the issuance of equity securities would no longer affect the classification of debt as of the balance sheet date and those debt arrangements would be classified as current liabilities
  - Entities with debt that contains subjective acceleration clauses would no longer be required to assess the likelihood of acceleration
Simplifying the classification of debt in a classified balance sheet (current versus noncurrent) (cont.)

Comments due Oct 28
REVENUE RECOGNITION
Recently updated industry white papers

- Changes to revenue recognition in the health care industry
- Changes to revenue recognition for not-for-profit organizations
Practice issue: Accounting for commissions

Are the costs incremental costs of obtaining the contract?  

Yes → Does the entity expect to recover the costs?  

Yes → Is the amortization period one year or less?  

Yes → Practical expedient: May elect to expense the cost as incurred

No → Expense the cost as incurred

No → Capitalize the cost
Commission payments subject to a threshold

- Company A pays a quarterly sales bonus based on cumulative sales.
- The bonus can be achieved by selling any combination of goods or services during a quarter, totaling at least $1,000,000.
- If a sales professional achieves the sales target, they will receive a bonus of $5,000.

Is the bonus an incremental cost of obtaining a contract?

YES – capitalize when the liability is recognized
“The entity would apply other GAAP to determine whether a liability for the commission payments should be recognized. When a liability is recognized, the entity would recognize a corresponding asset for the commissions. This is because the commissions are incremental costs of obtaining a contract with a customer. The entity has an obligation to pay commissions as a direct result of entering into contracts with customers. The fact that the entity’s program is based on a pool of contracts (versus a program in which the entity pays 3% for all contracts) does not change the fact that the commissions would not have been incurred if the entity did not obtain the contracts with those customers.”

TRG Paper 57
Commission subject to conditions

- Company B pays a $2,000 commission to salesperson upon signing of a three year service contract that will generate an estimated $1,500,000 in revenue.

- After the first 12 months of the agreement, there will be a one-time bonus of an additional $3,000 to the salesperson if the operating profit exceeds 10% in the first year.

Are the initial commission and bonus commission incremental costs of obtaining a contract?

- $2,000 – Yes, capitalize
- $3,000 – No, expense if and when incurred
LEASES
Recently released overview and guide

• Leases: Overview of ASC 842
  – High level summary

• A guide to lessee accounting under ASC 842
  – In-depth discussion and examples
Practice issue: Implementation

- Proposed deferral (discussed earlier)
- “Deferral of effective date” does not necessarily mean “delay getting started”
- Adoption is a very time-consuming effort
Lessons learned from public companies

• Identifying leases—not as easy as you might think

• Underestimating time to collect and abstract lease agreements

• Misjudging the complexities required to determine the incremental borrowing rate for different leases
Identifying leases: Embedded leases

- Embedded lease identification can involve time and judgment
- Many entities did not identify embedded leases under ASC 840
  - Limited accounting implications
- Under ASC 842, there are balance sheet implications
- Examples include:
  - Supply contracts
  - Service arrangements (including SAAS arrangements)
  - Transportation contracts
Embedded leases

Don’t limit the effort to the accounting department

Review expense activity

Physical inspection

Examine contracts
Implementation: Abstracting data

• Once leases have been identified, the relevant data must be abstracted
  – Relevant dates
  – Payment terms
  – Options

• Leases may be in foreign currency, or even in foreign language

• Information must be abstracted for disclosure purposes as well
Discount rate

- Interest rate implicit in the lease, or
- Lessees incremental borrowing rate (‘IBR’)

How is rate implicit in the lease determined?

- Rate implicit in the lease is the discount rate at which:
  - The sum of (i) lease payment and (ii) unguaranteed residual value
  - The sum of (i) the fair value of the underlying asset and (ii) any initial direct costs of the lessor

- Serious consideration should be given to the practical expedient
FASB staff Q&A: Estimating expected credit losses

Addresses frequently asked questions related to ASU 2016-13, including those related to:

• Use of historical loss information
• Making reasonable and supportable forecasts
• The reversion to historical loss information

*Further information on Topic 326 is available in our CECL Resource Center
Codification improvements - CECL

Narrow-scope amendments include:

- Permit organizations to record negative allowances associated with expected recoveries on assets that had already shown credit deterioration at the time of purchase.

- Provide transition relief when adjusting the effective interest rate for troubled debt restructurings (TDRs) that exist as of the adoption date.

- Extend the disclosure relief for accrued interest receivable balances to additional relevant disclosures involving amortized cost basis.

- Provide clarifications regarding application of the guidance in paragraph 326-20-35-6 for financial assets secured by collateral maintenance provisions.

Proposed ASU
Transition away from LIBOR

• The London Interbank Offered Rate (LIBOR) commonly reference in debt, investments, interest rate derivative and other contracts

• Expectation that banks will stop using after 2021

• Secured Overnight Financing Rate (SOFR) identified as its preferred alternative rate for U.S. dollar LIBOR.
Transition away from LIBOR – Potential accounting impact

- Assessment of debt modifications
- Lease modification accounting
- Reassessment of embedded derivatives
- Application of certain hedge accounting guidance
Scope

• Contracts that reference LIBOR or an interest rate that has been discontinued or is anticipated to be discontinued

Main provisions

• Optional expedients and exceptions for applying GAAP to contracts, hedging relationships, and other transactions affected by reference rate reform if certain criteria are met.
• Continued application of hedge accounting for hedge relationships that are impacted by reference rate reform yet remain highly effective.

Effective period

• From the issuance of a final ASU until Dec. 31, 2022
<table>
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<th>Proposed ASU</th>
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<td><strong>Convertible instruments</strong></td>
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<tr>
<td>Reduce the number of accounting models for convertible debt instruments and convertible preferred stock</td>
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<tr>
<td>Revise guidance for derivatives scope exception for conversion features and contracts in an entity’s own equity</td>
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<tr>
<td>Amend disclosures and EPS guidance</td>
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Convertible instruments (cont.)

Current guidance

- **Model 1**: Single instrument
- **Model 2**: Derivative separation
- **Model 3**: Cash conversion option separation
- **Model 4**: Beneficial conversion feature separation
- **Model 5**: Substantial premium separation

Proposed guidance

- **Proposed ASU**

**Model 1**: Single instrument

**Model 2**: Derivative separation

Only embedded conversion features that are not clearly and closely related to the host contract, meet the definition of a derivative and do not qualify for a scope exception from derivative accounting would be separately recognized.
Derivatives scope exception

- Applies to contracts in entity’s own equity
- Freestanding instruments (e.g. warrants)
- Embedded features (e.g. embedded conversion feature in a convertible instrument)

- Reduces form-over-substance based conclusions
  - Remote features would no longer cause derivative accounting

- Removes requirements to consider:
  - Whether the contract would be settled in registered shares
  - Whether collateral is required to be posted
  - Assessment of shareholder rights
Interactions between Topic 321, Topic 323 and Topic 815

• Paragraph 321-10-35-2, as amended by ASU 2016-01:

  If entity identifies observable price changes in orderly transactions for the identical or a similar investment of the same issuer

  Measure the equity security at fair value as of the date that the observable transaction occurred

• Result: Diverse views about the application of the measurement alternative and the equity method of accounting

Diverse views have also emerged about whether forward contracts and purchased options should be accounted for in accordance with Topic 321, Topic 323 or Topic 815.
Interactions between Topic 321, Topic 323 and Topic 815 (cont.)

• Observable price changes in orderly transactions that should be considered when applying the measurement alternative in accordance with ASC 321 include:
  − Transactions that require it to either apply or discontinue the equity method of accounting under ASC 323

• For the purpose of applying ASC 815-10-15-141(a), an entity should not consider whether, upon the settlement of the forward contract or exercise of the purchased option, the underlying securities would be accounted for under the equity method in ASC 323.
  − An entity also would evaluate the remaining characteristics in ASC 815-10-15-141 to determine the accounting for those forward contracts and purchased options.
New guide to accounting for debt and equity instruments in financing transactions

Updates include:

• Discussion of the accounting for bridge notes settled in a variable number of shares upon the occurrence of a qualified financing, with the number of shares determined based on the price at which shares are issued in the financing event

• A flowchart illustrating the four-step decision sequence involved in determining whether put and call options are clearly and closely related to the debt host contract

• Spotlights on future standard setting
A guide to accounting for investments, loans and other receivables

- Chapter 1: Overview
- Chapter 2: Accounting for equity securities
- Chapter 3: Accounting for debt securities
- Chapter 4: Recognition of credit losses on AFS debt securities
- Chapter 5: Accounting for loans and other receivables
- Chapter 6: Recognition and measurement of credit losses on financial assets measured at amortized cost and off-balance-sheet credit exposures
- Chapter 7: Fair value option
- Chapter 8: Presentation and disclosure considerations
QUESTIONS AND CLOSING REMARKS
Financial Reporting Resource Center

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Accounting – Technical guidance and developments regarding business combinations, financial instruments, goodwill, leases and revenue recognition

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THANK YOU FOR YOUR TIME AND ATTENTION