QUARTERLY ACCOUNTING UPDATE WEBCAST – SUMMER 2021

July 22, 2021

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Agenda

Topic	Minutes
Recent FASB & SEC Activity	35 minutes
Practice Issues	25 minutes

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Recent FASB & SEC activity

Recently issued FASB guidance

No.	Final ASU Title
2021-04	Earnings Per Share (Topic 260), Debt—Modifications and Extinguishments (Subtopic 470-50), Compensation—Stock Compensation (Topic 718), and Derivatives and Hedging—Contracts in Entity's Own Equity (Subtopic 815-40): Issuer's Accounting for Certain Modifications or Exchanges of Freestanding Equity-Classified Written Call Options (a consensus of the FASB Emerging Issues Task Force)

Date	Proposed ASU Title
5/5/21	Derivatives and Hedging (Topic 815): Fair Value Hedging—Portfolio Layer Method
6/16/21	Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities

Modifications of freestanding equity-classified written call options

Scope:

- Modifications or exchanges of freestanding equity-classified written call options (e.g., warrants) that remain equity classified after modification or exchange and are not within the scope of another Topic of the Codification

Main provisions:

Treat: As an exchange of the original instrument for a new instrument

Recognize: Effect on the basis of the substance of the transaction

Measure: Effect of the transaction based on guidance in ASU

ASU 2021-04

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Measuring the effects of modifications or exchanges

Modification or exchange	Measurement of the effect of transaction			
Part of, or directly related to, a modification or an exchange of an existing debt instrument or line-of-credit or revolving-debt arrangement	*difference between*	the fair value of the modified or exchanged written call option	*and*	the fair value of that written call option immediately before it is modified or exchanged
All others	*the excess, if any, of*		*over*	

ASU 2021-04

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Recognizing the effects of modifications or exchanges

Financing transaction to raise equity	Equity-issuance cost in accordance with ASC 340, "Other Assets and Deferred Costs"
Financing transaction to raise or modify debt	ASC 470, "Debt," and ASC 835, "Interest"
Compensation for goods or services	ASC 718, "Compensation – Stock Compensation"
Other modifications and exchanges	Recognized as a dividend (adjustment to net income (or net loss) in the basic EPS calculation)
Multiple-element transaction	Allocate effect to the respective elements in the transaction

ASU 2021-04

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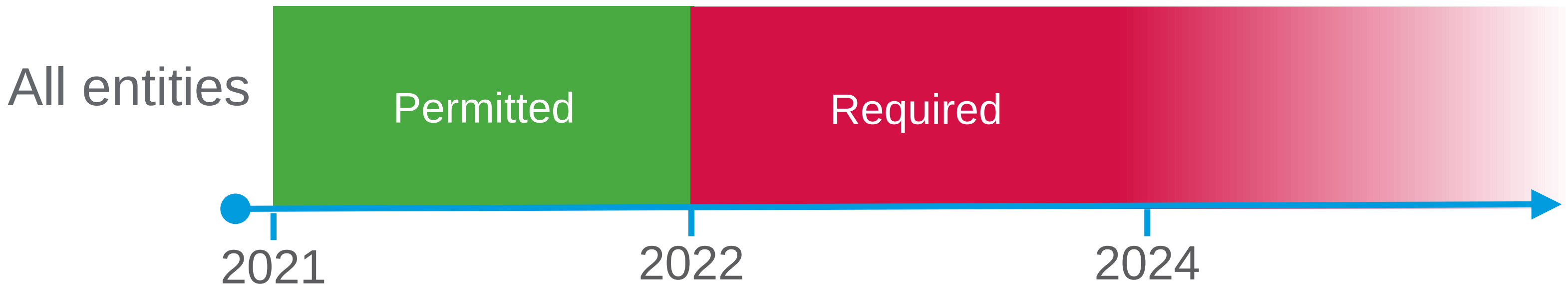
Effective date

Effective date for calendar year-ends



ASU 2021-04

SEC: Accounting considerations for warrants issued by SPACs

Fact pattern #1:

Warrants included provisions that provided for potential changes to the settlement amounts dependent upon the characteristics of the holder of the warrant.

Examples of differing terms:

- Payout upon a change in control/tender offer
- Cashless exercise
- Make-whole table

SEC: Accounting considerations for warrants issued by SPACs

Fact pattern #1:

Warrants included provisions that provided for potential changes to the settlement amounts dependent upon the characteristics of the holder of the warrant.

Analysis:

Because the holder of the instrument is not an input into the pricing of a fixed-for-fixed option on equity shares, such a provision would preclude the warrants from being indexed to the entity's stock.

Conclusion:

Warrants should be classified as a liability measured at fair value, with changes in fair value each period reported in earnings.

Warrant is not indexed to the entity's stock

↓

Liability classification

SEC: Accounting considerations for warrants issued by SPACs

Fact pattern #2:

Warrants included a provision that in the event of a tender or exchange offer made to and accepted by holders of more than 50% of the outstanding shares of a single class of common stock, all holders of the warrants would be entitled to receive cash for their warrants.

Analysis:

Tender offer is outside the control of the entity, but only certain of the holders of the underlying shares of common stock would be entitled to cash.

Conclusion:

Warrants should be classified as a liability measured at fair value, with changes in fair value each period reported in earnings.

Tender offer outside entity control

↓

Liability classification

SEC: Accounting considerations for warrants issued by SPACs

Example circumstances that could lead to conclusion that liability classification is required

SPAC has two classes of voting shares prior to merger, but tender offer provision pertains only to warrants on one class

After merger, combined company has a single class of common shares but there are outstanding preferred shares entitled to vote on an as-converted basis

SEC: Accounting considerations for warrants issued by SPACs

Other accounting and financial reporting considerations:

- Impact on initial allocation of proceeds amongst contemporaneously issued shares or other financial instruments
- Fair value should be determined in accordance with ASC 820, *Fair Value Measurement*
- Companies may contemplate modifying the warrant agreements in order to be able to account for them as equity post-modification
- Other financial reporting complexities addressed in OCA release, *Financial Reporting and Auditing Considerations of Companies Merging with SPACs*

Hedging a portfolio of prepayable assets

Pre-existing guidance

- Hedged item in a fair value hedge of interest rate risk was generally required to be an individual asset or liability or portions of individual assets or liabilities

ASU 2017-12

- Permits designating hedged item under a “last-of-layer” method when hedging a closed portfolio of prepayable financial assets

Proposed guidance

- Expands single-layer model to allow multiple-layer hedges of a single closed portfolio of prepayable financial instruments

Proposed

Proposal

Hedging a portfolio of prepayable assets – “Last of layer” method

- Allows an entity to hedge its exposure to fair value changes due to changes in interest rates
- Entity elects to hedge interest rate risk for a portion of the remaining term of the asset(s) being hedged
- Initial and ongoing analysis to support expectation that hedged item is expected to be outstanding as of assumed maturity date
- Hedge remains intact as long as the balance in the closed portfolio does not fall below the designated layer

Hedging a portfolio of prepayable assets - Example

Example:

- Bank A is hedging its interest rate risk associated with a closed portfolio of fixed rate prepayable commercial loans that have an aggregate balance of $400 million at hedge inception
- The hedging instrument is a 3 year receive-variable, pay-fixed interest rate swap with a $50 million notional amount
- Bank A designates the hedged item as the last $50 million of loan balances remaining in this closed portfolio
- Bank A expects the relationship to be highly effective as long as, with consideration given to prepayments, defaults and other events impacting the amount and timing of cash flows, $50 million of the portfolio is expected to be outstanding at the end of the 3 year hedge period

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Hedging a portfolio of prepayable assets – Portfolio layer method

Allows multiple layer-hedging relationships to be designated for a single portfolio

Permits flexibility to use different types of derivatives

Analysis required to support expectation that aggregate amount of hedged layers is anticipated to be outstanding for periods hedged

All assets in portfolio required to have contractual maturity date after earliest-ending hedge period and become prepayable before the latest-ending hedge period

Proposed

Proposal

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Hedging a portfolio of prepayable assets – Additional provisions

Eligible hedging instruments in a single-layer strategy may include spot-starting or forward-starting constant-notional swaps, or spot- or forward-starting amortizing-notional swaps

Number of hedged layers (that is, single or multiple) corresponds with the number of hedges designated

Guidance on the accounting for and disclosure of fair value hedge basis adjustments that would be applicable to both the current single-layer model and the proposed multiple-layer model

Fair value hedge basis adjustments should not be considered when determining credit losses for the assets included in the closed portfolio

Proposed

Proposal

Discount rate for lessees that are not public business entities

Scope

- Lessees that are not public business entities

Current guidance

- Practical expedient allows accounting policy election to use a risk-free rate as the discount rate for ***all*** leases

Proposed guidance:

- Risk-free rate election can be made by class of underlying asset, rather than at the entity-wide level
- When the rate implicit in the lease is readily determinable for any individual lease, the lessee would use that rate

Proposed disclosure requirement

- Which asset classes apply a risk-free rate

Proposed

Proposal

FASB staff clarifying comments on new goodwill impairment alternative

- ASU 2021-03 goodwill impairment alternative allows qualifying entities to perform the goodwill triggering event impairment ***as of the reporting date any time it reports financial information (including interim reports)***, instead of the date at which the triggering event occurred

i.e. An entity that reports financial information that would be affected by goodwill impairment, and that financial information is in compliance with US GAAP, on an interim basis, would have to perform the impairment triggering event analysis as of the interim reporting date

Intersection of environmental, social, and governance matters with Financial Accounting Standards

FASB Educational Paper provides:

- Overviews of ESG reporting and the FASB's role in setting financial accounting standards
- Examples of how an entity may consider the direct or indirect effects of material environmental matters when applying current GAAP, including:
  - The evaluation of whether there is substantial doubt about an entity's ability to continue as a going concern
  - The disclosure of risks and uncertainties
  - Valuing inventory at the lower of cost and net realizable value
  - Impairment of goodwill and indefinite-lived intangible assets
  - Estimating the useful life of a finite-lived intangible asset
  - Impairment indicators requiring the testing of a long-lived asset that is held and used for recoverability
  - Determining when an accrual is required for a loss contingency
  - Estimates of future taxable income for the recognition of deferred tax assets
  - Fair value measurements

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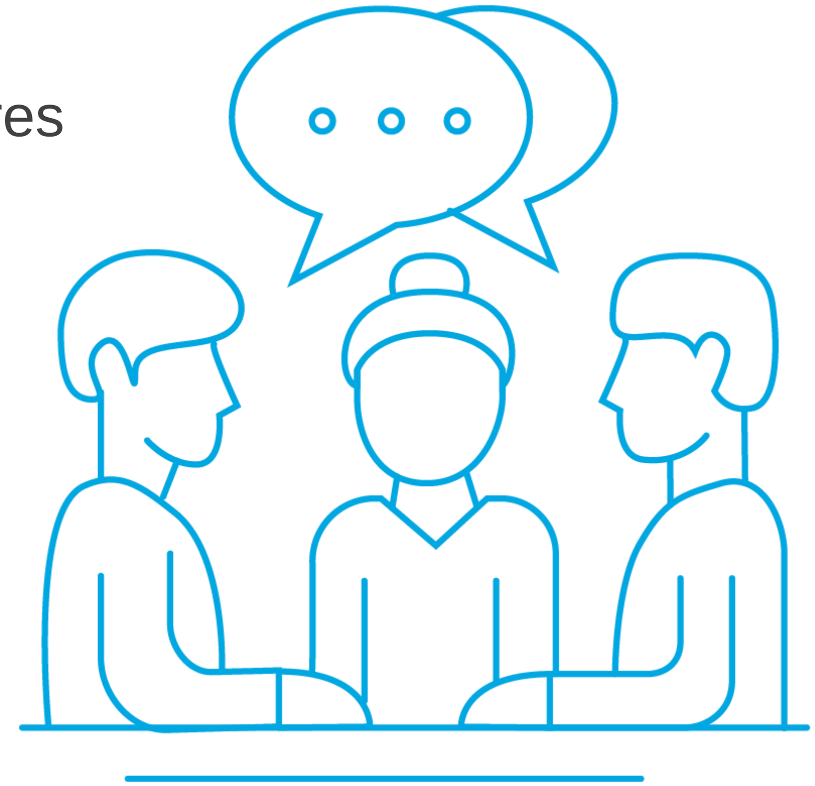
FASB hosts virtual credit losses roundtable

- Investor feedback:
  - CECL better than incurred loss model
  - Recommendations made for better quality disclosures
- Preparer feedback:
  - Financial institutions: Costs were greater than anticipated
  - Nonfinancial institutions: Too much time and resources with minimal impact
- Purchased Credit Deteriorated (PCD Assets)
  - Confusion on which assets qualify
- Troubled Debt Restructuring
  - Duplicative of CECL



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Practice issues

Revenue Recognition

Identifying performance obligations: NFP certifications/exams

Sample fact pattern:

- Association provides access to educational study materials and online certification in their field for a fixed one-time fee of $500
- Customers obtain access to the materials online until completion of exam
- Average time between access and exam date is 4 months
- Grading is generally completed within 30-45 days of taking the test
- Access to materials can be purchased for $450 without exam
- Additional grading fee of $100 if customer fails and retakes the exam
- 1% of customers never complete the exam

What are the performance obligations and when should revenue be recognized?

Identifying performance obligations: NFP certifications

Performance obligation	Timing of revenue recognition
Access to educational materials	• Over time over expected period of benefit • Estimate average period between purchase and completion of exam
Grading/certification	• Point in time on issuance of certificate • Breakage: Estimate number of customers who will never exercise their right to take the exam and recognize revenue as the other performance obligations are recognized

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Identifying performance obligations: NFP certifications example

- Customer purchases access to materials and exam for 100 employees on November 1 for $50,000
- SSP Allocation
  - Materials → $400 x 100 → $40,000
  - Grading/certification → $100 x 100 → $10,000
- Breakage estimate
  - 1% of 100 employees – 1 will not complete
  - $10,000 / 99 employees = $101.01 recognized per employee grading/certification)

Identifying performance obligations: NFP certifications example

Journal entries			
November 1	Cash Deferred revenue	$50,000	 $50,000
Monthly (Nov – Feb)	Deferred revenue Materials Revenue	$10,000	 $10,000
Grading of each exam	Deferred revenue Grading/certificate revenue	$101.01	 $101.01

Business combinations

Amortization pattern of customer related intangible assets

Useful life: The period over which an asset is expected to contribute directly or indirectly to future cash flows

Considerations:

- Whether the customer's demand for the buyer's products or services is projected to increase or decrease
- Whether the buyer's competition is expected to take actions that will affect the customer's demand

Pattern of amortization should be consistent with the assumptions used in estimating the fair value of the customer relationship intangible asset, which generally results in accelerated amortization

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Amortization pattern of customer related intangible assets

Reasonableness check related to using straight-line amortization method	
70% Test	Useful life should not be longer than 70% of the period over which cash flows were projected
95% Test	Useful life should not be longer than the period in the projected cash flows over which 95% of the asset's projected cash flows are generated
5% Test	In a high-tech industry or industry subject to significant obsolescence, the useful life should not extend past the last year in which the annual projected cash flows are 5% or more of the total projected cash flows

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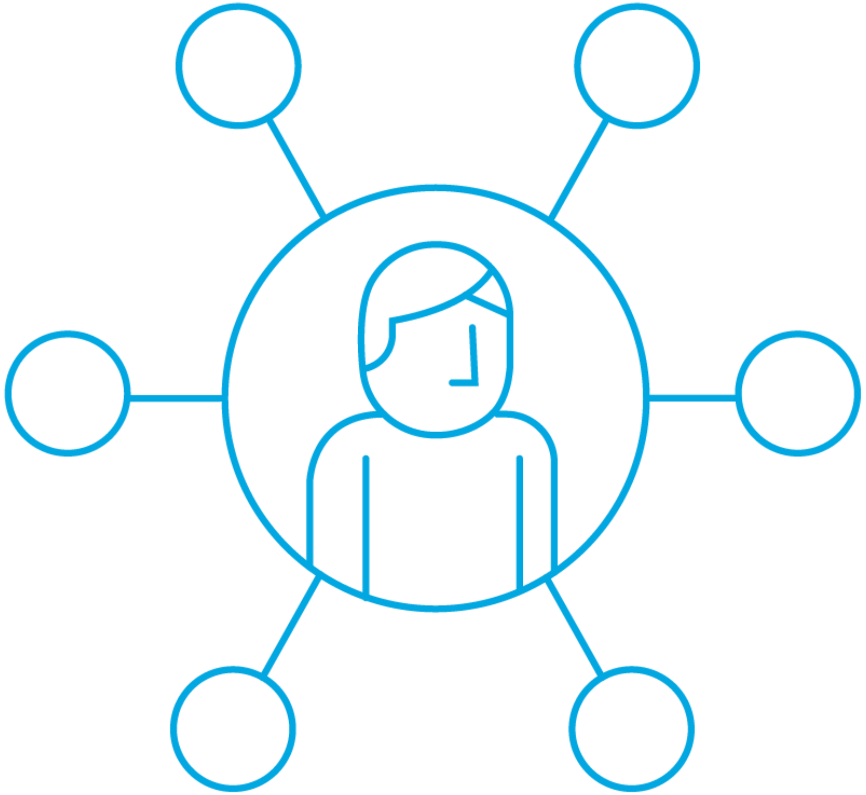
Receivables from affiliates

Accounting for related party transactions

- Transactions with related parties should be recorded in accordance with their economic substance
- Economic substance of a transaction may differ from its legal form

- **Example:** Making loans or recognizing receivables with no scheduled terms as to when or how the funds will be repaid



Definition of an asset (Concept Statement No. 6)

Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.

Three essential characteristics of an asset

- It embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows,
- a particular entity can obtain the benefit and control others' access to it
- the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred

Uncollectible receivables do not qualify as assets

Entity's ability to obtain future economic benefits commonly stems from legal rights

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Reporting related-party receivables

Does the receivable result from a routine and recurring transaction?

- Yes → Recognize and measure the same as a receivable from unrelated third party
- No ↓

Is there evidence of:
(a) A genuine indebtedness?
(b) Realizability at the inception of the debt?
(c) Intent of related party to pay in accordance with scheduled term of the receivable?

- Yes → Recognize and measure the same as a receivable from unrelated third party
- No ↓

Not an asset. Should be reported based on the substance of the transaction

Oct
21

Save the date!
Next quarterly
accounting update

QUESTIONS AND CLOSING REMARKS

RSM thought leadership


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