Accounting Update

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The Pace of Change in GAAP

• FASB is now taking a breather after a busy stretch
  – completed the big IFRS convergence projects
    • leases
    • revenue recognition
    • financial instruments

• Now focused on simplification
  – reducing preparation cost and complexity while maintaining or improving the usefulness of the information provided
What’s On the Way?

• Recent Accounting Standards Updates (ASUs) that become effective next year and beyond – focusing on those of general interest
What’s on the Way?

• Skipping
  – Recent ASUs covering
    • not-for-profit entities
    • defined benefit pensions
    • affordable housing
    • VIE consolidations
    • financial instruments primarily for financial institutions
  – Recent ASUs related to leases and revenue recognition
ASU 2016 – 15 (Cash Flows)

• Issued to reduce diversity in practice
• New standardized treatments for several items:
  – Debt prepayment and extinguishment costs
    • financing cash outflow
  – Settlement of zero (or near zero) coupon debt
    • cash payment attributed to implicit interest—operating cash outflow
    • cash payment attributed to principal—financing cash outflow
ASU 2016 – 15 (Cash Flows)

• New standardized treatments (continued):
  – Contingent consideration payments in a business combination
    • If paid “soon after”
      – investing cash outflow
    • If “not paid soon after”
      – payments of recorded liability—financing cash outflow
      – excess payment amounts—operating cash outflow
  – Proceeds received from settling insurance claims
    • Classified based on the nature of the loss
ASU 2016 – 15 (Cash Flows)

• New standardized treatments (continued):
  – Proceeds received from settlement of corporate-owned life insurance
    • investing cash inflow
      – however, premium payments may be classified as investing, operating or a combination
  – Mixed attribute cash receipts and disbursements and the predominance principle
    • apply specific GAAP requirements
    • If no GAAP, determine separately identifiable sources and uses
    • if not possible, classify based on “predominant” source or use
New standardized treatments (continued):

- Equity method distributions
  - Make a policy election choosing either:
    - Cumulative earnings approach
      » normal dividends are operating, liquidating dividends are investing
    - Nature of distribution approach
      » nature of activity generating the distribution*
        • ordinary income source—operating
        • gain/loss—investing
  
* If source information subsequently unavailable, then switch to cumulative approach reported as change in accounting principle (retrospectively)
ASU 2016 – 15 (Cash Flows)

• New standardized treatments (continued):
  – Beneficial interests in securitization transactions
    • Transferor’s beneficial interest obtained in a securitization of financial assets
      – disclosed as noncash activity
    • Cash receipts from payments on a transferor’s beneficial interests in securitized trade receivables
      – investing cash inflow

• Effective YBA 12/15/17 for public (+1 all other)
ASU 2016 – 16 (Deferred Taxes)

• GAAP previously prohibited recognition of deferred taxes on intra-entity asset transfers
• Now deferred taxes should be recognized at the time of transfer for all assets other than inventory
• Effective YBA 12/15/17 for public (+1 all other)
ASU 2016 – 18 (Cash Flows)

- Accounting for changes restricted cash
  - lack of guidance created diversity in practice
  - resolved by this ASU

- restricted cash to be included with cash and cash equivalents in reconciling change in cash during the year

- Effective YBA 12/15/17 for public (+1 all other)
Clarifying the Definition of a Business

- a business combination or acquisition of assets?
  - provides a “more robust framework”
    - uses same broad-level definition
      - “a business is an integrated set of activities and assets... providing a return...”
    - elaborates on same prior components of “inputs” and “processes” and “outputs”
      - single and similar asset situations—not a business
      - early-stage companies (lacking outputs)
        - potential to create outputs can qualify as a business
          - “continuation of revenues does not on its own indicate that both an input and a substantive process”

- Effective YBA 12/15/17 for public (+1 all other)
• Simplifies impairment testing for goodwill
  – eliminates 2\textsuperscript{nd} step of the regular impairment test
    • requiring a fresh determination of FVs of individual assets and liabilities
      – impairment was difference between this new net FV and carrying value of investment
  – step 1 result now used to measure impairment
    • difference between unit’s aggregate FV and carrying value
      – loss recognized should not exceed amount of goodwill
• Effective YBA 12/15/19 for public SEC (+1 for other public, +2 for private)
ASU 2017 – 09 (Stock Compensation)

• Reduce diversity and complexity of treatment of changes in terms or conditions of share based awards
  – clarify when to use “modification” treatment
    • for “substantive” changes
      – conditions for “nonsubstantive” (all of the following)
        » FV of modified award is same as original award
        » vesting conditions are the same
        » classification (as liab. or equity) is the same

• Effective YBA 12/15/17 (all entities)
Targeted improvements

– expands hedging treatments for

• cash flow hedges of forecasted purchases and sales of nonfinancial assets
  – hedged risk is no longer limited to only the overall variability in cash flows or variability related to foreign currency risk

• cash flow hedges of interest rate risk for variable rate instruments
  – removes requirement for indexing to benchmark rates

• fair value hedges of interest rate risk
  – SIFMA Municipal Swap Rate is added to eligible benchmarks
ASU 2017 – 12 (Derivatives and Hedging)

• Targeted improvements (continued)
  – more permissive rules for
    • fair value hedges of interest rate risk
      – measuring change in FV using coupon cash flows
      – covering partial-term hedges
      – hedges of prepayable financial instruments
      – hedges of closed portfolios of prepayable financial assets
ASU 2017 – 12 (Derivatives and Hedging)

• Targeted improvements (continued)
  – new Income Statement reporting requirements
    • Fair value hedges
      – entire FV change of hedging instrument reported on the same line as earnings effect of hedged item
        » no longer requires separation of “ineffective” portion
    • Cash flow and net investment hedges
      – entire FV change of hedging instrument (included in measuring hedge effectiveness) is recorded in OCI
      – reclassified to earnings in same Income Statement line item when the hedged item affects earnings

  – some other simplifications

• Effective YBA 12/15/18 for public (all other +1)
ASU 2017 – 15 (Steamship Entities)

• Eliminates entire topic (995)
  – statutory tax provisions for mineral reserve deposits required options for deferral of tax effects (740)
    • provisions expired in 2017
Expected 2018 Q1 ASU

• Simplifying the Balance Sheet Classification of Debt
  – Debt should be reclassified as noncurrent if (either)
    • it is contractually due to be settled more than 1 year after the balance sheet date
    • the entity has a contractual right to defer settlement for at least 1 year after the balance sheet date
  • Effective YBA 12/15/19 for public (all other +1)
Looking Ahead

• What should FASB be looking at?
  – Performance reporting
    • Distinguishing revenues from gains and expenses from losses
      – surprisingly few pages in GAAP directed toward them
      – inconsistent with user interest in understanding performance
        » persistent vs. transitory items

Debt extinguishment gains
Debt Extinguishments

• We expect they will soon be back in the news
• A long and sordid history of gains taking
  – 1975
    • FASB required extraordinary treatment in 1975 (SFAS 4)
  – 2002
    • FASB did away with this treatment (SFAS 145)
      – these are “often routine, recurring transactions”
  – 2008
    • Great Recession
      – interest rates fell to historic lows
Debt Extinguishments

• History
  – 2015
    • FASB did away with extraordinary items altogether (ASU 2015-1)
  – 2017
    • interest rates back on the rise
Debt Extinguishments

• Will users be adequately informed by the coming wave of extinguishment gains?
  – extraordinary treatment isn’t available either by rule (SFAS 145) or based on the merits (ASU 2015-1)
  – will they even be given their own separate line?
  • required only if “unusual” or “nonrecurring”
    – FASB’s own words (in SFAS 145)—debt extinguishment
      » “part of the risk management strategy at many companies”
      » “part of ... ongoing activities to manage interest rate risk”
Our Recommendation

• Encourage FASB to continue its performance reporting projects
  – no illusions that they will be timely for the coming wave of debt extinguishment gains

• Fast-track an ASU to restore the separate line item reporting requirement that predated SFAS 4
  – SFAS 145 didn’t restore this former requirement when it undid the extraordinary treatment
Questions?